WHAT THE EURO CRISIS MEANS FOR TAXPAYERS AND THE U.S. ECONOMY, PART I

HEARING

BEFORE THE

SUBCOMMITTEE ON TARP, FINANCIAL SERVICES AND BAILOUTS OF PUBLIC AND PRIVATE PROGRAMS

OF THE

COMMITTEE ON OVERSIGHT AND GOVERNMENT REFORM

HOUSE OF REPRESENTATIVES

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WHAT THE EURO CRISIS MEANS FOR TAXPAYERS AND THE U.S. ECONOMY, PART I

THURSDAY, DECEMBER 15, 2011

HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON TARP, FINANCIAL SERVICES AND BAILOUTS OF PUBLIC AND PRIVATE PROGRAMS,
COMMITTEE ON OVERSIGHT AND GOVERNMENT REFORM,
Washington, DC.

The subcommittee met, pursuant to notice, at 10:04 a.m., in room 2154, Rayburn House Office Building, Hon. Patrick T. McHenry (chairman of the subcommittee) presiding.

Present: Representatives McHenry, Meehan, Ross, Issa, Quigley, Maloney, Welch, and Cooper.

Staff present: Michael R. Bebeau, assistant clerk; Molly Boyl, parliamentarian; Katelyn E. Christ, research analyst; Linda Good, chief clerk; Peter Haller, senior counsel; Ryan M. Hambleton, professional staff member; Christopher Hixon, deputy chief counsel, oversight; Ryan Little, manager of floor operations; Mark D. Marin, senior professional staff member; Jaron Bourke, minority director of administration; Ashley Etienne, minority director of communications; Adam Koshkin, minority staff assistant; Lucinda Lessley, minority policy director; Jason Powell and Steven Rangel, minority senior counsels; and Brian Quinn, minority counsel.

Mr. MCHENRY. Good morning. This is the Subcommittee on TARP, Financial Services and Bailouts of Public and Private Programs. Our hearing today is, What the Euro Crisis Means for Taxpayers and the U.S. Economy. This is the first of two hearings; we have an additional hearing tomorrow morning at 9:30 a.m. in this room with the New York Fed President, a representative from our Central Bank right downtown, and a representative from Treasury as well.

It is the tradition of this subcommittee to read the mission statement of the Oversight and Government Reform Committee.

We exist to secure two fundamental principles: first, Americans have a right to know that the money Washington takes from them is well spent and, second, Americans deserve an efficient, effective Government that works for them. Our duty on the Oversight and Government Reform Committee is to protect these rights. Our solemn responsibility is to hold Government accountable to taxpayers because taxpayers have a right to know what they get from their Government. We will work tirelessly in partnership with citizen watchdogs to deliver the facts to the American people and bring genuine reform to the Federal bureaucracy. This is the mission of the Oversight and Government Reform Committee.

I recognize myself now for 5 minutes for an opening statement.

Over 3 years ago Americans witnessed domestic and global markets deteriorate, resulting in missions of job losses and unprecedented measures by governments and central banks to prop up financial institutions. As the U.S. economy remains vulnerable in the midst of our recovery, just across the Atlantic, the European Union, our friends, fight to fend off a second wave of economic and financial turmoil.

Today's hearing examines the economic unrest facing Europe, actions undertaken by central banks and international organizations in response, options that remain in our disposal, and potential consequences to the U.S. economy and taxpayers.

In 2010, what first appeared as a Greek crisis spread throughout the EU and now dictates global headlines, stock markets, and the way European nations are categorized. As events worsened this summer, the crisis began to take out heads of European states and even managed to build the closest of relationships between President Sarkozy of France and Chancellor Merkel of Germany in their efforts to save the Euro.

Notably, the EU instituted the European Financial Stability Facility and encouraged the European Central Bank and the IMF to take extraordinary measures to address the liquidity and perhaps the solvency issue in the crisis generally facing European nations and their banks.

Thus far, it seems their actions have failed to be the bazooka markets desired. Consequently, the Greek crisis transformed into a full-fledged and full-blown Eurozone crisis, intensifying the contagion to the larger economies of Italy and Spain that have a cumulative sovereign debt of roughly $4 trillion.

Today, as European leaders work to strengthen the framework of the EU, financial markets have become more dependent on the continued willingness of central banks to use their balance sheets to rescue the global economy. The central banks are not shying away from this. Just last month, in an effort to aid European banks that had trouble accessing dollars due to market skepticism about their health, six central banks, led by the Federal Reserve, made it cheaper for banks to borrow dollars to ease Europe's sovereign debt crisis.

While welcomed by the markets, some financial experts have warned that the Federal Reserve is allowing the European Central Bank to create unlimited amounts of claims against the Fed. Since Fed currency swaps reached nearly $600 billion during the height of the 2008–2009 crisis, it is important to recognize what the Federal Reserve determines is prudent exposure to the European Central Bank.

Furthermore, it is prudent for the Fed to review whether this precedent reduced the incentives of European banks to sell underperforming assets during the intervening calm. For instance, would European banks have acted to raise capital and sell bad assets sooner if they could not rely on capital injection from the Fed?

Another item worth examination is the role of the Eurozone leaders in determining the conditions of credit default swaps on Greek bonds. After leaders declared that holders of Greek bonds would take voluntary haircuts, billions of dollars of credit default swaps were unable to serve their purpose. By these actions, the sanctity of a contract is questioned. Such uncertainty may have long-term consequences as market participants must now factor in such risk to a great degree in the agreements that they make.

If we learned anything from the last crisis, it is that impromptu precedents by governments increases uncertainty and the likelihood of capital injections on behalf of the taxpayers. In addition to market uncertainty, the reality of European banks' spreadsheets and spreading their assets and reducing lending due to undercapitalization has global markets fearful of another recession.

The implications of a European recession on a recovering U.S. economy are significant. A second recession out of Europe would reduce U.S. exports, negatively impact the health of our banks and non-bank financials, and visibly influence the value of the U.S. dollar.

With that said, the severity of these effects on the U.S. economy is anyone's guess. Consequently, the only certainty is Europe's crisis is now a global crisis. As daily headlines proclaim, capital injections to the tune of billions and trillions of Euros and dollars, reinforcing the interconnectedness of the global economy, it is vital that the Congress conduct vigorous oversight on rescue proposals and threats to our economy, threats to American jobs, threats to American people's way of life, threats to American people's value of the currency that they hold, their savings.

Simple questions still need to be answered, such as, Are the actions of the Federal Reserve consistent with its mandate and are the firms that are seeking liquidity simply illiquid or perhaps insolvent? I am interested to hear from our expert witnesses today about their views on the Eurozone current potential rescue efforts and the consequences the crisis may have on the U.S. economy and its citizens.

I appreciate your attendance on the panel and I now recognize the ranking member, Mr. Quigley of Illinois, for 5 minutes.

[The prepared statement of Hon. Patrick T. McHenry follows:]

Congressman Patrick McHenry
Opening Statement
"What the Euro Crisis Means for Taxpayers and the U.S. Economy"
December 15, 2011

Over three years ago, Americans witnessed domestic and global markets deteriorate, resulting in millions of job losses and unprecedented measures by governments and central banks to prop up financial institutions.

As the United States economy remains vulnerable in the midst of a recovery, just across the Atlantic, our European friends fight to fend off a second wave of economic and financial turmoil.

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In 2010, what first appeared as a Greek crisis spread throughout the E.U. and now dictates global headlines, stock markets, and the way European nations are categorized.

As events worsened this summer, the crisis began to takeout heads of European states, and even managed to build the closest of partnerships between President Sarkozy and Chancellor Merkel in their effort to save the euro.

Notably, the E.U. instituted the European Financial Stability Facility and encouraged the European Central Bank and the IMF to take extraordinary measures to address the liquidity – and perhaps solvency – crisis facing European nations and their banks. Thus far, its actions have failed to be the bazooka markets desire.

Consequently, the Greek crisis transformed into a full-blown eurozone crisis, intensifying contagion to the large economies of Italy and Spain that have a cumulative sovereign debt of roughly 4 trillion dollars.

Today, as European leaders work to strengthen the framework of the E.U., financial markets have become more dependent on the continued willingness of the central banks to use their balance sheets to rescue the global economy.

The central banks are not shying away. Just last month, in an effort to aid European banks that had trouble accessing dollars due to market skepticism about their health, six central banks – led by the Federal Reserve – made it cheaper for banks to borrow dollars to ease Europe's sovereign-debt crisis.

While welcomed by markets, some financial experts have warned that the Federal Reserve is allowing the European Central Bank to create "unlimited amounts of claims" against the Fed.

Since Fed currency swaps reached nearly 600 billion dollars during the 2008/2009 crisis, it is important to recognize what the Federal Reserve determines as prudent exposure to the European Central Bank. Furthermore, it is prudent for the Fed to review whether this precedent reduced the incentives of European banks to sell underperforming assets during the intervening relative calm. For instance, would European banks have acted to raise capital and sell bad assets sooner if they could not rely on capital injections from the Fed?

Another item worth examination is the role of eurozone leaders in determining the conditions of credit default swaps on Greek bonds. After leaders declared that holders of Greek bonds would take "voluntary haircuts," billions of dollars of credit default swaps were unable to serve their purpose. By these actions, the sanctity of a contract is questioned. Such uncertainty may have long term consequences as market participants must factor in such risks in the agreements they make.

If we learned anything from the last crisis, it is that impromptu precedents by governments increase uncertainty and the likelihood of capital injections on behalf of taxpayers.

In addition to market uncertainty, the reality of European banks shedding assets and reducing lending, due to undercapitalization, has global markets fearful of another recession.

The implications of a European recession on a recovering United States economy are significant. A second recession out of Europe would reduce U.S. exports, negatively impact the health of our banks and non-bank financials, and visibly influence the value of the U.S. dollar. With that said, the severity of these effects on the U.S. economy is anyone's guess.

Consequently, the only certainty is Europe's crisis is a global crisis.

As daily headlines proclaim capital injections to the tune of Billions and Trillions of euros and dollars, reinforcing the interconnectedness of the global economy, it is vital that Congress conducts oversight on rescue proposals and threats to our economy. Simple questions still need to be answered – such as, "Are the actions of the Federal Reserve consistent with its mandate, and are the firms that seek liquidity simply illiquid or perhaps insolvent?"

I am interested to hear from our expert witnesses about their views on the eurozone, current and potential rescue efforts, and consequences the crisis may have on the United States economy and citizens.

I appreciate their attendance and look forward to their testimony.

Mr. QUIGLEY. Thank you, Mr. Chairman.

Today's hearing will examine what the European debt crisis means for U.S. taxpayers and the U.S. economy. Trillions of Euros in debt remain outstanding for Eurozone countries like Italy, Spain, Greece, Portugal, and others. Weak revenues from a weak economy have imperilled the capacity of these governments to repay their debts, thereby risking default. A default by a major European economy would have devastating consequences for the American taxpayer.

As Mr. Elliott will testify, in 2010, our exports to the European Union totaled $400 billion. We have over $1 trillion of foreign direct investment in the European Union and we are exposed to nearly $5 trillion in potential losses on loans and commitments to European governments, banks, and corporations.

If economic powerhouses like Spain or Italy were to become insolvent, the ripple effect throughout the global economy would be catastrophic. If Europe sinks into prolonged recession, American small businesses that export to Europe would lose out on valuable customers, retirees whose retirement plans are invested in European assets would be put at risk, our economy would grow more slowly or slide into recession, and American standards of living would decline.

There can be no question that a healthy European economy is vital to the national interest of the United States and the American taxpayer. But we must protect the American taxpayer if the Euro crisis is not successfully resolved. I look forward to hearing testimony from our Government witnesses on what they see as the proper role, if any, of the U.S. Government.

Either way, Europe must reform itself. Countries like Greece, Italy, and others need to address their short-term financial challenges, but they also need to develop credible, long-term debt reduction plans. Of course, if this sounds to you like the pot calling the kettle black, you would be right. Here in the United States we have repeatedly failed to legislate a credible long-term debt reduction plan. Politics, not economics, nearly saw the U.S. Government default on its debt in early August.

Europe's challenge is also political. While Europe surely has the economic resources to resolve this crisis, it has repeatedly failed to do so. European leaders will have to surmount their political differences and agree that saving the European Union will require a shared sacrifice. It would be a tragedy if the post-war European spirit of cooperation floundered on this crisis. It would be equally tragic if our own leaders were unable to come to an agreement on steps to reduce our own long-term debt.

The truth is that the mission of government matters, but reckless decisions have made it harder to fulfill that mission. I join my colleague, Chairman McHenry, in urging leaders at home and abroad to take the necessary steps to resolve this crisis and help restore the global economy to a sustainable growth.

Thank you and I yield back.

Mr. MCHENRY. I thank the ranking member.

Members may have 7 days to submit opening statements for the record.

We will now recognize our panel before us today. Dr. Desmond Lachman is a resident fellow at the American Enterprise Institute and holds a Ph.D. in economics from Cambridge University; Dr. Anthony Sanders is professor of finance in the School of Management at George Mason University; Mr. Douglas J. Elliott is a fellow at the Brookings Institute; Mr. Joshua Rosner is a partner at Graham Fisher & Co.; Mr. Bert Ely is a principal of Ely & Co., Inc., and an adjunct scholar at the Cato Institute.

I believe I know at least four of you have testified before, but it is the standard practice of the Oversight and Government Reform Committee that all witnesses be sworn, so if you would please rise and raise your right hands.

[Witnesses sworn.]

Mr. MCHENRY. All right, you may be seated.

Let the record reflect that all the witnesses answered in the affirmative.

Seeing as you have testified before, if you will summarize your statement. You see the red, yellow, and green lights before you. When yellow pops up, that means, well, it means just what it means when you are at a stop light: hurry up. And obviously green means go and red means stop.

So, with that, we will recognize Dr. Lachman for 5 minutes.

STATEMENTS OF DESMOND LACHMAN, PH.D., RESIDENT FELLOW, AMERICAN ENTERPRISE INSTITUTE; ANTHONY SANDERS, PH.D., DISTINGUISHED PROFESSOR OF REAL ESTATE FINANCE; DOUGLAS J. ELLIOTT, FELLOW, ECONOMIC STUDIES, INITIATIVE ON BUSINESS AND PUBLIC POLICY, BROOKINGS INSTITUTE; JOSHUA ROSNER, MANAGING DIRECTOR, GRAHAM FISHER & CO., INC.; AND BERT ELY, PRINCIPAL, ELY & CO., INC.

STATEMENT OF DESMOND LACHMAN, PH.D.

Dr. LACHMAN. Thank you, Chairman McHenry, Ranking Member Quigley, members of the committee, for giving me this honor to testify before you this morning.

In my oral statement, what I would like to do is three things: I would like to set out the reasons that I think that there is going to be a significant intensification of the Euro debt crisis in the months immediately ahead that could result in the Euro's unraveling within the next 12 months, so this is a crisis that really does have a sense of urgency; I would then like to draw out the serious risks that the Euro crisis poses to the U.S. economic recovery should there be an intensification of the Euro crisis; and, last, I want to consider the potential cost to the U.S. taxpayer of the various measures that have been undertaken by the IMF and by the Federal Reserve to diffuse the crisis.

Over the past few months there has been a marked intensification of the European debt crisis that suggests we could get an unraveling even as early as 2012. The Greek economy now appears to be in virtual free fall. Its banks are losing deposits. It is only a matter of time, a matter of months, before we are going to get a hard default of Greece.

Second, there is contagion from the Greek crisis that is now affecting Italy and Spain, Europe's third and fourth largest economies, which are regarded in the markets as too big to fail, but too big to bail. Should those problems intensify, the question of the Euro's existence would be very much in question.

The European debt crisis is also having a material impact on the European banking system, which is in the throes of a credit crunch that is likely to intensify in the months ahead, and what we are seeing is we are seeing the German and French economies showing the clearest of signs of slowing, moving into recession.

Now, European policymakers and the IMF are hoping that the countries in the European periphery can correct their large public finance and external imbalances by several years of the severest of fiscal austerity within the framework of a fixed exchange rate system that doesn't allow them to devalue to boost exports as an offset to the fiscal tightening. I very much doubt whether such an approach can work because it is more than likely to throw those countries into the deepest of recessions that is going to make the collection of taxes difficult and is going to have a very big political backlash.

A deepening of the European crisis could very well derail the U.S. recovery. We have already had mentioned the idea that it could diminish U.S. export prospects, it could result in a weakening of the Euro that would make it difficult for the United States in third markets, but the most important channel through which the European crisis could affect the United States would be through the financial crisis. U.S. money market funds have close to a trillion dollars deposited with European banks. The U.S. banks are very exposed to Germany and France.

Let me touch on the IMF and the Federal Reserve. The IMF lending commitments to Greece, Ireland, and Portugal already total around $100 billion. Considering that the United States has a 17.5 percent share in the IMF, this lending puts U.S. taxpayers at risk to the tune of $20 billion. In assessing how serious is the risk for U.S. taxpayers, it is of note that the IMF has never lent money on this scale to any country in relation to the size of those countries as it has to Greece, Ireland, and Portugal. The IMF's commitment to these countries are as much as 10 percent of their GDPs and one-quarter to a third of their tax collections.

At the recent European Summit, the European countries are proposing to make bilateral loans to the IMF to the tune of $260 billion, or $200 billion Euros, that would be intended to loan to Italy and Spain. It is important to recognize that if those bilateral loans by the European countries give those countries a claim on the IMF, as opposed to a claim on Italy and Spain, the U.S. taxpayer would be put at risk for those loans to Italy and Spain.

If Italy and Spain do have to go to the IMF for large-scale loans, the exposure to the U.S. taxpayers to those countries could be enormous. Considering that the IMF's combined lending commitment to Italy and Spain could well exceed a trillion dollars, what we are talking about is U.S. taxpayers could be at risk for up to $200 billion.

In assessing the potential risk to the U.S. taxpayer from IMF lending to European periphery, one has to consider that the risk of the unraveling of the Euro is a distinct possibility. Were that unraveling to occur in a disorderly manner, it would have a devastating impact on the European periphery's economic outlook and its public finances. Considering that IMF loans to the periphery could reach levels that would be unprecedentedly high in relation to those countries' taxpayers, there would be a material chance that those countries would have difficulty in repaying those loans.

Last, judging by its 2008–2009 experience with currency swaps, the Federal Reserve's dollar swap lines could reach $600 billion in the event that the European crisis were to intensify. However, one must suppose that the risk to the U.S. taxpayer from the Federal Reserve swaps would be circumscribed by the fact that the main counter-party to those swaps would be the European Central Bank, rather than the countries in the European periphery, and one should suppose that the European Central Bank could print the Euros to buy the dollars to repay those loans.

Thank you.

[The prepared statement of Dr. Lachman follows:]

The Euro Crisis and the US Taxpayer

Testimony for the House Committee on Oversight and Government Reform Subcommittee on TARP, Financial Services, and Bailouts of Public and Private Programs

Desmond Lachman

Resident Fellow
American Enterprise Institute

December 15, 2011

Thank you Chairman McHenry, Ranking Member Quigley, and members of the Subcommittee for affording me the great honor of testifying before you today. My name is Desmond Lachman, and I am a Resident Fellow at the American Enterprise Institute. I am here in my personal capacity and I am not here to represent the AEI's view.

In the testimony that follows I set out the reasons why I think that there will be a further significant intensification of the Euro-zone debt crisis in the months immediately ahead that could result in the Euro's unraveling within the next twelve months. I also draw out the serious risks that the Euro-zone crisis poses to the US economic recovery, and I consider the potential cost to the US taxpayer of the various measures being undertaken by the IMF and the Federal Reserve to defuse the crisis.

The Euro Crisis is intensifying

1. Over the past few months, there has been **a marked intensification of the European debt crisis** that could have major implications for the United States economy in 2012.

   Among the signs of intensification are the following:

   a. The **Greek economy now appears to be in freefall** as indicated by a 12 percent contraction in real GDP over the past two years and an increase in its unemployment rate to 18 ½ percent. Greek banks are now rapidly losing deposits. This makes a substantial write-down (of perhaps as much as 75 cents on the dollar) in Greece's US $450 billion sovereign debt highly probable within the next few months. Such a default would constitute the largest sovereign debt default on record and would almost certainly accentuate the contagion that is already in evidence in the European periphery.

b. Contagion from the Greek debt crisis has been affecting not simply the smaller economies of Ireland and Portugal, which too have solvency problems. It is now also impacting **Italy and Spain**, Europe's third and fourth largest economies, respectively. This poses a real threat to the Euro's survival in its present form.

c. The European debt crisis is having a material impact on the European banking system, which raises the real **risk of a major European credit crunch**. There are already signs of substantial deleveraging and credit tightening by the European banks. This tightening is occurring at the very time that European economies are weakening and at a time that major fiscal consolidation efforts are underway.

d. There are very clear indications of an appreciable **slowing in German and French economic growth**. It is all too likely that the overall European economy could soon be tipped into a meaningful economic recession should there be a worsening in Europe's banking crisis. A worsening in the growth prospects of Europe's core countries reduces the chances that the countries in the European periphery can grow themselves out of their present debt crisis.

2. The European Central Bank (ECB) is correctly warning that a Greek default would have a devastating effect on the Greek banking system, which has very large holdings of Greek sovereign debt. This could necessitate the imposition of capital controls or the nationalization of the Greek banking system. The ECB is also rightly fearful that **a Greek default will soon trigger similar debt defaults in Portugal and Ireland** since depositors in those countries might take fright following a Greek default. This has to be a matter of major concern since the combined sovereign debt of Greece, Portugal, and Ireland is around US $1 trillion.

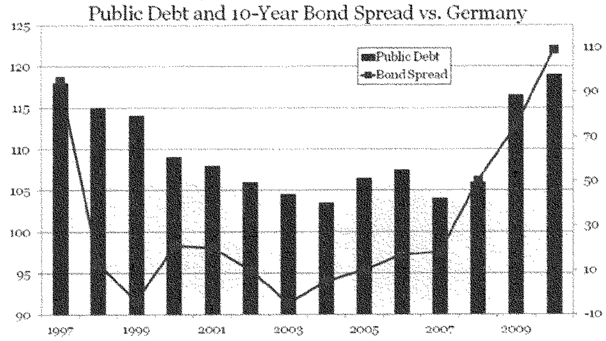
3. Since July 2011, **the Italian and Spanish bond markets have been under substantial market pressure**. This has necessitated more than US $130 billion in ECB purchases of these countries' bonds in the secondary market.

An intensification of contagion to Italy and Spain would pose an existential threat to the Euro in its present form given that the combined public debt of these two countries is currently around US$4 trillion.

4. While European policymakers are partly right in portraying Italy and Spain as innocent bystanders to the Greek debt crisis, **Italy and Spain both have pronounced economic vulnerabilities**. Italy's public debt to GDP ratio is presently at an uncomfortably high 120 percent, while it suffers from both very sclerotic economic growth and a dysfunctional political system. For its part, Spain is presently saddled with a net external debt of around 100 percent of GDP, it still has a sizeable external current account deficit, and it is still in the process of adjusting to the bursting of a housing market bubble that was a multiple the size of that in the United States.

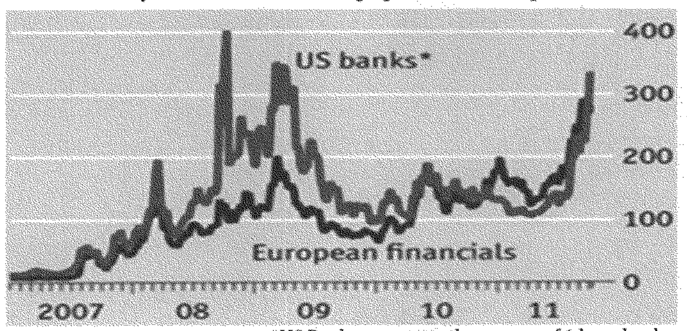
Italy's Public Debt is High

Public Debt and 10-Year Bond Spread vs. Germany



5. Sovereign debt defaults in the European periphery would have a major impact on the balance sheet position of the European banking system. The IMF estimates that **the European banks are presently undercapitalized** by around US $300 billion, while some private estimates consider that the banks are undercapitalized by more than US $400 billion. It is of concern to the European economic outlook that there are already signs of the European banks selling assets and constraining their lending to improve their capital ratios. Private market analysts are fearful that the European banks might reduce lending by as much as US$3 trillion over the next eighteen months.

US and European Banks' CDS Spreads
Five-year credit default swap spreads in basis points



*US Banks represents the average of 6 large banks

Source: Markit, the Economist

6. European policymakers are hoping that the countries in the European periphery can correct their large internal and external imbalances by several years of strict fiscal austerity within the framework of a European-wide fiscal treaty to be negotiated by March 2012. It remains to be seen whether such an approach can work within the straightjacket of Euro membership that precludes currency devaluation to boost exports as an offset to the negative economic impact of budget tightening. This would especially appear to be the case at a time that the European economy already shows signs of weakening and at a time that Europe is about to experience a major credit crunch. Indeed, there is the very real risk that continuing to apply substantial fiscal tightening will lead to a **very deep economic recession.** A deep recession would make it very difficult for countries to reduce their budget deficits and would undermine their political willingness to remain within the Euro.

Implications for the United States Economy

7. Considering that the European economy accounts for over 30 percent of global economic output, **a deepening of the European crisis could very well derail the US economic recovery**. In principle, a deepening in the European economic crisis could impact the US economy through three distinct channels:

a. A renewed European economic recession would **diminish US export prospects** to an important market for US goods.

b. **A weakening in the Euro against the dollar**, which would very likely flow from a European banking crisis and from questions about the Euro's survival in its present form, would put United States companies at a marked disadvantage with respect to European companies in third markets.

c. In much the same way as the US Lehman crisis of 2008-2009 severely impacted the European economy through **financial market dislocation** a European banking crisis would materially impact the US economy both through the financial market channel and through a generalized increase in global economic risk aversion.

8. Treasury Secretary Geithner has correctly asserted that the United States financial system has relatively limited direct exposure to the Greek, Irish, Portuguese, or Spanish economies. However, this assertion overlooks the fact that **the US financial system is hugely exposed to the European banking system,** which in turn is directly exposed to the European periphery. Among the indicators of this heavy US exposure are the following:

   a. According to the Fitch rating agency, short-term loans by US money market funds to European banks still total around US $1 trillion or more than 33 percent of their total overall assets.

   b. According to the Bank for International Settlements, the US banks have exposure to the German and French economies in excess of US $1.2 trillion.

   c. According to BIS estimates, US banks have written derivative contracts on the sovereign debt of the European periphery in excess of US $400 billion.

European Rescue Efforts

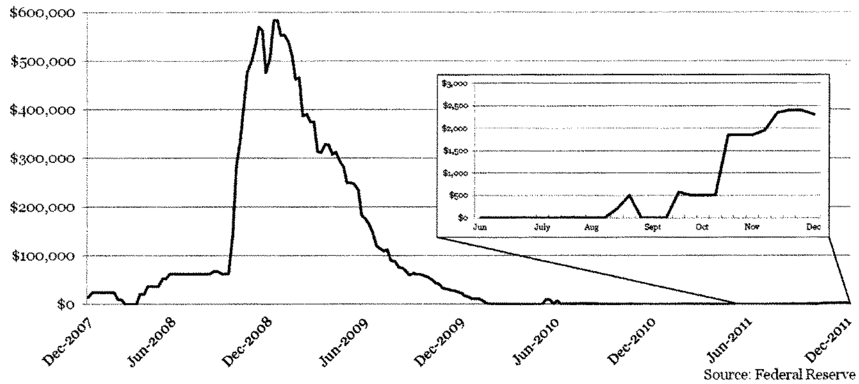
9. In an attempt to forestall an unraveling of the Euro, a major international effort has been undertaken to support countries in the European periphery. While the Europeans have taken the lead, these efforts have also been supported by **the IMF and Federal Reserve,** which puts US taxpayers' money at risk. The main European financial support programs to date are the following:

   a. Over the past eighteen months, **the IMF and the European Union** have committed financial support to Greece, Ireland, and Portugal, in the amounts of US$150 billion, US $125 billion, and US$110 billion, respectively. In each of these programs, the European Union has contributed around two thirds of the funds while the IMF has contributed the remaining one third.

   b. **The European Central Bank** has provided substantial financial support in the form of large scale purchases of Greek, Irish, Italian, Portuguese, and Spanish sovereign debt in the secondary market. These purchases have totaled around US$300 billion to date.

   c. In November 2011, the US Federal Reserve announced that it would be providing temporary **US dollar currency swaps** to help alleviate the dollar funding problems of the European banks. It acted in coordination with the European Central Bank, the Bank of England, the Bank of Canada, the Bank of Japan, and the Bank of Australia. This move was partly motivated by the perceived need to make dollars available to European banks at cheaper rates to facilitate their loan repayments to US money market funds. Judging by the experience in 2008-2009 when these currency swaps reached around US$600 billion, this has the potential of creating a large exposure of the Federal Reserve to the European Central Bank.

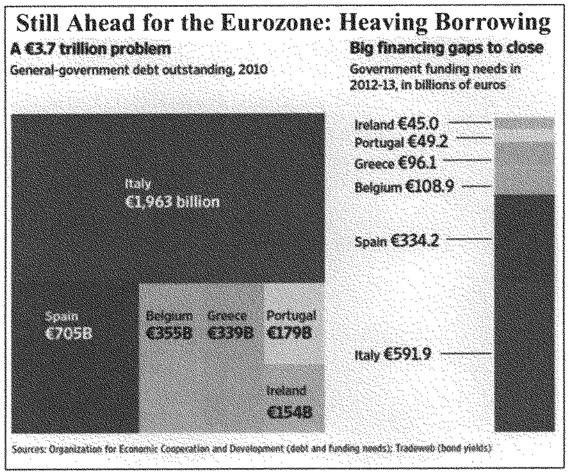
Central Bank Liquidity Swaps
In Millions of USD



Source: Federal Reserve

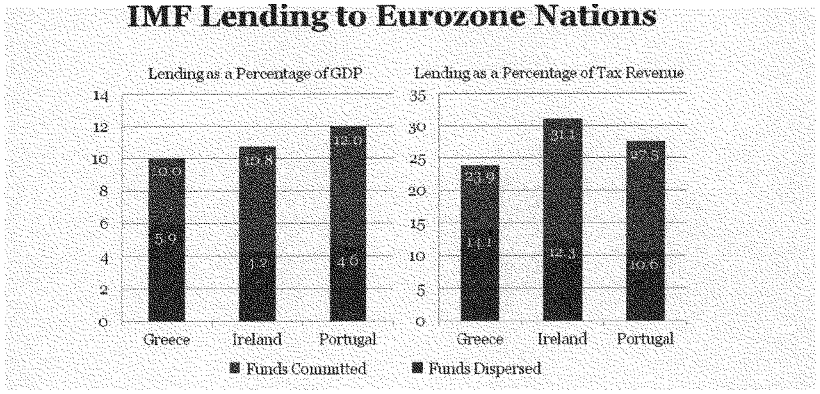
10. In the months ahead, one has to expect **further large scale lending commitments by the IMF and the European Union** to support Italy and Spain, which both have considerable financing needs and which both have come into the market's sights. There is every reason to expect that this support will substantially exceed that made to date for Greece, Ireland, and Portugal given the very size of the Italian and Spanish economies. Both of these countries are experiencing considerable difficulty in financing themselves in the market and they have both seen their borrowing rates rise to levels that are not sustainable over the longer run.

11. Judging by the size of Italy's financing needs over the next two years, **Italy alone might need an IMF-EU program of around US$800 billion** to save the Italian government from having to access the market for financing in 2012 and 2013. Meanwhile Spain might need IMF-EU support of the order of $450 billion to save its government from having to access the market for financing over the next two years



Risks to the US Taxpayer

12. IMF lending commitments already made to Greece, Ireland, and Portugal total over US$ 100 billion. Considering that the US has a 17 ¾ percent share in the IMF, this lending puts the US taxpayer at risk for almost US$20 billion. In assessing how serious is the risk to the US taxpayer, it is of note that **the IMF has never lent this scale of money to any country** in relation to that country's size as it has done to Greece, Ireland, and Portugal. The IMF's commitments to these latter countries are as much as 10 percent of their GDPs and between one quarter and one third of their annual tax revenue collections.



Source: IMF

13. At the recent European Summit, the EU countries agreed that they would make **bilateral loans to the IMF** of the order of US$ 260 billion. Those proposed loans were intended to augment the IMF's US$390 billion in overall available resources for potential lending operations to Italy and Spain. It is important to recognize that if the bilateral loans by the European countries give the lending countries a claim on the IMF, as opposed to a claim on Italy and Spain, the US taxpayer would be on the hook for any lending by the IMF to Italy and Spain that might be financed by those bilateral European loans.

14. If Italy and Spain did have to go to the IMF for large scale loans, the exposure of US taxpayers to those two countries could be very large. Considering that the IMF's combined lending commitment to Italy and Spain could be of the order of US$1.3 trillion, **the US taxpayers' eventual exposure could be of the order of US$220 billion**.

15. In assessing the **potential risk to the US taxpayer from IMF lending** to the European periphery, one has to consider that the risk of an unraveling of the Euro is a distinct possibility. Were that unraveling to occur in a disorderly manner, it would have a devastating impact on the European periphery's economic outlook and its public finances. Considering that IMF loans to the periphery could reach levels that would be unprecedentedly high

in relation to those countries' tax bases, there would be a material chance that those countries would have difficulty in repaying those loans.

16. Judging by its 2008-2009 experience with currency swaps, the Federal Reserve's dollar swap lines could reach around US$600 billion in the event that the European crisis were to intensify. However, one must suppose that **the risk to the US taxpayer from the Federal Reserve's swaps would be circumscribed** by the fact that the main counterparty to those swaps would be the European Central Bank rather than the countries in the European periphery. One must suppose that the European Central Bank would be able to buy whatever quantity of US dollars that it might need to repay the Federal Reserve. It could do so through printing Euros even though this might entail a meaningful Euro depreciation with respect to the US dollar.

Mr. McHENRY. Thank you, Dr. Lachman.

Dr. Sanders.

STATEMENT OF ANTHONY SANDERS, PH.D.

Dr. SANDERS. Chairman McHenry, Ranking Member Quigley, and members of the subcommittee, thank you for inviting me to testify today.

The Eurozone is teetering on collapse and it has been decades in the making. The cause of their problems is excessive government spending, leading to excessive government debt, coupled with slow GDP growth.

The largest European countries are expected to have real GDP growth of 1.3 percent for 2012 and unemployment of 9.9 percent. The IMF has also produced a long-term real GDP forecast in which they have discovered that most of the European zone will have less than 2 percent GDP growth by 2016.

And if we take a look at the household and financial debt in Europe, we find out that the U.K.'s debt-to-GDP ratio, including households and financials, is over 900 percent. Japan is over 600 percent and Europe is almost 500 percent debt-to-GDP. The United States is over 300 percent. In summary, the Eurozone, Japan, and the United States are drowning in debt.

In a recent article from an economist at the European Central Bank itself shows that there is a significant negative effect of the size of government on growth.

The European Union will unify, break up, or downsize, but regardless of what option they choose, they are still spending too much money and have taken on too much debt and have reduced the ability to pay for it, which is slow GDP growth. Additional debt is not the answer; it is the problem.

The obvious solution is austerity. But making loans to the European Central Bank and individual countries does not solve the underlying structural problem, it only makes the debt-to-GDP problem even worse; it is simply a short-term solution to lower GDP growths. And how is this possibly going to help bail out the European situation?

Now, if Germany and France are successful in creating a fiscally integrated Europe, there will be less of a rush to purchase U.S. treasuries, leading Treasury rates to rise as people flee our markets. But given that the Fed is already the largest purchaser of U.S. treasuries, this could be a problem. China is flat on Treasury purchases and the U.K. and Japan continue to increase their purchases of treasuries. But the U.K. and Japan are not enough to pick up the slack from China's flat-line Treasury purchases.

Now, the Fed has been active in the European bailout starting in 2007, actually, a little bit before, with its discount window of operations, and it peaked in 2008. The largest European borrower from the Fed was the failed Belgian bank Dexia. While most of the discount window loans have been repaid, we are still in the dark on the guarantees.

Recently, the ECB drew $552 million from the Fed's swap line last week, in November. These are 7 day swaps at an interest rate of 1.08 percent. The Central Bank also borrowed the same amount in the prior week, etc. It begs the question, how long will the Fed keep the swap line open? While we cannot see the swap line in real time, the evidence indicates that the basis swap has a very short half-life, meaning that it is able to drive down the Euro rate momentarily, then immediately rises back up, showing that this is ineffective.

A recent disagreement about the size of the Fed's intervention, discount window, and guarantees was in the media between the Fed and the Bloomberg Markets Magazine. The Bloomberg Markets said that the Fed had committed $7.7 trillion as of March 2009, almost the size of our national debt at one point recently, to rescuing the financial system when all guarantees and lending limits were added up. The Fed disagreed and said that any given day the Fed emergency credit from its liquidity programs was never more than $1.5 trillion. Whether we are looking at any given day or the cumulative impact, these are very large numbers historically, indicating the Fed is in fact attempting a bailout of the Eurozone.

Now, on the Fed side, it is clear that the guarantees of the Eurozone could be problematic to U.S. taxpayers if things do not improve, and I just don't see the story for improvement in the Eurozone. And the swaps with Europe could be costly as well. Since there is little transparency on the Fed's discount window and guarantees, it is difficult to measure taxpayer exposure.

In addition to the Fed, the IMF, which is the U.S.'s largest stakeholder, is also active. They have a line of credit for IMF crisis funding in the amount of $100 billion. Given the structural problems facing the Eurozone, there is little likelihood that the Eurozone will continue to have problems since there is a lack of will to cut government spending and entitlements, so I would expect that $100 billion LOC to be used and not paid back.

In summary, the Eurozone's structural problems cannot be solved by low interest rates and guarantees from the Fed or the IMF. In fact, engaging in a bailout of Europe could actually jeopardize U.S. taxpayers and is a perverse solution to the problem. The best way to protect U.S. taxpayers is to increase transparency of the Fed, take back the $100 billion line of credit at the IMF, and undertake spending cuts ourselves in order to reduce our deficit and massive debt loan exposure.

Thank you.

[The prepared statement of Dr. Sanders follows:]

MERCATUS CENTER
George Mason University
BRIDGING THE GAP BETWEEN ACADEMIC IDEAS AND REAL WORLD PROBLEMS

TESTIMONY

WHAT THE EURO CRISIS MEANS FOR TAXPAYERS AND THE U.S. ECONOMY, PART 1
DECEMBER 15, 2011

Anthony B. Sanders
Distinguished Professor of Real Estate Finance, George Mason University and Senior Scholar, Mercatus Center at George Mason University

United States House Committee on Oversight and Government Reform
Subcommittee on TARP, Financial Services and Bailouts of Public and Private Programs

Chairman McHenry, Ranking Member Quigely and Members of the Subcommittee, thank you for inviting me to testify today. My name is Anthony B. Sanders. I am the Distinguished Professor of Finance at George Mason University and senior scholar at the Mercatus Center. I was previously Director of asset-backed and mortgage-backed securities research at Deutsche Bank and the co-author of "Securitization" (along with Andrew Davidson) as well as many economic and finance publications.

THE EURO CRISIS

The Eurozone is teetering on collapse and it has been decades in the making. The cause of their problems is 1) excessive government spending leading to 2) excessive government debt coupled with 3) slow GDP growth.

The core European countries (Germany, France, Italy, Spain, Netherlands, Belgium, Austria, Greece and Portugal) are expected to have real GDP growth of 1.3% for 2012 and unemployment in 2012 of 9.9% (see Figures 1 and 2). The IMF also produced a longer-term Real GDP forecast. I have outlined the core (France, Germany, Italy and Spain) and they are all projected to have Real GDP growth in 2016 of less than 2% (actually, France is forecast to barely break 2%). At the same time, the European core countries have excessively high Government Debt to GDP ratios (see Figure 3) with Greece at 145% and Italy at 118.4% Government Debt-to-GDP. The other Eurozone nations have Government Debt-to-GDP ratios in excess of 80%.

If we look at Household and Financial Debt in addition to Government Debt, the UK's Debt to GDP ratio exceeds 900%. Japan is over 600% and Europe is almost 500% Debt to GDP. The U.S. is over 300%. In summary, Euro, Japan and the U.S. are drowning in debt. And a recent article from economists at the ECB that finds:

"…we analyse a wide set of 108 countries composed of both developed and emerging and developing countries, using a long time span running from 1970-2008, and employing different proxies for government size… Our results show a significant negative effect of the size of government on growth. …Interestingly, government consumption is consistently detrimental to output growth irrespective of the country sample considered (OECD, emerging and developing countries)."

The European Union will unify, break up or downsize. But regardless of what option they choose, they still have too much spending and debt relative to the ability to pay for it: GDP growth. But additional debt is not the answer. It is the problem.

The obvious solution is austerity (reduction in government spending). But making loans to the European Central Bank or individual countries doesn't solve the underlying structural problems; it only makes the Debt to GDP problem even worse. It is simply a short-term solution and actually encourages the Eurozone to delay making the hard decisions.

THE FED'S PREDICIMENT

If Germany/France is successful in creating a fiscally integrated Eurozone, there will likely be less of a rush to purchase US Treasuries (leading Treasury rates to rise). Given that The Fed is already the largest purchaser of U.S. Treasuries, this could be a problem (see Figure 5). China is flat on Treasury purchases, but the UK and Japan continue to increase their purchases of Treasuries (see Figure 6). But the UK and Japan are not enough to pick up the slack from China's flat-lined Treasury purchases.

But what if the Germany/France plan fails? There will likely be a rush to US Treasuries (driving down our yields). The Fed will be watching that possible outcome very closely.

The Fed has been active in the Eurozone bailout starting in 2007 with its Discount Window operations (see Figure 7) that peaked in 2008.[1] The largest Eurozone borrower from The Fed was the failed Belgian bank Dexia. While most of the discount window loans have been repaid, we are still in the dark on the guarantees.

Recently, the ECB drew $552 million from The Fed's Dollar Swap Line in the last week of November. These are seven-day dollar swaps at an interest rate of 1.08%.[2] The central bank also borrowed the same amount in an eight-day swap arrangement in the prior week. It begs the question "How long will The Fed keep their swap line open?" While we cannot see the swap line in real time, the evidence indicates that the basis swap approach has a very short half-life (see Figure 8). The one year basis swap shows the same temporary impact (see Figure 9).

A recent disagreement about the size of The Fed's intervention (discount window and guarantees) was in the media between The Fed and Bloomberg Markets Magazine.[3] The Bloomberg article said the Fed had committed $7.77 trillion as of March 2009 to rescuing the financial system when all guarantees and lending limits were added up. The Fed disagreed and stated that on any given day, Fed credit from its emergency liquidity programs was never more than about $1.5 trillion. Whether we are looking at "any given day" or the cumulative impact, these are very large numbers indicating that The Fed is attempting a bailout of the Eurozone.

And yesterday, Fed Chair Bernanke announced that The Fed stands ready to provide further easing based on Eurozone risk.[4] Since The Fed can't really push down rates much further, The Fed must be contemplating expanding The Fed's balance sheet to provide additional liquidity and marginally lowering interest rates. Retirees and people living on fixed incomes will be further harmed by The Fed's reaction to the Eurocrisis.

On a related issue, The Fed and Treasury should save their bailout tools for the U.S. The GDP boost from additional Federal borrowing is almost zero (see Figure 10). The M1 Money multiplier continues to fall (see Figure 11). When we plot these Federal government intervention measures together (see Figure 10), it shows that intervention has lost effectiveness.

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[1] http://www.bloomberg.com/news/2011-04-01/foreign-banks-tapped-fed-s-lifeline-most-as-bernanke-kept-borrowers-secret.html

[2] http://online.wsj.com/article/BT-CO-20111201-714662.html

[3] http://www.reuters.com/article/2011/12/07/us-usa-fed-lending-idUSTRE7B51W420111207

[4] http://www.bloomberg.com/news/2011-12-14/bernanke-signals-risks-from-europe-crisis-keep-fed-ready-for-more-easing.html

On The Fed side, it is clear that guarantees to the Eurozone could be problematic to U.S. taxpayers. And the swaps with Europe could be costly as well. But since there is little transparency on The Fed's discount window and guarantees, it is difficult to measure taxpayer risk exposure.

THE IMF

In addition to Fed operations, the International Monetary Fund (IMF) of which the U.S. is the largest stakeholder is also active in the Eurozone bailout. The U.S. has a line of credit approved for an IMF crisis fund in the amount of $100 billion. Given the structural fiscal problems of the Eurozone, there is little likelihood that the Eurozone won't continue to have problems since there is a lack of will to cut government spending and entitlements. So I would expect that the $100 billion LOC to be used and not paid back.

SUMMARY

The Eurozone's structural problems cannot be solved by low interest loans and guarantees from The Fed and the IMF. In fact, engaging in a bailout of the Eurozone could jeopardize U.S. taxpayers.

The best way to protect U.S. taxpayers is to increase transparency at The Fed, take back the $100 billion line of credit at the IMF and undertake spending cuts ourselves in order to reduce our deficit and massive debt loan.

APPENDIX: FIGURES

Figure 1.

Shaded cells indicate IMF staff estimates

Country	Subject Descriptor	Units	Scale	Country/Series-specific Notes	2009	2010	2011	2012	2013	2014	2015	2016
Austria	Gross domestic product, constant prices	Percent change			-3.888	2.128	3.282	1.640	2.037	2.040	1.899	1.778
Belgium	Gross domestic product, constant prices	Percent change			-2.663	2.106	2.420	1.544	1.739	1.783	1.845	1.833
Cyprus	Gross domestic product, constant prices	Percent change			-1.662	1.041	0.037	1.000	2.830	2.760	2.701	2.699
Estonia	Gross domestic product, constant prices	Percent change			-13.899	3.105	6.549	4.005	4.156	3.728	3.782	3.804
Finland	Gross domestic product, constant prices	Percent change			-8.227	3.644	3.469	2.245	2.056	2.007	2.014	1.976
France	Gross domestic product, constant prices	Percent change			-2.632	1.384	1.652	1.399	1.867	2.099	2.062	2.081
Germany	Gross domestic product, constant prices	Percent change			-5.078	3.562	2.725	1.273	1.502	1.499	1.255	1.293
Greece	Gross domestic product, constant prices	Percent change			-2.339	-4.354	-5.000	-2.000	1.500	2.300	3.000	3.296
Ireland	Gross domestic product, constant prices	Percent change			-6.995	-0.430	0.363	1.484	2.161	2.040	3.302	3.311
Italy	Gross domestic product, constant prices	Percent change			-5.217	1.296	0.630	0.323	0.540	0.600	1.140	1.240
Luxembourg	Gross domestic product, constant prices	Percent change			-3.639	3.516	1.575	2.741	2.676	2.931	2.902	3.118
Malta	Gross domestic product, constant prices	Percent change			-3.299	3.149	2.450	2.199	2.170	2.327	2.306	2.349
Netherlands	Gross domestic product, constant prices	Percent change			-3.529	1.634	1.630	1.345	1.528	1.648	1.806	1.828
Portugal	Gross domestic product, constant prices	Percent change			-2.507	1.331	-2.169	-1.844	1.190	2.453	2.220	2.000
Slovak Republic	Gross domestic product, constant prices	Percent change			-4.782	4.021	3.250	3.300	4.303	4.240	4.240	4.240
Slovenia	Gross domestic product, constant prices	Percent change			-8.077	1.209	1.900	2.000	2.393	2.307	2.200	2.005
Spain	Gross domestic product, constant prices	Percent change			-3.722	-0.147	0.773	1.123	1.765	1.863	1.945	1.846

Figure 2.

Table 2.2. Selected European Economies: Real GDP, Consumer Prices, Current Account Balance, and Unemployment

(Annual percent change unless noted otherwise)

	Real GDP			Consumer Prices[1]			Current Account Balance[2]			Unemployment[3]		
		Projections			Projections			Projections			Projections	
	2010	2011	2012	2010	2011	2012	2010	2011	2012	2010	2011	2012
Europe	**2.2**	**2.0**	**1.5**	**2.4**	**3.1**	**2.1**	**0.3**	**0.1**	**0.4**	. . .	. . .	. . .
Advanced Europe	**1.8**	**1.6**	**1.3**	**1.9**	**2.8**	**1.7**	**0.8**	**0.8**	**1.0**	**9.4**	**9.2**	**9.1**
Euro Area[4,5]	1.8	1.6	1.1	1.6	2.5	1.5	–0.4	0.1	0.4	10.1	9.9	9.9
Germany	3.6	2.7	1.3	1.2	2.2	1.3	5.7	5.0	4.9	7.1	6.0	6.2
France	1.4	1.7	1.4	1.7	2.1	1.4	–1.7	–2.7	–2.5	9.8	9.5	9.2
Italy	1.3	0.6	0.3	1.6	2.6	1.6	–3.3	–3.5	–3.0	8.4	8.2	8.5
Spain	–0.1	0.8	1.1	2.0	2.9	1.5	–4.6	–3.8	–3.1	20.1	20.7	19.7
Netherlands	1.6	1.6	1.3	0.9	2.5	2.0	7.1	7.5	7.7	4.5	4.2	4.2
Belgium	2.1	2.4	1.5	2.3	3.2	2.0	1.0	0.6	0.9	8.4	7.9	8.1
Austria	2.1	3.3	1.6	1.7	3.2	2.2	2.7	2.8	2.7	4.4	4.1	4.1
Greece	–4.4	–5.0	–2.0	4.7	2.9	1.0	–10.5	–8.4	–6.7	12.5	16.5	18.5
Portugal	1.3	–2.2	–1.8	1.4	3.4	2.1	–9.9	–8.6	–6.4	12.0	12.2	13.4
Finland	3.6	3.5	2.2	1.7	3.1	2.0	3.1	2.5	2.5	8.4	7.8	7.6
Ireland	–0.4	0.4	1.5	–1.6	1.1	0.6	0.5	1.8	1.9	13.6	14.3	13.9
Slovak Republic	4.0	3.3	3.3	0.7	3.6	1.8	–3.5	–1.3	–1.1	14.4	13.4	12.3
Slovenia	1.2	1.9	2.0	1.8	1.8	2.1	–0.8	–1.7	–2.1	7.3	8.2	8.0
Luxembourg	3.5	3.6	2.7	2.3	3.6	1.4	7.8	9.8	10.3	6.2	5.8	6.0
Estonia	3.1	6.5	4.0	2.9	5.1	3.5	3.6	2.4	2.3	16.9	13.5	11.5
Cyprus	1.0	0.0	1.0	2.6	4.0	2.4	–7.7	–7.2	–7.6	6.4	7.4	7.2
Malta	3.1	2.4	2.2	2.0	2.6	2.3	–4.8	–3.8	–4.8	6.9	6.3	6.2
United Kingdom[5]	1.4	1.1	1.6	3.3	4.5	2.4	–3.2	–2.7	–2.3	7.9	7.8	7.8
Sweden	5.7	4.4	3.8	1.9	3.0	2.5	6.3	5.8	5.3	8.4	7.4	6.6
Switzerland	2.7	2.1	1.4	0.7	0.7	0.9	15.8	12.5	10.9	3.6	3.4	3.4
Czech Republic	2.3	2.0	1.8	1.5	1.8	2.0	–3.7	–3.3	–3.4	7.3	6.7	6.6
Norway	0.3	1.7	2.5	2.4	1.7	2.2	12.4	14.0	12.8	3.6	3.6	3.5
Denmark	1.7	1.5	1.5	2.3	3.2	2.4	5.1	6.4	6.4	4.2	4.5	4.4
Iceland	–3.5	2.5	2.5	5.4	4.2	4.5	–10.2	1.9	3.2	8.1	7.1	6.0
Emerging Europe[6]	**4.5**	**4.3**	**2.7**	**5.3**	**5.2**	**4.5**	**–4.6**	**–6.2**	**–5.4**	. . .	. . .	. . .
Turkey	8.9	6.6	2.2	8.6	6.0	6.9	–6.6	–10.3	–7.4	11.9	10.5	10.7
Poland	3.8	3.8	3.0	2.6	4.0	2.8	–4.5	–4.8	–5.1	9.6	9.4	9.2
Romania	–1.3	1.5	3.5	6.1	6.4	4.3	–4.3	–4.5	–4.6	7.6	5.0	4.8
Hungary	1.2	1.8	1.7	4.9	3.7	3.0	2.1	2.0	1.5	11.2	11.3	11.0
Bulgaria	0.2	2.5	3.0	3.0	3.8	2.9	–1.0	1.6	0.6	10.3	10.2	9.5
Serbia	1.0	2.0	3.0	6.2	11.3	4.3	–7.2	–7.7	–8.9	19.6	20.5	20.6
Croatia	–1.2	0.8	1.8	1.0	3.2	2.4	–1.1	–1.8	–2.7	12.2	12.7	12.2
Lithuania	1.3	6.0	3.4	1.2	4.2	2.6	1.8	–1.9	–2.7	17.8	15.5	14.0
Latvia	–0.3	4.0	3.0	–1.2	4.2	2.3	3.6	1.0	–0.5	19.0	16.1	14.5

Figure 3. European Debt to GDP

Hit # <GO> to select an index or <TAB> to change date.

EU Govt Debt as % of GDP — Page 1/2

Source Copyright European Communities 1995-2010		Current Value	Date	Previous 12/31/09 Value	Date	Pct Chng
1) Debt as % of GDP Belgium	EUDB60BE	96.20	12/10	95.90	12/09	.31
2) Debt as % of GDP Germany	EUDB60DE	83.20	12/10	74.40	12/09	11.83
3) Debt as % of GDP Spain	EUDB60ES	61.00	12/10	53.80	12/09	13.38
4) Debt as % of GDP France	EUDB60FR	82.30	12/10	79.00	12/09	4.18
5) Debt as % of GDP Ireland	EUDB60IE	92.50	12/10	65.20	12/09	41.87
6) Debt as % of GDP Italy	EUDB60IT	118.40	12/10	115.50	12/09	2.51
7) Debt as % of GDP Luxembourg	EUDB60LU	19.10	12/10	14.80	12/09	29.05
8) Debt as % of GDP Netherland	EUDB60NL	62.90	12/10	60.80	12/09	3.45
9) Debt as % of GDP Austria	EUDB60AT	71.80	12/10	69.50	12/09	3.31
10) Debt as % of GDP Portugal	EUDB60PT	93.30	12/10	83.00	12/09	12.41
11) Debt as % of GDP Finland	EUDB60FI	48.30	12/10	43.30	12/09	11.55
12) Debt as % of GDP Eurozone	EUDBEURO	85.30	12/10	79.80	12/09	6.89
13) Debt as % of GDP Greece	EUDB60GR	144.90	12/10	129.30	12/09	12.06
14) Debt as % of GDP EU 15	EUDB6015	60.40	12/07	62.80	12/06	-3.82
15) Debt as % of GDP Denmark	EUDB60DK	43.70	12/10	41.80	12/09	4.55
16) Debt as % of GDP Sweden	EUDB60SE	39.70	12/10	42.70	12/09	-7.03
17) Debt as % of GDP UK	EUDB60UK	79.90	12/10	69.60	12/09	14.80
18) Debt as % of GDP Slovakia	EUDBSK	41.00	12/10	35.50	12/09	15.49
19) Debt as % of GDP Slovenia	EUDBSI	38.80	12/10	35.30	12/09	9.92
20) Debt as % of GDP Poland	EUDBPL	54.90	12/10	50.90	12/09	7.86

Australia 61 2 9777 8600 Brazil 5511 3048 4500 Europe 44 20 7330 7500 Germany 49 69 9204 1210 Hong Kong 852 2977 6000
Japan 81 3 3201 8900 Singapore 65 6212 1000 U.S. 1 212 318 2000 Copyright 2011 Bloomberg Finance L.P.
SN 322640 EST GMT-5:00 H628-45-6 04-Dec-2011 20:14:46

Figure 4. Global Debt as Percentage of GDP

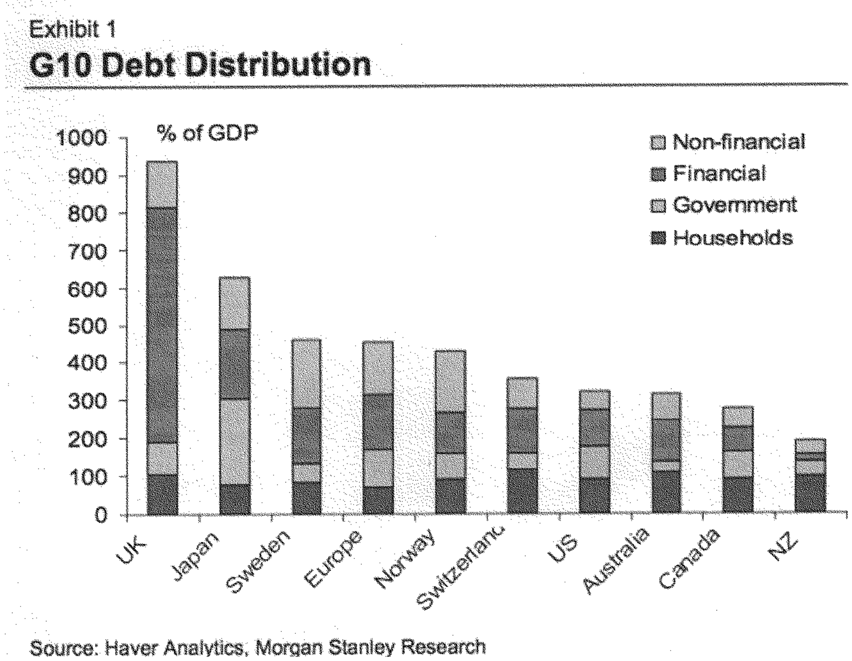


Figure 5. The Fed's Balance Sheet

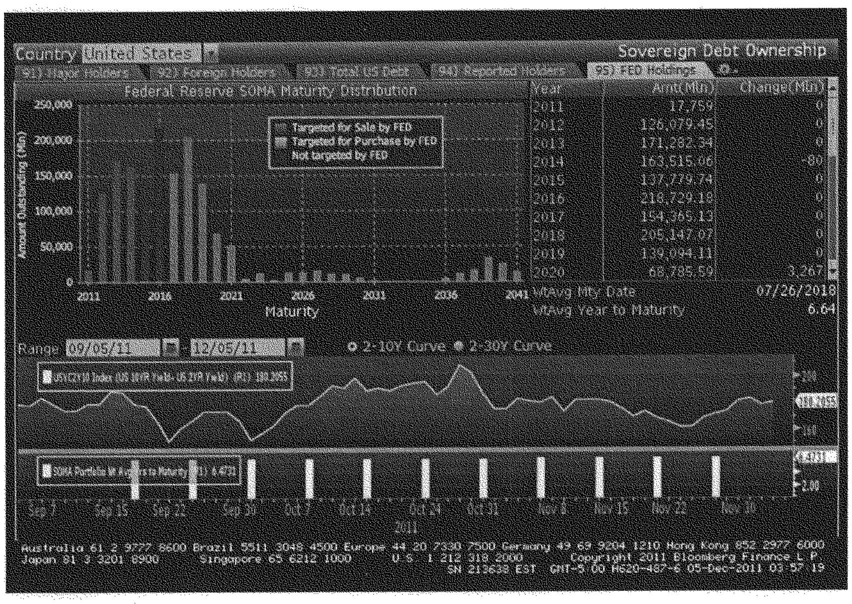


Figure 6. Who Owns Our Treasury Debt?

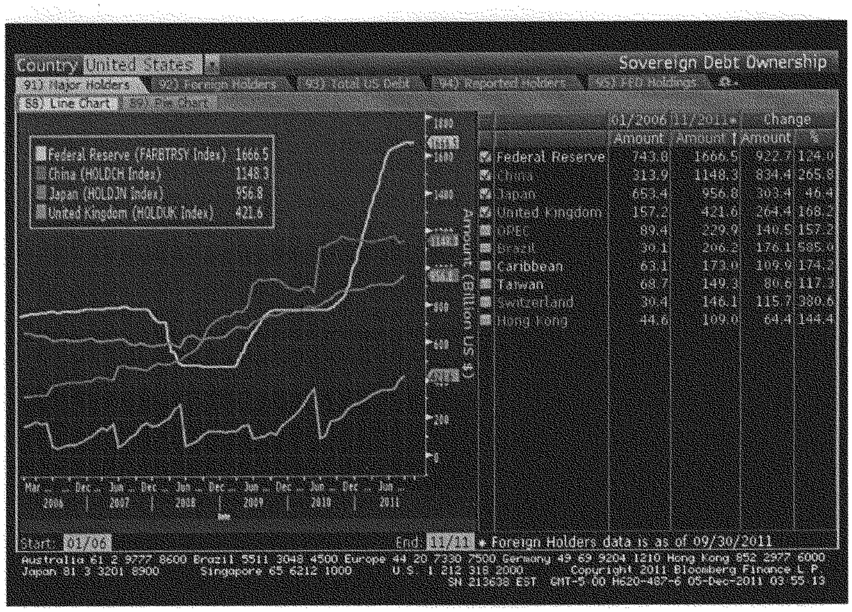
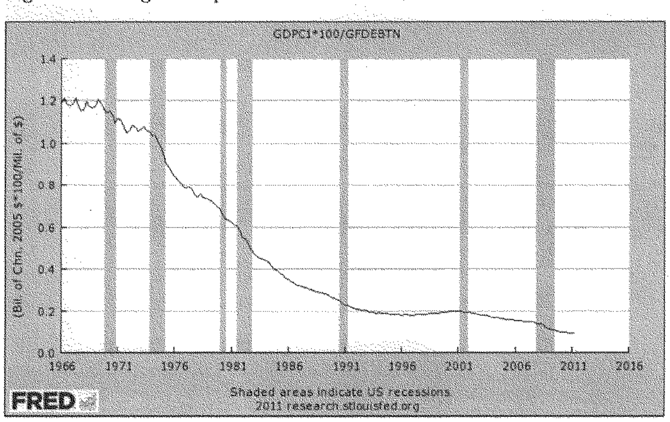


Figure 7. The Fed's Discount Window Operations

Figure 8. 3 Month Basis Swap Dropping Back to November 30 Levels

Figure 9. One year Basis Swaps

Figure 10. Marginal Impact of Additional Federal Debt on Real GDP



Mr. McHENRY. Thank you, Dr. Sanders.
Mr. Elliott.

STATEMENT OF DOUGLAS J. ELLIOTT

Mr. ELLIOTT. Let me add my own thanks to you, Chairman McHenry, Ranking Member Quigley, and members of the subcommittee, for inviting me here today. As has been noted, I am a fellow in economic studies at the Brookings Institution, but I am here in an individual capacity and not representing the Institution, which does not take policy positions.

I commend you for calling this hearing, since the Euro crisis is deeply worrying. There is a significant chance that the crisis could go badly enough wrong that Europe plunges into a deep recession that puts the United States into at least a mild recession. Trouble in Europe will communicate itself to our shores strongly and quickly because, as the ranking member noted, we have $400 billion of exports to Europe annually, a trillion dollars of direct investment there, and our banks have almost $5 trillion of credit exposure.

Now, the good news is that the Eurozone as a whole does have the resources to avoid that kind of disaster if the 17 nations stick together effectively. Europe is one of the world's largest economies and the Eurozone as a whole has debt ratio similar to the United States, meaning that their fiscal problems require serious action, as ours do, but the situation can certainly be remedied.

I personally believe there is a three in four chance that Europe will muddle through, but very complicated political constraints in Europe still leave us with a one in four chance of disaster, again, in my view. Even assuming a good outcome, the crisis is likely to get worse before it gets better, as it will probably take the imminent possibility of catastrophe to allow politicians over there to break through those tough political constraints. At that point of crisis, it may be necessary for European leaders to produce a comprehensive package backed by as much as two trillion Euros of available funds. Not all of this would be used in practice, as long as a backstop this large is credibly committed. The markets need to know that there is insurance for the worst emergency, in which case they are likely to go back to supplying at least some of the necessary funds themselves.

I believe the IMF could play a very useful role in any comprehensive solution. First, adding some IMF funding to the mix would help reassure financial markets that the total resources necessary would in fact be available. Second, it would be a clear sign that the rest of the world stands ready to help Europe through its troubles, which should also be viewed positively by the markets. But most importantly, the IMF is in the best position to impose conditions on lending to troubled Eurozone countries since it is viewed as more dispassionate and less political about Europe's situation than would be true for purely European institutions. Further, it can provide a great deal of technical advice, which is more likely to be taken when the IMF is also a provider of funding. We all listen more carefully to people who are also providing money to us.

If Europe produces a credible and comprehensive plan that involves the IMF appropriately, then we should support that IMF role. I do not believe that this would require additional U.S. funding of the IMF, but just the use of resources we have already provided. The IMF has almost $400 billion of uncommitted resources and Europe is planning to commit another $200 billion Euros to the IMF, with the possibility of some matching funds from certain non-European nations not including the United States.

The risk to the U.S. taxpayer from IMF lending, I believe, would be small for a variety of reasons. A key one is that IMF lending is in a legally privileged position that makes it much safer than, for example, the TARP funds that were invested by U.S. taxpayers. IMF loans are effectively senior in their claims to all other borrowings; whereas, the TARP funds were deliberately invested at the level of equity, which is much riskier. This was done in order to stabilize the financial markets by protecting other suppliers of funds to the banks. In addition, even if everything does go wrong, the United States bears less than a fifth of the risk from IMF lending.

I want to emphasize our taxpayers and other citizens are already at great risk from the Euro crisis. If it goes badly wrong, our citizens and the businesses they own will lose large sums of money both here and abroad. Federal Government tax receipts will fall significantly, eventually requiring taxpayers to pay more than they otherwise would have done. In my view, supporting IMF intervention would reduce the total risk to America by much more than the quite modest financial risk that our share of the IMF funding would represent. Sometimes the riskiest choice is to take no chances at all.

There are a few other things that America can do, principally along the lines of the Fed swap facilities with the European Central Bank that have been described and the provision of technical advice. However, this is a European problem and they will need to provide the backbone of any solution.

Thank you for the opportunity to testify and I welcome any questions when we get to that point.

[The prepared statement of Mr. Elliott follows:]

Douglas J. Elliott
December 14, 2011

Thank you Chairman McHenry, Ranking Member Quigley, and members of the subcommittee, for requesting my views on the crisis in the eurozone and the implications for America. My name is Douglas Elliott. I am a Fellow in Economic Studies at the Brookings Institution, although I am here in an individual capacity and not representing the institution, which does not take policy positions.

Summary

Let me start by very briefly summarizing my testimony. There is a significant chance that the Euro Crisis could go badly enough wrong that Europe plunges into a deep recession that puts the US into at least a mild recession. The eurozone has the resources to avoid such an outcome and I believe there is a three in four chance that they will do so, but the one in four chance of disaster could come to pass due to very complicated political constraints in Europe. The crisis is likely to get worse before it gets better, as it will probably take the imminent possibility of disaster to allow the politicians to break through those political constraints. At that point, it may be necessary for European leaders to produce a comprehensive package backed by as much as 2 trillion euros of available funds.

The IMF could play a very useful role in any comprehensive solution, by providing some of the firepower to reassure the markets, and, more importantly, by supplying discipline to the execution of the rescue plans through enforcing conditionality on loan disbursements. If Europe produces a credible and comprehensive plan that involves the IMF appropriately, then we should support that IMF role. I do not believe this would require additional US funding of the IMF, but just the use of resources we have already provided.

The risk to the US taxpayer would be very small, for a variety of reasons. A key one is that IMF lending is in a legally privileged position that makes it much safer than, for example, the TARP funds that were invested by US taxpayers. More importantly, US taxpayers and citizens are already at risk to the Euro Crisis to a much greater extent than the quite modest risk that an IMF loan would represent. The total risk to US taxpayers would therefore be considerably reduced by appropriate IMF involvement.

There is little else the US can do, other than the continued provision of Fed swap lines to the ECB and the willingness to give technical advice where we can help and moral support. This is primarily a European problem to be solved by them, even though the implications for us would be quite serious if they get this badly wrong.

Background

The Euro Crisis is deeply concerning, in part because the path it follows is likely to be the main determinant of whether the U.S. goes back into recession. If Europe were to be shaken by a series of nations defaulting on their government debt, I am convinced that the continent would plunge into a severe recession. Their recession would trigger a recession of our own, although a less severe one, through a number of links across the Atlantic.

First, there is trade. Over $400 billion of our exports in 2010 went to the European Union[1]. We should expect to lose a significant portion of this while Europe is in deep recession. At the same time, European firms would likely gain global market share at the expense of American sales and jobs, as the Euro depreciated and difficulties in selling within Europe spurred greater export efforts. Beyond Europe, emerging market countries like China also export substantial amounts to Europe and would find their growth slowing considerably. Our exports to those nations would be hit.

Second, there is investment. US firms have over $1 trillion of direct investment in the European Union, owning companies, real estate, and other assets over there. Profits from those operations, which are significant for our global firms, would decline markedly. We also have large sums invested in other nations, outside of Europe, that would be caught up in the same synchronized economic decline.

Third, there are financial flows. US banks, and their subsidiaries, have $2.7 trillion in loans and other commitments to eurozone governments, banks, and corporations, and roughly $2 trillion more of exposure to the UK[2]. US insurers, mutual funds, pension funds, and other entities also have a great deal committed to Europe. Credit losses would set back the progress we have made in moving beyond the financial crisis. Those losses would be exacerbated by additional problem loans in the rest of the world, including our own country, that would be induced by global economic problems.

Fourth, there is the effect on business and consumer confidence. We saw a taste of this in August, when problems in Europe quickly communicated themselves to our own financial markets and to confidence levels. Individuals and businesses are already scared. They would surely pull back on spending and investment still further if the European situation went badly wrong.

The combined effects of these four channels would almost certainly be enough to put us back in recession, although it is difficult to quantify the effects precisely, especially since there are numerous scenarios for exactly how the Euro Crisis could blow up.

Europe will probably muddle through, even though the process will be ugly and frightening. However, there is perhaps a one-in-four chance of a truly bad outcome, leading to a series of national defaults that include Greece, Portugal, Ireland, Spain, and Italy. There is also a small chance of one or more countries leaving the Euro, which would create still more damage. My one-in-four probability estimate is necessarily a very rough one. There are many different ways things could go wrong, since the eurozone

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[1] I generally use figures for the European Union rather than the narrower eurozone, because the UK and other EU members that do not use the euro are so closely tied to the eurozone countries that I believe they would also be severely impacted.

[2] My colleague, Domenico Lombardi, has a good summary of the financial exposures in testimony he gave to the Senate, available at http://www.brookings.edu/testimony/2011/0922_european_debt_crisis_lombardi.aspx

is made up of 17 nations with their own political, economic, and financial systems. Each risk has a low probability, but there are a multitude of those risks, which add up to a significant cumulative risk. I have attached a short paper giving more details about the crisis, particularly why it is so hard to solve and how it may proceed from here. The paper can also be found on the internet at: http://www.brookings.edu/papers/2011/0822_euro_crisis_elliott.aspx

You will note that I believe there is about a three in four chance that Europe will get through this without national defaults beyond Greece and without any countries leaving the eurozone. This means that I am more optimistic than a number of American analysts, including some on this panel, although more pessimistic than most European analysts. Why do I think it likely Europe will manage its way out of this crisis without further defaults?

First, the eurozone has the financial resources to handle this crisis if the nations choose to stand together. The eurozone as a whole is roughly in the same fiscal position as the US, which is to say that strong action is required over time, but financial markets recognize the capacity of the eurozone as a whole to pay its bills. Certain individual countries within the eurozone are in more precarious positions, but the zone as a whole is one of the world's largest economies and can bear high levels of debt in absolute terms.

Second, there is a very strong political will to have "the European Project" succeed. This is a lifetime project to which virtually all of the key European leaders are committed. They believe, correctly in my view, that strong cooperation within Europe is to their economic advantage and that it is the key to maintaining a major global role. Whether one agrees with this assessment or not, the leaders *are* strongly committed to this path, even if their publics are not always quite as enthused. The current crisis has highlighted areas of disagreement, and even dislike, between eurozone countries. However, the leaders have already agreed to much greater levels of political integration than would have seemed possible two years ago and have crossed a number of lines they had previously drawn in the sand in order to do it. In the end, they are likely to do what it takes to avoid the collapse of the eurozone.

Third, Europe is closely inter-linked economically and the leaders know this. Germany may have an instinctive impulse to let nations suffer if they have been irresponsible in German eyes, but they also recognize that the damage to Germany of a collapse of the European periphery would be severe. Take the kind of linkages that I have described between America and Europe and magnify them relative to the size of each national economy and you will have a sense of the degree of interdependence.

That said, I do fear, and expect, that it will take one more round of the crisis before European leaders finally, on their sixth attempt, take action strong enough to halt the crisis firmly. The national political constraints on these leaders are harsh and I believe it will take an even stronger level of fear to move them across the finish line.

Potential solutions

Last week's Euro Summit took a number of useful steps that lay the groundwork for the ultimate solution to the problems. (Please see my preview piece on the summit, which largely foreshadowed the actual decisions and their consequences, available at: http://www.brookings.edu/papers/2011/1207_euro_crisis_elliott.aspx).

However, these steps focus on the medium-term, leaving considerable risk in the next three to nine months. During that time, it seems quite likely that something will spook the financial markets enough that Spain or Italy will find itself temporarily unable to borrow from the private markets at an acceptable interest rate. This would set in motion a degree of contagion across countries and in the financial sector that the eurozone leaders could not allow to continue. At that point, I believe they will finally bite the bullet and come up with a source of funds massive enough to reassure the markets that financing will be available from the public sector to the full extent needed.

The eurozone has the resources on its own to quell the crisis, if they utilize the full power of the European Central Bank (ECB) in combination with stabilization mechanisms funded by the national governments in the eurozone. They have previously established the European Financial Stability Fund (ESFS) which has about 250 billion euros of untapped resources. This can be magnified modestly by various forms of financial leverage, although not to the extent eurozone leaders had previously hoped. The ESFS could also be bolstered by additional national commitments and by the upcoming European Stability Mechanism (ESM), which is a superior vehicle for providing support to troubled national governments and markets. The ESM is now slated to be up and running by the middle of next year.

The key, however, is likely to be the ECB. It has the power to create euros in unlimited amount, thereby giving it the financial punch to reassure the markets. Obviously, "printing money" can create unacceptable inflation if pursued to an excessive extent, but this does not appear likely to be a problem in the current context, given the recessionary conditions in Europe and the relatively small amount that would be needed in relation to the size of the European economy. There are also ways to offset the ECB's bond purchases to avoid expanding the money supply and the ECB has been doing such sterilization to this point, although it need not continue to do so.

There are also political and institutional constraints on the ECB, however these could be overcome fairly straightforwardly if there is the political will in the eurozone to harness the ECB more fully. Ultimately, of course, governments should be taking these quasi-fiscal support actions, not the central bank, so it is critical that the eurozone has a method of passing the responsibility on to governments and government-created facilities over time.

The role for America

Although the eurozone could handle this crisis with its own resources, and clearly bears the key responsibility, there is likely to be a very useful role for the IMF to play. First, adding some IMF funding to the mix would help reassure financial markets that the total resources necessary would truly be available. Second, it would be a clear sign that the rest of the world stands ready to help Europe through its troubles, which should also be viewed positively by the markets. Most importantly, the IMF is in the best position to impose conditionality on lending to troubled eurozone countries, since it is viewed as more dispassionate and less political about Europe's situation than would be true for purely European institutions. It has the history and technical resources to credibly impose conditions on disbursements of funds as they are needed. Further, it can provide a great deal of technical advice, which is more likely to be taken when the IMF is also a provider of funding. We listen more carefully to people who are also providing us money.

The markets may need to see total resources of as much as 2 trillion euros credibly available to support Italy, Spain, and the other eurozone countries that could need support if the crisis gets worse. Knowing these funds are committed should reassure markets and reduce the amount of such public funds that have to be used in practice. However, the full amount must credibly be available in order for this reassurance to work.

I believe that the IMF's currently available funds, plus funds recently promised to the IMF from the eurozone and any matching funds other nations may provide, would be sufficient for the IMF's share of any comprehensive solution to the crisis. The IMF currently has available resources of a bit under $400 billion, the eurozone has pledged another 200 billion euros, and there are likely to be further funds from other countries. Therefore, I do not believe that additional US resources would need to be committed to the IMF to handle this crisis. The Europeans should provide the great bulk of the support, with the IMF funding providing a useful augmentation of sufficient size to ensure the IMF has the leverage to impose its conditionality effectively.

If we reach the point where a comprehensive package of up to 2 trillion euros is needed, and if the European governments and their central bank step up appropriately with a credible plan and the necessary resources, then the US should support an IMF role, for the reasons I have outlined. The risk to US taxpayers would be very low. The eurozone can solve its problems without further defaults, in which case neither the IMF nor private investors would lose money on lending to these countries. Even if one or more defaults were to occur, the IMF has an excellent track record of being repaid, principally because IMF loans are senior to other national obligations. Let me stress that. This is very different from the TARP program in that IMF loans are in the most favored position available to a creditor, having a priority in repayment higher than other lenders. In the TARP program, we deliberately put taxpayers in at an equity level, which is much riskier, in order to reassure other suppliers of funds that it was safe to continue to deal with the banks, thereby stabilizing our financial system. Finally, in the extremely unlikely event that the IMF lost money anyway, we would absorb less than a fifth of the cost, since most IMF funds come from other nations, including European ones.

Our taxpayers and other citizens are *already* at great risk from the Euro Crisis. If it goes badly wrong, our citizens and the businesses they own will lose large sums of money both here and abroad. Federal government tax receipts will fall significantly, eventually requiring taxpayers to pay more than they would otherwise have done. Supporting IMF intervention would reduce the total risk to America by much more than the quite modest financial risk that our share of the IMF funding would represent.

There are a few other things that America can do, principally along the lines of the Fed swap facilities with the ECB and the provision of technical advice. However, this is a European problem and they will need to provide the backbone of any solution.

Thank you for the opportunity to testify. I welcome any questions you have for me.

Mr. McHenry. Thank you, Mr. Elliott.
Mr. Rosner.

STATEMENT OF JOSHUA ROSNER

Mr. Rosner. Thank you, Chairman McHenry, Ranking Member Quigley, and members of the subcommittee, for inviting me to testify on this important subject.

To fully assess the risks to the United States and our proper role in the Eurozone crisis, it must first be clear what the crisis is and is not. It is not a bailout of populations of the weaker European economy such as Greece, Ireland, Portugal, Italy, Spain, Hungary, or Belgium. After all, the populations of those countries are being forced to give up portions of their sovereignty in the name of austerity toward a fiscal union.

Rather, it is partially a bailout of banks in the core countries of Europe, of their stockholders and creditors who, failing to gain sufficient access to capital markets, would need to be recapitalized by their host country governments. It is a transfer of losses from bank creditors onto the backs of ordinary people without requiring any cost to those banks whose practices helped lead us to the problem. It is much a tale of overlending as it is of overborrowing. And just as nobody should feel undue sympathy for those who miscalculated the amount of debt they could service, nobody should feel for those who miscalculated their lending risks.

The fundamental construct of the Euro is flawed, and its basis depends on substantially different economies and different levels of competitiveness among those economies sharing the same currency. Those economies have proven unable to rationalize their differences in a monetary union. In the United States we have a transfer mechanism allowing tax dollars to be reallocated from the wealthiest states toward those less fortunate. The core European countries have demonstrated an unwillingness to accept such as necessity. The solution is either to move forward with a fiscal union complete with transfer of payments or break up. Ultimately, these are political decisions and currently there appears to be little popular support in Germany, Finland, and the Netherlands for such a real fiscal union. Unless that changes, the Eurozone will have to shrink its membership or dissolve. Either result will inevitably lead to significant stakeholder losses, which importantly may now include the Fed.

Proper U.S. policy should support our values around the world, not undermine them. We should support the apportioning of losses first to equity investors and then to unsecured lenders according to long-established and well understood rules of priority. We should no longer support privatization of gain and socialization of loss. Doing so leads to distortion of market incentives and further risk-taking by those who have demonstrated an inability to properly manage risk.

The European crisis demonstrates all too clearly that the problem is now well beyond moral hazard. A great many of the decisions being made in the name of crisis management are not being made by the elective representatives of the people of the countries of Europe. Rather, they are being made by technocrats. Accordingly, the crisis is moving into a stage where it may represent the death of representative democracy, but also the destruction of global markets. I urge you to consider whether this is truly the approach to crisis management that our country should be supporting and endorsing.

In May 2010, the Fed reopened swap lines to the European Central Bank in an effort to bolster liquidity for institutions in these markets, but at what cost? On November 30, 2011, to increase the attractiveness of these lines, the Fed lowered the interest rate by a half percentage point. Since then, 3-month lending through the lines increased from $400 million to over $50 billion. While the actions of the Fed may well be justified and consistent with U.S. policy goals, they are nonetheless being made in near darkness and without substantial involvement by our own elected officials. As a result of this commitment of financial support, we are now supporting undemocratic approaches implemented largely by authorities who have demonstrated an ongoing inability to either recognize the scope and scale of the problems or come to a consensus on how to address the rolling crisis and prevent it from spreading. They have, instead, sought to deny the problems and downplay the impacts. When they don't like the market's assessment of the problems, they have chosen to shoot the messenger and imperil market function through limitations of trading of sovereign bonds and credit default swaps. Are these proper policies for the United States to endorse?

By providing unlimited swap lines to be used by institutions in the Eurozone, institutions which may in fact be insolvent, not just illiquid, we have effectively allowed the Fed to direct U.S. foreign policy in support of a single currency for the Eurozone. As the risks of the losses of the Fed rise in the event of a breakup of the Eurozone, they seem likely to commit us further to support of that union in its current form. While the Fed has technical expertise in these matters, such policy decisions should not be made without informing Congress. I suggest that you consider whether the Fed's efforts should be directed more toward quantification of the problem and providing technical advice to Congress.

Dodd-Frank sought to reduce the opacity and require the Fed to disclose which firms receive loans from the discount window. In the spirit of that legislative intent, why hasn't the Fed required the ECB to inform them of recipients of funds from swap lines as condition of the arrangement?

While there are many more questions to be asked and answered, these questions suggest there are real reasons for the Fed to have concern about ongoing instability in highly interrelated markets of Europe. There also appears to be a real and rational basis for the actions they have taken toward short-term stability goals during the crisis. Furthermore, we can believe the Fed is acting appropriately, but without more information and a broad discussion, we don't know whether the Fed's focus on short-term stabilization properly aligns with longer term U.S. policy goals.

Perhaps we should support a European Union, but have our elected representatives affirmatively decided in favor of continued support for a single currency? It seems fair to consider that such foreign policy decisions should rightly be made not by an independent central bank, but, instead, by the Secretary of State, U.S.

Trade Representative, and the Secretary of Treasury with informed consent of the President and Congress.

Thank you, and I would be pleased to address your questions.

[The prepared statement of Mr. Rosner follows:]

Testimony of Joshua Rosner before the Subcommittee on TARP, Financial Services and Bailouts of Public and Private Programs:

"What the Euro Crisis Means for Taxpayers and the U.S. Economy."

December 15, 2011

Thank you Chairman McHenry and members of the subcommittee for inviting me to testify on this important subject.

To fully assess the risks to the United States and our proper role in the Eurozone crisis it must first be clear what the crisis is and is not. It is not a bailout of the populations of the weaker European economies such as Greece, Ireland, Portugal, Italy, Spain, Hungary or Belgium. After all, the populations of those countries are being forced to give up portions of their sovereignty in the name of austerity toward a fiscal union.

Rather, I would contend, it is a bailout of banks in the core countries of Europe, of their stockholders and creditors who, failing to gain sufficient access capital markets, would need to be recapitalized by their host country governments. It is a transfer of losses from banks and corporations onto the backs of ordinary people without requiring any recognition of losses by those banks whose risk management and lending practices created the problem. It is as much a tale of over lending as it is of over borrowing and, just as nobody should feel undue sympathy for those who miscalculated the amount of debt they could service, nobody should feel for those who miscalculated their lending risks.

The fundamental construct of the Euro is flawed and its basis depends on substantially different economies and different levels of competitiveness among those economies sharing the same currency. Those economies have proven unable to rationalize their differences in a monetary union. In the United States we have a transfer mechanism that allows tax dollars to be reallocated from the wealthiest states toward those less fortunate, - the core European countries have thus far demonstrated an unwillingness to accept such as necessity. The solution is either to move forward with a fiscal union complete with transfer of payments or to break up. Ultimately, these are political decisions and currently there appears to be little support for such a fiscal union by populations of creditor countries including Germany, Finland and the Netherlands. Unless that changes, the Eurozone will have to shrink its membership or dissolve. Either result will inevitably lead to significant stakeholder losses, which importantly may now include the Federal Reserve. It is fair to question why our central bank has adopted a policy with such fundamental policy implications, and the potential for large losses without consideration by Congress.

Proper US policy should seek to support our values around the world, not undermine them. We should support the apportioning of losses first to equity investors and then to unsecured lenders according to long-established and well-understood rules of priority. We should no longer support the privatization of gains and socialization of losses. Doing so leads to distortions of market incentives and further risk taking by those who have demonstrated an inability to properly manage risk. The European crisis demonstrates all too clearly that the problem is now well beyond moral hazard - a great many of the decisions made in the name of crisis management are not being made by the elected representatives of the people of Europe, rather they are being made by technocrats. Accordingly, the crisis is moving into a stage where it represents the death of representative democracy and also the destruction of global markets. I urge you to consider whether this is truly the approach to crisis management that our country should endorse and support.

In May 2010, the Fed reopened swap lines to the European Central Bank in an effort to make sure that there was ample dollar funding for institutions in these markets – the swap lines effectively bolster market liquidity – but at what cost? On November 30th of 2011, the Fed, working together with four other central banks and the ECB, expanded the attractiveness of these swap lines by lowering the interest rate by a half percentage point. Since these changes became effective, three month lending through the lines increased from $400 million prior to the announcement to over $50 billion. While the actions of the Federal Reserve may well be justified and consistent with US policy goals, they are nonetheless being made in near darkness and without substantial involvement by our own elected officials. As a result of our commitment of financial support to members of the European Union, we are now, in effect, supporting un-democratic approaches implemented largely by authorities who have demonstrated an ongoing inability to either recognize the scope and scale of the problems they face or to come to a consensus on the proper approach to address the rolling crisis and prevent it from spreading further. They have instead sought to deny the problems and downplay the impacts. When they don't like the markets assessments of the problems, they have chosen to 'shoot the messenger' and imperil market functions through limitations on trading of sovereign bonds and credit default swaps. Are these proper policies for the United States to endorse?

By providing unlimited swap lines to be used by institutions in the Eurozone, institutions which may in fact be insolvent, we have effectively allowed the Federal Reserve to direct US foreign policy in support of a single currency for the Eurozone. As the risks of losses to the Federal Reserve rise, in the event of a breakup of the Eurozone, they seem likely to commit us to further support of that union in its current form. While the Federal Reserve has technical expertise in these matters, such policy decisions should not be made without input from

Congress. I suggest that you consider whether the Federal Reserve's efforts should be directed more toward quantification of the problem and providing technical advice to Congress.

There are more questions raised by the Fed's actions than there are answers and we must strive to have those questions answered. Dodd Frank sought to reduce opacity and required the Federal Reserve to disclose which firms received loans from the discount window:

- In the spirit of that legislative intent, why have they not required the European Central Bank inform them of the recipients of funds from the swap lines as a condition of the arrangement?
- Are the firms that have sought liquidity support from the swap facilities still solvent and merely illiquid, or are illiquid conditions the result of insolvency?
- Who, specifically, are the beneficiaries of the Federal Reserves policy actions?
- What are the direct and indirect exposures, to Europe, of the US banks and insurance companies?
- News sources have suggested the Federal Reserve sought to have the largest US banks reduce their counterparty exposures to Eurozone sovereigns and counterparties. Why then is the Federal Reserve stepping up their commitment when US banks have seemingly backed away from many of those exposures?
- In what circumstances is it appropriate for the Fed, acting as lender of last resort, to replace private creditors and become the market?
- What are the specific policy goals of the Fed's actions?
- Are the actions of the Fed fully consistent with their mandates?
- While the Fed may argue that it has limited credit risk from these swap lines, given that their counterparty is the European Central Bank and not the financial institutions, what losses could be realized if the Eurozone disintegrated?
- During our own financial crisis the Fed assured us that the AAA tranches of CDOs posed no credit risk even though the underlying collateral was junk. What assurances do they have that Europeans would meet their obligations in such a scenario?
- If, in an event of default by a sovereign counterparty to the European Central Bank, the Fed sought to secure collateral of that institution held on reserve, would that be done with direction and input of Congress or the Executive Branch?
- What would the impact be to US trade if European banks were unable to provide historic levels of funding to Asian, Latin and other European economies?
- What are the real prospects for a resolution to the Eurozone crisis in the

event that the Eurozone enters recession?

While there are many more questions to be asked and answered, these questions suggest there are real reasons for the Fed to have concerns about the ongoing instability in the highly interrelated markets of Europe. There also appears to be a real and rational basis for the actions they have taken toward short-term stability goals during this crisis. Furthermore, we can ***believe*** that the Fed is acting appropriately, but without more information and a broader discussion, we don't ***know*** whether the Federal Reserve's focus on short-term stabilization properly aligns with longer term US policy goals.

Perhaps we should support a European Union but have our elected representatives affirmatively decided in favor of continued support for a single currency? It seems fair to consider that such foreign policy decisions should rightly be made, not by an independent central bank, but instead by the Secretary of State, US Trade Representative and the Secretary of Treasury with informed consent of the President and Congress.

Thank you, and I'll be pleased to address your questions.

Mr. MCHENRY. Thank you so much, Mr. Rosner.
Mr. Ely.

STATEMENT OF BERT ELY

Mr. ELY. Chairman McHenry, Ranking Member Quigley, and members of the subcommittee, I appreciate the opportunity to testify to you today about the Euro crisis and what it could mean for U.S. taxpayers and our economy.

I wish I could speak more positively about the Euro situation than my fellow panelists, but I feel that I cannot.

Europe would not be experiencing its economic crisis if the Euro had never been created or if at least the Eurozone had not been expanded to 17 countries. The fundamental problem with the Eurozone is that it ties 17 quite dissimilar economies to a common currency. While the total population of the Eurozone approaches that of the United States, the Eurozone lacks the economic, cultural, and language integration that has long benefited the United States. The Eurozone's insufficient integration greatly impairs the sustainability of the Eurozone as it is now constituted.

A key characteristic of a sustainable currency are such as the United States is that there are minimal barriers to the movement of goods, services, and labor within the currency area.

Unfortunately, these keys to sustainability are not present in the Eurozone as it is now constituted, as there still are many practical barriers to the movement of goods, services, and labor within the EU. Arguably, the Euro subsidized the retention of national laws, which impair the efficiency of industry in the Eurozone countries, and especially export-oriented industries. Consequently, export goods produced in these countries have steadily lost international competitiveness. This is especially true across the southern tier of the Eurozone, Greece, Italy, Portugal, and Spain.

In many regards, the Euro suffers the same weaknesses as the classic gold standard, which the United States abandoned in 1933, or any commodity standard which ties several or many countries to a fixed relationship between the currency units of account of those countries. Because national economies evolve at different rates of economic growth and public policy innovation, economic tensions develop among countries tied to each other by a common currency. The fixed relationships between units of account become increasingly difficult to maintain until a breaking point is reached and the fixed relationships are irretrievably broken. The same phenomena is occurring within the Eurozone.

Abandoning a common currency represents a country's shift to a fixed to a floating exchange rate. Abandoning the Euro, though, would be quite painful for a country. First, debts such as mortgages and bonds denominated in Euros would have to be abrogated and rewritten in the new local currency to spare debtors from being crushed by repayment obligations in a now suddenly more expensive Euro.

Second, owners of Euros in the weak Euro nations fearful of being forced to convert their Euros into their country's new, less valuable currency appear to be shifting their Euros to banks in stronger Eurozone countries. The recent last ditch attempt to fix the Euro by amending the EU treaty to impose greater fiscal discipline in the EU will not work in the short-term because the fiscal problems in many Eurozone countries are so deeply imbedded that they cannot be fixed within a few years. It will be a decades-long process that will not move at a uniform pace throughout the Eurozone. My written testimony discusses these problems.

Bottom line, the weaker Eurozone countries have much to do to enhance their ability to stay in the Eurozone. How many will succeed in doing so is a huge question with global implications.

Turning to how a Euro crisis could impact the U.S. economy and U.S. taxpayers, a Euro crisis could throw the EU into a recession. However, if enough dominoes topple within the Eurozone, Europe could experience a long, deep recession or worse. Given the highly interconnected nature of the global economy, U.S. experts to Europe would decline, which would harm the U.S. economy. A European recession could trigger a global economic slowdown, with the United States possibly falling into a recession as the European economy sorted itself out.

A slowing U.S. economy would increase the already enormous U.S. budget deficit as tax receipts declined and Federal spending rose. Consequently, the U.S. economy would increasingly look like the most troubled European countries, huge amounts of deficits and rapidly rising debt-to-GDP ratio. It would not be a pretty picture.

Unfortunately, the United States has few options for dealing with a Euro crisis. The best it can is urge the EU to aggressively address its problems in order to hold the Eurozone together as best it can. I am skeptical as to how much help the IMF can be. In particular, the United States should encourage the weaker Eurozone countries to address structural problems to improve their competitiveness, thereby improving the likelihood that they can stay in the Eurozone.

Given its financial weaknesses, the Federal Government should not supply any direct assistance to help the Euro such as buying the debt of any Eurozone country. However, I do support the U.S. dollar swap arrangements the Fed recently entered into with five other central banks. These arrangements provide liquidity to help the European financial system function while the EU works through its problems. I foresee no taxpayer risk from these swaps.

The United States should take the Euro crisis as yet another wake-up call that it must put its economic house in order by trimming budget deficits, reducing its debt-to-GDP ratio, increasing domestic savings, reducing the U.S.'s net debtor position with the rest of the world, addressing entitlement challenges, removing taxes and disincentives for savings and investing, and increasing the economy's international competitiveness. This is an enormous politically challenging task, but as a country we must undertake it, for we are not immune to being laid low by excessive debt and deficit spending, as has Greece and possibly other Eurozone countries.

Thank you for this opportunity to testify. I welcome your questions.

[The prepared statement of Mr. Ely follows:]

Testimony by Bert Ely
to the
Subcommittee on TARP, Financial Services and Bailouts of Public and Private Programs
of the
House Committee on Oversight and Government Reform
at a hearing titled
What the Euro Crisis Means for Taxpayers and the U.S. Economy
December 15, 2011

Mr. Chairman McHenry, Ranking Member Quigley, and members of the Subcommittee, I very much appreciate the opportunity to testify to you today about the Euro crisis and what it could mean for U.S. taxpayers and the U.S. economy. After briefly presenting my perspective on the economic situation in Europe as I viewed it yesterday morning when I submitted this written testimony, I will then speculate on ways in which the Euro crisis could impact taxpayers and the U.S. economy and discuss U.S. policy responses to a Euro crisis, including the November 30 announcement of new U.S. dollar swap arrangements between the Federal Reserve and five other central banks.[1]

The economic situation in Europe

I do not hold myself out an expert on the European economy but clearly it is facing serious economic problems including the survivability of the Euro, stresses within the European Union, and economic weaknesses throughout Europe. I will summarize key issues plaguing the European economy.

The Euro.

Europe would not be experiencing its economic crisis had the Euro never been created or at least if the Euro zone had not been expanded to the number of countries it now has. Today, the Euro zone is a monetary union of 17 member countries of the 27-nation European Union (EU). The other ten EU members, notably the United Kingdom, Sweden, and Denmark, have elected to keep their own currencies rather than converting to the Euro. Two small but still significant European countries – Switzerland and Norway – have not joined the EU and therefore have retained their own currencies.

The fundamental problem with the 17-nation Euro zone is that it ties seventeen quite dissimilar economies to a common currency. While the total population of the Euro zone countries – 332 million – is somewhat greater than the current U.S. population – 313 million – and the GDP of the Euro zone approaches that of the United States, the Euro zone lacks the economic, cultural, and

[1] The Bank of Canada, the Bank of England, the Bank of Japan, the European Central Bank, and the Swiss National Bank.

language integration that has long benefited the United States. The Euro zone's insufficient integration impairs the sustainability of the Euro zone as it is now constituted.

A key characteristic of a sustainable currency area (e.g., the United States, Canada, and Australia) is that there are minimal barriers to the movement of goods, services, and labor within the currency area. Put another way, a sustainable currency area is a free-trade area with a relatively unrestrained movement of goods, services, and labor so that market forces can lessen regional differences, in part by disciplining local and regional government policies which impede an area's economic competitiveness. The continuing shift of economic activity within the United States reflects the workings of those market forces.

Unfortunately, these keys to sustainability are not present in the Euro zone as it is now constituted. While the EU abolished internal tariffs, there still are many practical barriers to the movement of goods, services, and labor within the EU. While some of these barriers are informal – differences in language, culture, and attitudes – other barriers reflect the operation of national laws, notably labor laws that have not been harmonized within the Euro zone, much less across the entire EU. Arguably, the Euro subsidized the retention of national laws which impair the efficiency of industry in that country, and especially export-oriented industries – these countries have enjoyed low interest rates on their private-sector and public-sector debt. However, there is no free lunch – export goods produced in these countries have steadily lost international competitiveness. This has been especially true across the southern belt of the Euro zone – Greece, Italy, Portugal, Spain, and further north, in Ireland.

In many regards, the Euro, as a unit of account (e.g., dollar, pound, franc, mark, etc.), suffers the same weaknesses as the classical gold standard or any commodity standard (e.g., silver, copper, wampum, cigarettes, etc.) which ties several or many countries to a fixed relationship between the units of account of those countries. Because national economies evolve at different rates of economic growth and public-policy innovation (e.g., such as reducing labor-market rigidities or modernizing tax systems), economic tensions develop – the fixed relationships between units of account become increasingly difficult to maintain until a breaking point is reached and the fixed relationships are irretrievably broken. That is what happened in the early 1930s as various nations abandoned the gold standard (e.g. Britain in 1931 and the United States in 1933). The Euro faces the same threat, with Greece the most likely candidate to first abandon the Euro, returning to the drachma as its national currency.

Abandoning a commodity standard or a common currency effectively represents a shift from a fixed-exchange rate to a floating exchange rate for the country's currency. Almost certainly a new Greek drachma, a new Italian lira, or a new Spanish peseta would be worth less, relative to other currencies, than the Euro, which would make those countries' exports more competitive, to the extent that a potential competitive advantage was not wiped out by more costly imports and/or increased domestic inflation. The immediate effect of a country such as Greece shifting back to its old currency from the Euro would be comparable to a nation with its own currency devaluing that currency relative to other currencies. The country presumably also would become more attractive as a tourist destination, at least for budget-minded tourists.

In many ways, the Euro is comparable to a currency board, an arrangement in which a country ties the value of its unit of account to that of another country, usually a large country with a strong economy. In the Euro zone, the Euro can reasonably be viewed today as merely another name for the German mark. Also, a number of small countries effectively use the currency of a large country as its own currency. For example, Panama effectively uses the U.S. dollar as its currency; the U.S. dollar is legal tender in Panama. Ecuador similarly uses the U.S. dollar as its currency. Arguably, Greece effectively uses the German mark as its own currency. However, because the Greek economy has not kept up with the German economy, that linkage may no longer be sustainable, in which case Greece has no choice but to abandon the Euro.

Abandoning the Euro, though, would be quite painful for a country and its people and businesses, for two key reasons. First, debts such as mortgages and bonds denominated in Euros would have to be abrogated and rewritten in the new local currency to spare debtors from being crushed by repayment obligations in a now suddenly more expensive Euro. This abrogation would be comparable to what occurred in the United States after it abandoned the gold standard in 1993 – the Gold Reserve Act of 1934 abrogated the gold clause in all public and private contracts, a legislative act the U.S. Supreme Court upheld in 1935. One can readily wonder what steps creditors in the weak Euro countries are taking to protect themselves against a comparable abrogation.

Second, owners of Euros in the weak Euro nations, fearful of being forced to convert their Euros into their country's new, less valuable currency, appear to be shifting their Euros to banks in stronger Euro-zone countries, notably Germany, into other currencies, such as the Swiss Franc or the U.S. dollar, or into gold or other commodities. According to a recent New York Times article, Greeks have withdrawn almost 40 billion Euros from the Greek banking system over the last year, equal to about 17 percent of Greek GDP, including 14 billion Euros in September and October.[2] Such currency shifting further exacerbates the liquidity problems in the banks of the economically weak Euro-zone countries while reducing the banks' capacity to lend.

The recent last-ditch attempt to fix the Euro by amending the EU Treaty to impose greater fiscal discipline on the Euro zone, will not work, at least in the short term. First, even if the United Kingdom were to back away from its veto of the proposed treaty changes, it is questionable if voters in other nations which held a referendum about the treaty changes would support the changes. News reports yesterday indicated that there is growing resistance within some non-Euro zone EU countries to the proposed changes in the EU treaty.

Second, the fiscal problems in many Euro zone countries are so deeply embedded that they can not be fixed within a few years – it will be a decades-long process that will not move at a uniform pace throughout the Euro zone. Some of these deep-seated problems are discussed in the following sections of this testimony.

Excessive public debt rapidly expanding due to huge budget deficits.

Excessive public-sector debt is an underlying cause of the weakness in many Euro-zone countries. Worse, that debt is growing rapidly, relative to a country's GDP, due to annual budget deficits. Although the Maastricht Treaty, which created the EU in 1992, established ceilings of public-debt-to-GDP (60%) and annual budget deficits (3% of GDP) for EU members, those ceilings are essentially unenforceable, with the consequence that most EU countries now exceed the public-

[2] Thomas, Landon, "Pondering a Dire Day: Leaving the Euro," The New York Times, December 12, 2011, pg. B1.

debt-to-GDP ceiling. According to IMF data, key Euro zone countries had the following public-debt-to-GDP ratios for 2010: Greece – 143%; Italy – 119%; Belgium – 97%; Ireland – 95%; Germany – 84%; France – 82%; and Netherlands – 64%. Of course, the United States does not look too good by this measure either – with a public-debt-to-GDP ratio of 94% for 2010.

The public debt problem in the Euro zone is worsening rapidly due to large government spending deficits, rising interest rates, and weak economies. According to Eurostat,[3] government deficits as a percent of GDP among select countries were as follows: Ireland – 31.3%; Greece – 10.6%; Portugal – 9.8%; Spain – 9.3%; France – 7.1%; Italy – 4.6%; and Germany – 4.3%. As debt piles up in these countries, due to these large deficits, interest rates are rising on public debt, which exacerbates their deficit and debt problems. Slow economic growth or worse, a European recession, will only make matters worse. Where it all ends is anyone's guess, but a fracturing of the Euro zone has become increasingly inevitable.

Efforts by the EU to hold itself together and to preserve the Euro led to the creation of the European Financial Stability Fund (EFSF) and the growing pressure on the European Central Bank (ECB) to become an even bigger purchaser of European government debt. However, the ECB does not have an unlimited capacity to finance EU governments – it is merely a vehicle for effectively redistributing to the EU weaker countries the creditworthiness of Europe's larger, stronger economies, notably Germany and to some extent, France. However, even Germany has its limits – economically and politically – as to the extent to which it can support the ECB and the EFSF in their efforts to help embattled nations work through their economic problems while struggling to stay in the Euro zone.

External assistance, though, cannot save the day for Europe. The IMF has limited resources since ultimately it is backed by increasingly indebted countries nor can Europe realistically look to surplus countries, notably China and Japan, for substantial funding assistance. The United States, with its substantial outstanding debt and huge budget deficits certainly cannot be tapped to help finance Europe, except for modest IMF contributions.

Restructuring sovereign debt, such as the "voluntary" 50% debt reduction proposed for Greek bonds, may become a necessity, but such debt restructurings could become classified as debt defaults under credit default swaps (CDS), which would trigger huge losses under those CDS contracts for banks, insurance companies, and other parties who provided default insurance on sovereign debt. Those CDS losses would topple dominoes throughout Europe, and beyond. Growing uncertainty among investors about their ability to collect on CDS they purchased on sovereign debt that later defaults is leading to higher interest rates on sovereign debt, further exacerbating the government deficit and debt problem in the Euro zone. Europe's turkeys, in the form of years of excessive government spending, are finally coming home to roost, and they may stay a while.

Banks weakened by excessive holdings of sovereign debt.

European banks are substantial investors in sovereign debt, specifically bonds issued by their home country as well as by other EU countries. There are a variety of institutional and structural

[3] http://epp.eurostat.ec.europa.eu/portal/page/portal/eurostat/home/

reasons that vary from country to country as to why European banks are substantial investors in bonds issued by EU nations, but the Basel risk-based capital standards, which have treated sovereign debt as riskless, certainly increased the incentive for banks to hold sovereign debt.

Unfortunately, there is no such thing as riskless sovereign debt, as Europe is now learning. However, the damage is done, through losses on sovereign debt caused by the recognition of a loss when the debt is sold for less than book value, the debt defaults, or is restructured. Banks also face losses to the extent that they will have to pay out for losses incurred under CDS contracts, should events of default under those contracts ever be declared. All of these losses will deplete the banks' equity capital, rendering some EU banks insolvent.

As a result of recent stress tests, many EU banks clearly need to raise fresh equity capital, but many of them will not be able to demonstrate the going-forward earning power needed to attract that capital. What then? Will undercapitalized or insolvent European banks be allowed to continue operating, as the United States permitted hundreds of insolvent S&Ls to stay open during the 1980s, thereby making a mockery of the Basel III risk-based capital standards now being phased in? Or will individual nations or the EU launch TARP-like programs to invest taxpayer monies in the weak banks, hoping that the banks eventually will be restored to sufficient profitability so that they can raise fresh private-sector equity capital in the capital markets?

One can easily envision many marketplace distortions in the European financial markets over the next few years as the EU and its member countries deal with their banking problems, problems that could grow worse before they get better, should Europe slide into a full-fledged recession. How those distortions spill over into the United States is a question Congress, banking regulators, and the U.S. financial-services industry need to address.

Demographics – an aging population and the entitlements challenge.

A key driver of the EU's fiscal woes is the welfare state, and especially its public pension schemes. This problem parallels the U.S. entitlements challenge of dealing with an aging population and more specifically a growing portion of the population who is retired and drawing a pension, sometimes at a high level relative to income earned during working years. Given the political challenge of extending the retirement age and/or reducing retirement benefits, the entitlement obligations now bearing down on the Euro zone countries suggest that these countries will experience great difficulty in eliminating their budget deficits, or at least trimming them substantially so they can eventually reduce their public-debt-to-GDP ratio. Who will continue to buy the debt of these countries, especially of the most indebted ones, and at what interest rate is at the heart of Europe's fiscal challenges.

Labor market rigidities and other economic impediments.

Another long-term economic challenge facing the Euro-zone countries are labor-market rigidities, which vary from country to country, reinforced by strong labor unions. These rigidities have two key negative effects. First, they increase the difficulty of employers adjusting to changing economic conditions by laying off employees, restructuring jobs, relocating factories, and other labor-related actions which enable employers to improve labor productivity and therefore their competitiveness. This is an especially challenging circumstance in the weaker countries already having to function with a stronger currency than they would have if they had not converted to the Euro. Put another way, implicit in converting to the Euro is adopting those public policies, including labor policies, which will enable that country to compete successfully against other Euro-zone countries in terms of exports as well as import substitution. It is not clear how well that obligation is understood within the Euro zone.

Second, Europe lacks the labor mobility comparable to what has long existed in the United States. To some extent this lack of mobility is a function of language and cultural differences among the Euro zone countries but national labor laws also are widely viewed as impediments to labor mobility. Consequently, pockets of unemployment persist, with their attendant social-welfare costs which adds further to national budget deficits.

A host of other public-policy issues arise in the weaker Euro zone economies that impair their ability to compete and prosper in the Euro zone. Tax systems and effective tax collection are often cited as a contributing cause of government budget deficits, notably in Greece and Italy. Impediments against entrepreneurial initiatives and a lack of venture capital also can be cited. Bottom line, the weaker Euro zone countries have a lot of work to do to enhance their ability to stay in the Euro zone. How many will succeed in doing so is huge question, with global implications.

How a Euro crisis could impact the U.S. economy and U.S. taxpayers

A Euro crisis would slow European economic activity, possibly throwing the EU back into recession. Hopefully that would be as bad as it would get. However, if enough dominoes toppled within the Euro zone, Europe could experience a deep, prolonged recession, or worse. Given the highly interconnected nature of the global economy, U.S. exports to Europe would decline, which would have negative effects on the U.S. economy. To the extent that a European recession triggered a global economic slowdown, which is quite possible, then U.S. economic activity would slow even more, with the U.S. possibly falling into a recession as the European economy sorts itself out. The U.S. unemployment rate surely would rise.

Clearly a slowing U.S. economy would increase the already enormous U.S. budget deficit as tax receipts declined and federal spending related to unemployment rose. There also might be new rounds of stimulus spending. Consequently, the U.S. economy would look more and more like the most troubled European countries – huge budget deficits and a rising debt-to-GDP percentage. It will not be a pretty picture.

Possible U.S. policy responses to a Euro crisis

Unfortunately, the United States has few options for dealing with the Euro crisis – either before or after the Euro zone begins to crumble. At the present time, the best the United States can do is continue urging the EU to work aggressively in addressing its problems in order to hold the Euro zone together as best it can. In particular, the United States should encourage the weaker Euro zone countries to continue addressing their structural problems so as to improve their competitiveness, thereby improving the likelihood that they can remain in the Euro zone. Further expansion of the Euro zone should be questioned while there is so much uncertainty about the future of the Euro.

Given its financial weaknesses, the federal government certainly should not supply any direct financial assistance to help preserve the Euro, such as buying the debt of any of the Euro zone countries. However, I am supportive of the U.S. dollar swap arrangements recently entered into with five other central banks, as noted above. These arrangements provide liquidity, in the form of U.S. dollars, which will help to keep the European financial system functioning while the EU works through its problems.

Four of those central banks – the Bank of Canada, the Bank of England, the Bank of Japan, and the Swiss National Bank – are outside the Euro zone. Given the terms of the swap arrangements, I see no taxpayer risk, as a practical matter, with these four swap arrangements. Swap deals such as these have been done for decades without any loss. Arguably there is a slight taxpayer risk in any swap arrangement with the ECB – it might not return all the dollars it borrowed upon the termination of the swap. However, that is such a slight risk relative to the importance of lending dollars to the ECB that I do not worry about it.

Above all, the United States should take the Euro crisis as yet another wake-up call that the United States must put its economic house in order by trimming budget deficits, gradually reducing its debt-to-GDP ratio, increasing the domestic savings rate, reducing the magnitude of the United States' net-debtor position with the rest of the world, addressing the entitlements challenges posed by Social Security and Medicare, improving its tax system by removing disincentives for savings and investing, and increasingly the economy's international competitiveness. This is an enormous, difficult, and politically challenging task, but it is one that we as a country must undertake, for we are not immune from being laid low by excessive debt and deficit spending, as has Greece and soon possibly other Euro zone countries.

Thank you for this opportunity to testify this morning. I welcome your questions.

Mr. MCHENRY. I thank the panel's testimony. We will now go to questions. I recognize myself for 5 minutes.

Dr. Sanders, let's begin at the beginning The Federal Reserve has foreign currency swaps, it is a normal function of the Federal Reserve for quite a number of years. Explain what that means.

Dr. SANDERS. Well, in a nutshell, what it means is that the Eurozone can actually swap currencies with us. In other words, we send cheap dollars over to Europe and they ship expensive Euros over to the United States.

Mr. MCHENRY. Okay. So why is this an issue to the Federal Reserve in this current environment? Why is this foreign currency swap agreement an issue right now?

Dr. SANDERS. Well, again, it is not being done at parity, which means we are just not providing them, swapping the currencies at a market rate; it is actually a subsidized rate, we cut the rate on it.

Mr. MCHENRY. Okay.

Dr. SANDERS. So, in other words, we are, again, subsidizing Europe for the swap.

Mr. MCHENRY. Okay. So really the issue here is that we have reduced the cost of this exchange and made it below what is the current market rate; therefore, incentivizing the European Central Bank to transact this type of swap agreement with the U.S. Federal Reserve.

So, in light of that, Dr. Lachman, I have asked you this question before, what do you see, in your view, the likelihood that the Euro makes it out of this, that the Euro actually exists as a currency in the medium term?

Dr. LACHMAN. Well, I think you need to distinguish between losing a number of countries and the whole Euro disappearing. I think that it is very likely that within the next year, 18 months, we are going to see several countries exit the Euro, we are going to see countries like Greece, Portugal, Ireland, probably Spain be forced to leave the Euro. But the Euro itself as a currency between Germany and like countries, the northern European countries, probably including France, that is very likely to continue to exist.

Mr. MCHENRY. Let's go across the panel. Dr. Sanders, do you agree?

Dr. SANDERS. Again, as I have said in my reply, I don't think the Euro can be saved. They can save the core, but the fantasy that they can bail out the pigs, whether it is the pig banks or the loans to the pigs, whatever, it is mission impossible, they can't do it, so it has to break up.

Mr. MCHENRY. Okay. Portugal, Italy, Ireland.

Dr. SANDERS. Greece.

Mr. MCHENRY. Greece.

Dr. SANDERS. Spain.

Mr. MCHENRY. Spain. Thank you. Just want to make sure, because Occupy Wall Streeters have a different analysis for what a pig is.

Mr. Elliott.

Mr. ELLIOTT. Yes, I am completely confident the Euro will continue to exist, certainly the core absolutely, and I think it is highly likely that all 17 members stay.

Mr. MCHENRY. Mr. Rosner.

Mr. ROSNER. I think it is likely in the medium term that the Euro continues to exist. I think that it will be difficult to have members exit, but I do expect there to be an exit of some peripheral members within the medium term.

Mr. MCHENRY. Okay.

Mr. Ely.

Mr. ELY. Yes. I think I am generally in agreement with my fellow panelists. I think the weaker countries are going to have to exit, and basically it is the southern tier countries plus possibly Ireland. If they leave relatively soon, despite the problems of transitioning back to their previous currencies, this may actually be positive for them and for the global economy because they will have cheaper currencies, their exports will become more competitive, and this may be, as painful as it is going to be for them to exit, this may be better both for those countries and for the global economy if they leave sooner, rather than later, so they can go through the adjustment process. For the remaining countries in the core, again, they have to address the classic problem of any kind of common currency area, and that is that within any one country the policies are not too far out of sync from what they are in the other countries in that currency area. That is a huge long-term challenge.

Mr. MCHENRY. Mr. Rosner.

Mr. ROSNER. Yes. You have to remember, though, part of the problem that we have watched in the way they have tried to address the crisis thus far is that they have tried to avoid that default from occurring in the periphery by any means. So we have watched attempts to come to voluntary write-downs of debts, of Greece, as example, and tried to do so without it becoming a default in name, triggering the CDS. That is part of the problem of the core, is they don't want to allow it to be called a default because of what that would mean for CDS. It creates a problem, though, in the timing and the delay. We have delayed this. So at the point where Greece was recognized as a problem, the credit was probably trading or should have been valued at about 80; and today we are trying to get 50 percent write-downs, and the truth is the Greek debt is not even worth that. The longer we wait, the larger the write-downs will be, but that is being stymied, the timing of that, by this intent to do everything we can to avoid calling it a default, when ultimately it will end up a disorderly default unless we recognize it as something that needs to happen sooner, rather than later.

Mr. MCHENRY. Now, my time has expired, but the point here, why this is a discussion and why we are having this hearing today, is in light of opening up a below market swap rate with the Federal Reserve and the view that the survivability of the Euro as it currently exists does expose the taxpayer to risk, that is the concern we have today as policymakers and that is why we are trying to have this oversight hearing today.

With that, I recognize Mr. Quigley for 5 minutes.

Mr. QUIGLEY. Thank you, Mr. Chairman.

Mr. Ely, you said something that made me alter what I was originally going to ask. You said it might be better for these smaller countries to be forced out than go through this adjustment period. Are you assuming that they are going to get significant help before they are forced out, or they are just going to have to go through this painful adjustment process to get to that on their own?

Mr. ELY. Again, this is all highly speculative because we haven't had any exits from the Euro before. My sense is that they would not get much help, but what the exiting would do would help in: number one, it would probably lead to the kind of debt restructuring that Joshua was just talking about, but, also, it would enable them to—their currency would be more competitive, their export goods would be more competitive, they would be more attractive for tourism. That is particularly thought to be the case with Greece. And I think that this would allow them to start to turn around their economies.

The alternative, by staying in the Eurozone, is just an increasingly Draconian austerity which potentially can create some very serious political problems. But I think it is like in any kind of bankruptcy situation; at some point in time you have to recognize the reality of it, go through the debt adjustment process and deal with competitiveness issues. And I think that for some of these countries the only way they can do that is by leaving the Eurozone.

Mr. QUIGLEY. If anyone else on the panel would like to chime in. I guess I want to understand more thoroughly, Mr. Elliott, why standing alone would be good for them and what impact it might have on the United States.

Mr. ELLIOTT. I would like to say two things. First is a background point which I would be happy to expand on. You are hearing, in large part, political judgments here. You are hearing judgments as to whether these countries have the political will and capability to deal with their longstanding problems.

Mr. QUIGLEY. And while you are into that, sorry for interrupting, if you could add. It seems to me, from your previous statements, that they have the financial capability of solving this and this is all about political will.

Mr. ELLIOTT. That is certainly my view. If you take the Eurozone as a whole, they have, clearly, the ability to deal with this economically. So then the question is will they take the political actions necessary to do so. As you can tell from my testimony, I am significantly more positive about that than my fellow panelists. One reason for that is I think too often we look at what has been agreed to date and think that tells us what the ultimate outcome will be. This is like looking at the debt ceiling debate here a few days before the agreement and concluding there will never be an agreement because they are so far apart, or looking at the current budget negotiations and assuming that, because we can't seem to agree, the Government will shut down and never startup again.

I think there is very strong political will within Europe to get through this together. They have made a lot of mistakes. I am not trying to say they have been brilliant about this at all. But my view is, when they get to the edge of the abyss, they really will be likely to do what they have to do.

Mr. QUIGLEY. Dr. Sanders, you seem——

Dr. SANDERS. Agitated?

Mr. QUIGLEY [continuing]. Interested in——

Dr. SANDERS. I just want to throw in my two cents and agree with something Josh said.

Mr. QUIGLEY. That is one of our jobs here.

Dr. SANDERS. I think one of the only solutions for them is to write down the debt. But again, that is politically, as Mr. Elliott said, dangerous, but it is also economically dangerous and perhaps impossible. They just came out with a report the other day saying Greece is not following austerity, they are not moving fast enough, in fact, they are kind of dragging their feet. Is that a surprise? Absolutely not. This was predicted a long time ago. So, in other words, any bailout is going to have to be serious. Banks are going to have to take it on the chin, governments are going to have to take it on the chin, and, again, look at the debt loads and government spending of even Germany and France. They have massive social states. They can't do this either, in the long run. Maybe they can do it for a year, but forget it over the long run. There is all too debt-laden and all too big.

Mr. QUIGLEY. Dr. Lachman.

Dr. LACHMAN. I think that the essence of the problem in countries like Greece, Portugal, and Ireland is that these countries are insolvent, and providing them with additional funding isn't a solution. It is not just a question that this is a political problem; it is a problem that they can't reduce those imbalances within a fixed exchange rate system. If they try to do massive amount of fiscal austerity within a fixed exchange rate system, you get the result that we are seeing in Greece, with a country collapsing. When a country's economy collapses, they don't collect the taxes; the debt ratios rise. Greece's debt ratio at the start of the IMF program was supposed to peak at 130 percent. The latest IMF estimates are that it is going to peak at 190 percent of GDP. This country is clearly insolvent. One has to write down the debt and then one has to deal with the problems that that causes for the banking system.

If I might just add one point just in connection with the swaps that the Fed is making. To be sure, they are providing a cheaper credit, but part of the reason for that is the U.S. money market funds have huge amounts of deposits on the banks of the European banks that they are trying to repatriate back home. So by providing those kinds of lines of credit, we are not simply helping the Europeans, we are helping ourselves by avoiding any of these money market funds eventually having to break the buck as they did in 2008.

Mr. QUIGLEY. Thank you. My time has expired.

Mr. MCHENRY. Mr. Cooper for 5 minutes.

Mr. COOPER. Thank you, Mr. Chairman, and thank the distinguished panelists.

I think perhaps the most important question is the simplest: Is this a crisis of the Eurozone or really more of a crisis of the west? As most of you have pointed out that just the trade implications alone mean that we have a stake in this crisis, whether we want one or not. So when you globally talk about taxpayer exposure, we have to remember that countless Americans are shareholders, and they are shareholders in institutions that perhaps have lent tens, hundreds of billions, maybe even trillions of dollars to countries or entities in the Eurozone.

It goes without saying that we share many cultural and other ties with this troubled area, and sometimes unspoken is the idea that the entire capitalist system is built, to some degree, on confidence and leverage and trust. Just a few years ago there was a prominent banker at Citicorp, Walter Wristin, who had the famous doctrine that no sovereign country could ever default. And he was not a creature of government; he was one of the preeminent spokesmen of the U.S. private sector. So things have a way of changing.

Mr. ELY. If I could address that. Mr. Wristin obviously didn't know his history because there certainly have been plenty of sovereign defaults before he made that statement and we have seen them since, and unfortunately they will probably continue.

With regard to the question whether this is a crisis of the west or of capitalism, I think things have become so intertwined globally that it is really a global or potentially a global crisis, and when we look beyond the west, let's say to Japan or to China, to pick two countries in Asia, each of them have some very serious problems; different in some regards, but in Japan, for instance, we have a debt-to-GDP ratio that exceeds, I believe, any country in Europe, and in China I think a lot of people are just waiting for that bubble to blow up. So I think that it is more than just a crisis of the west or of capitalism; I think it comes back to the issue of just too much debt. I believe Josh made that point, that there is just too much spending on the global credit card, so to speak, and that that is what has to be reined in, including in the United States.

Mr. COOPER. Those are all valid points. This is a complex issue. Too much debt generally depends on the ability to repay, and that is itself subject to many different factors. David Walker, the former Comptroller General of the United States, pointed out that, at least according to his measure of fiscal responsibility, of the top 34 nations, that the United States ranks 28th, behind some of the countries in Europe, in terms of our fiscal responsibility. Now, there are different ways to measure this and none of us wants to be unduly alarmist, but we clearly have a lot of work to do in our own country since our own credit rating was threatened this summer for the first time in modern history.

So as we approach these issues, another dimension seems to be almost the longer you wait to deal with it, the more the contagion spreads and the greater the risk to confidence. I wonder almost if we had intervened early with Ireland and Greece or one of these most troubled nations, if the contagion could have been limited. Of course, the origin of all this seems to be excessive debt, inability to repay, promises that can't be kept, and we are certainly subject to that in this country, when so often we even refuse to acknowledge the real debts of our own country, the real obligations.

So I see that my time is expiring. I recall that one person has called for a competition to have the best idea to calmly allow a sovereign nation to default or a sovereign nation to leave the Eurozone. Are you aware of any good ideas in that area so that the dismemberment can be managed in a sensible way, if indeed that is what it comes to?

Mr. ELY. I believe I am the one who made that comment. There actually is a little bit of historical experience with currency arrangements, currency common areas and the like coming unglued. It is not quite, certainly nothing of the magnitude that we have today. It is not going to be an easy process, but I think it comes down to a question of what are the alternatives. As bad as it may be for someone to exit, it is potentially worse not only for the particular country, but for the broader economy, to delay the inevitable, and I frankly think, the more I look at this, the more I think the sooner the problems are addressed the better.

Mr. COOPER. Thank you, Mr. Chairman. I see my time has expired.

Mr. MCHENRY. Mr. Meehan of Pennsylvania for 5 minutes.

Mr. MEEHAN. Thank you, Mr. Chairman. I want to thank each of the panelists for your preparation for this and the remarkable capacity you had to take these complex issues and try to put them down into 5 minutes. That, in and of itself, is a challenge, but this is a sobering issue and I thank you for the work you are putting into it.

Dr. Sanders, you mentioned something that I wasn't quite sure I understood, that there was a discrepancy in the identification of whether some of these commitments were $7 trillion or $1.5 trillion, the Fed disagreed. What is that about and why aren't we getting unanimity about something that fundamental?

Dr. SANDERS. What that is about was the Fed did not disclose the discount window operations, and they still haven't disclosed exactly fine details on it and they have not disclosed their guarantee programs yet. But what happened was, with the Freedom of Information Act, Fox News and Bloomberg asked for the discount window information, it was produced, but the Fed and Bloomberg counted it differently.

Mr. MEEHAN. I think it was Mr. Rosner that used the word opacity, but isn't this the essence? Why are they entitled to be able to keep that kind of fundamental information, if it is tying back to guarantees from U.S. taxpayers, private?

Dr. SANDERS. Well, I think the way I would answer that is I think they are worried about bank runs. So if they don't disclose the discount window, then there is not information out there. Although, again, I would argue the exact opposite. I would say if there is a threat of a bank run, I want to know that information in advance. I don't think the Fed should be putting American taxpayers at risk, although they have lowered interest rates so low that retirees and fixed income households are already getting pummeled, but that is a different issue, so they are getting harmed by the Euro crisis that way. But, again, I think Chairman Bernanke will defend the Fed being secret. I think a lot of these problems would be settled down a little bit if we had made them transparent. They really should be.

Mr. MEEHAN. Mr. Rosner, you used the word opacity. I was struck by that, I made a note on it, and I think that why isn't the European Central Bank being asked to tell who is getting the loans? Or respond to my first question. I am interested in your insight.

Mr. ROSNER. Well, I think it is a great question and I think that part of the problem here is that there is a huge difference between illiquidity and insolvency, and one has to wonder whether part of the reason of the opacity is to protect those who were seen as illiquid from being shown to be insolvent. Okay? And I think that is something——

Mr. MEEHAN. What do you see is the difference? What is the difference between illiquidity and insolvency?

Mr. ROSNER. If you have short-term funding issues, but the assets on your balance sheet actually allow you to be well capitalized over the longer term, you are solvent. If you are fundamentally insolvent, you are insolvent, and no amount of liquidity will repair that, it will just smooth over the market impact of that for the short-term. But this is part of the problem that is going on, is the Europeans have taken step after step to make claims of solvency over institutions that are fundamentally insolvent and mask it in illiquidity or liquidity problems.

Mr. MEEHAN. And would they be principally the countries Italy——

Mr. ROSNER. No, I think it is also the core. I think, as we have seen, you have had problems at Dexia, you have had problems at Commerce Bank, you have had problems at several of the German and French banks, and it is not clear to me that there just is liquidity problems; it seems to me that in some cases there are insolvency problems. In fact, I think we also have to realize that part of the fiscal disciplines that everyone is talking about, everyone is calling for includes getting governments out of the business of providing funding for creditors' benefit on institutions that are fundamentally insolvent. That is a commitment of fiscal resources toward private creditors, as opposed to allowing market discipline to force losses to be recognized by——

Mr. MEEHAN. And what do we do, then, to make those creditors, who I guess are passing on that risk, so to speak, how do we put them back into their appropriate place in the line so that they are the ones who accept both the benefit of the risk, but the impact of the downturn?

Mr. ROSNER. I think to some degree it is by stepping away. It is certainly not by doing what the Troika in Europe did to Ireland, which is force the Irish government to recognize the debts of its banks as sovereign obligations as a way of preventing core banks from having to take losses on those obligations.

Mr. MEEHAN. Would the run on the banks, then, cause there to be an overall run on the whole European system?

Mr. ROSNER. I think there would be runs on insolvent institutions if we had enough information. I don't think that there is a problem if regulators stepped in ahead of that run and shut down or forced good bank, bad bank resolutions of those institutions that were fundamentally insolvent. We would head off the bank runs, as opposed to what we are doing, which is the capital markets keep trying to give information to the European leadership, telling them where the problems are, and the leadership does everything they can to avoid that coming out. We saw a bank stress test in Europe in the spring of 2010 saying that only 7 of 91 institutions had real problems. Now, we have seen since then that that stress test was deeply flawed and inaccurate. We have done quite a bit to cover up insolvency issues in the name of illiquidity or liquidity issues.

Mr. MEEHAN. Thank you, Mr. Chairman. I yield back.

Mr. MCHENRY. I thank you.

Mr. Rosner, I know you detail that in the American financial system in your book, Reckless Endangerment, which is quite a read.

Mr. Welch for 5 minutes.

Mr. WELCH. Thank you, Mr. Chairman, for calling the hearing. I thank the panel.

Is it basically the consensus that Congressman Meehan's question that implied more information is better is a point that all of you agree with?

Mr. ROSNER. No.

Mr. WELCH. Do the others agree with it?

Dr. LACHMAN. Yes.

Dr. SANDERS. Yes.

Mr. ELY. I agree that more information is better, but the key question is how do people and how do policymakers, specifically, react on it. What counts is not what is spoken, but what actions are taken.

Mr. WELCH. So is that a you can't handle the truth?

Mr. ELY. That is, to a great extent.

Mr. WELCH. Let's go to Mr. Elliott. You say no. It is hard to understand—what sounds like what we like; as long as we can confuse voters, we may be alright. But voters don't like that, and rightly so. So why do we have that standard that appears to apply to bankers? Mr. Elliott, you seem to be saying there is some upside to keeping things obscure.

Mr. ELLIOTT. It is a question of balance. That is, I agree in many ways with what Josh was saying, but the problem is, in practice, particularly in the middle of a crisis, it is often very hard to tell the difference between illiquidity and insolvency, so there is a fear that, for example, if you publish the discount window borrowings in the short-term so people know very quickly, that if a bank does borrow a lot of the discount window, which is secured borrowing, they actually bring good assets, generally, to get that money, that if they do that, which is important for liquidity, they will be seen as potentially insolvent.

Mr. WELCH. So let me ask——

Mr. ELLIOTT. So I think most people agree that the discount window, if you do publish it, that you do at least want a delay of time.

Mr. WELCH. So there would be a difference, in your view, if I understand what you are saying, about managing information in the midst of a crisis, where the market may react emotionally and hair-trigger. But what about having systems that allow markets to digest over time in realtime what is going on?

Mr. ELLIOTT. I think if there is enough of a gap of time, then I am definitely comfortable with that. Figuring out what the right gap is is hard, and it is very important not to create a stigma——

Mr. WELCH. Let me go to Mr. Rosner. I don't have that much time, so I appreciate that.

Mr. ROSNER. If we believe that these shareholder-owned corporations have an obligation to shareholders, and we believe that markets can only work efficiently where there is symmetry of information, how can we argue against the disclosure of that information on the belief that there is no such thing as a rational investor who can read a balance sheet, understand an income statement, and know what assets are on a bank's balance sheet?

Mr. WELCH. Thank you.

Dr. Sanders and then Mr. Ely.

Dr. SANDERS. Again, I see Mr. Elliott's point. A delay may make some sense; however, the problem is if you look at many major banks around the world, Europe, the United States, if you mark their books to market on all their asset-backed securities and MBS, they would all be insolvent. So I think that signal is already out there. So under those set of circumstances I don't see the necessity to the Fed keeping everything blind.

Mr. WELCH. Okay, let's go to Mr. Ely and then finish with Dr. Lachman.

Mr. ELY. Just very quickly, I just think in this day and age it is naive to think that you can keep the markets ignorant of what is really going on. There is an enormous amount of chatter that takes place in the money markets and you have the analysts. But the real downside of trying not to disclose information in any approaching realtime basis is rumors develop, so people may make judgments and basically kind of see false negatives in the sense that they will assume that maybe the problem is more widespread or is spread by a particular institution, when in fact it is not. So there is a downside to not disclosing information.

Mr. WELCH. Thank you very much.

My remaining time to Dr. Lachman.

Dr. LACHMAN. I think in the European context the problem is a lot deeper, it is that the Europeans have allowed the banks to keep the sovereign debt of the periphery on their banking books at 100 cents on the dollar, which is patently not correct. So we get the ridiculous result that we had that Mr. Rosner mentioned, that you have a stress test that says all of these banks are just fine because we are assuming that it is impossible for any of the countries to default. So I think that they are not doing a service by being very opaque and actually encouraging the perpetuation of some sort of myth that these debts are in fact going to be repaid.

Mr. WELCH. Okay, I want to thank the panel. Great panel.

Mr. Chairman, I yield back.

Mr. MCHENRY. I thank my colleague.

We will now start a second round and I recognize myself for 5 minutes.

So I guess the question is how large do you envision the swap line? How large do you think it can get? In the crisis in 2008–2009, we hit about $600 billion in the swap line. Dr. Lachman, what is your view?

If you all could just keep it brief on this round.

Dr. LACHMAN. No, I think that you could quite easily go up to $600 billion Euro. You are talking about a European banking system that is huge in relation to that of the United States. You are talking about an economy that is a third of the global economy, that the banking sector is really very important. So the chances of you going to $600 billion, I am just thinking in terms of the amount of money that the U.S. money market funds have parked a trillion dollars, so to get above $600 billion wouldn't seem to me a stretch.

Mr. MCHENRY. Dr. Sanders.

Dr. SANDERS. Oh, I agree with Dr. Lachman. I think, in fact, it could get above that amount and get to the $1 trillion level or perhaps even higher. And, again, the problem is, since we are not seeing what is going on in real time, I know Chairman Bernanke, yesterday, said no plans to bail out Europe, but again, since it is all off balance sheet, we can't see it, I would say that they probably are going to expand the swap lines.

Mr. MCHENRY. Mr. Elliott.

Mr. ELLIOTT. Short answer is I don't know. I am not deeply worried about it, though; the European Central Bank is a very, very good credit.

Mr. ROSNER. I don't think you can know until you have a sense to how they are going to move forward in trying to resolve the crisis, recognize the losses, address it. Obviously, from a dollar funding need in the European banking system today, if we continue on this trajectory, I don't disagree with either Dr. Sanders or Dr. Lachman. But it is unknowable at this point.

Mr. MCHENRY. Sure.

Mr. ELY. I agree that it is unknowable; however, the longer these problems continue and the greater the continued uncertainty about the strength of these banks and their parent governments, then one can easily see the amount drawn under the swap lines going up and up and up.

So what I worry about as much as anything else is the prolongation of it. When is the fever going to break? When will things start to turn around? When will banks be able to resume or be able to fund themselves more in the private markets? That, to me, is what the real key issue is. And until we get to that point where there is greater market confidence in the banks, we are going to see substantial amounts drawn on the lines and maybe even approaching a trillion dollars.

Mr. MCHENRY. Mr. Elliott, let's say the Fed goes beyond simply the swap line, which they have in the last crisis. We are expressing concern now based on our view of the survivability of Europe and the Eurozone as it is currently constructed. What if they go beyond that? What policy options do you believe the Fed has in the event of even greater stress in the European financial markets? Throw out some scenarios that you could envision happening.

Mr. ELLIOTT. Sure. The scenarios I am going to throw out, I think, are extremely unlikely, and I don't think we would probably want them to do it. I mean, look, the Fed could do the same thing. Actually, I haven't checked legally, but I imagine that they could do the same thing that the various central banks in Europe are doing, which is find a way to get some money into the IMF, for example, or find a way to loan money to the European Financial Stability Fund or something like that. But I just don't see, nor do I think it would be desirable, for the Fed to be putting money directly into any of these rescue funds.

I think mostly the Fed is at the limit of what it can do directly as regard to Europe. Obviously, it could do more monetary stimulus here to deal with concerns about Europe, but I don't think there is a lot of room to do things.

Mr. MCHENRY. And European banks that have a presence in the United States already have an open line with the Fed as it stands now, with their open markets function, because they too are American banks, have a presence here.

Mr. ELLIOTT. Exactly.

Mr. MCHENRY. Could you envision the Fed purchasing American-originated assets held by European banks? Could they do that?

Mr. ELLIOTT. I believe they could. I think it is hard to imagine unless they were making the same opportunity available to other banks to sell the same kind of assets.

Mr. MCHENRY. Okay. But American-originated, I mean, that would be sort of the nexus there.

Mr. ELLIOTT. Yeah.

Mr. MCHENRY. Could you imagine a TALF-like facility for European assets, European bank assets?

Mr. ELLIOTT. I think if the assets are U.S. assets, yes, I could imagine doing another version of the TALF. If the assets are basically European-based assets, it is hard for me to imagine us doing that.

Mr. MCHENRY. Okay. I am just asking scenarios because the range of options. What we saw the Fed do in the last crisis, and to Dr. Sanders' point, this question about was it $7 trillion or was it $1 trillion or a trillion and a half, the real question that the average American citizen has is what is the Federal Reserve doing. So this lack of information means that many Americans will just simply fill in the blanks on what happens in that black box.

To Mr. Rosner's point, which is a bank's actual assets, as a stockholder of a bank, it is hard to tell if the bank is doing great or awfully or what the range is in between. So that lack of information, that is the reason why I want to at least have some scenarios, so we are not completely surprised by the Fed.

Mr. Rosner.

Mr. ROSNER. I was just going to say in the short-term it doesn't seem like the Fed is going to have to take a lot more action than they have done with the swap line, in part because, again, in an attempt to kick the can down the road, we have seen the European Central Bank offer 1 percent money for 3 years to their banks.

It seems increasingly likely that the way they are going to deal with sovereign debt auctions next year is banks within each sovereign nation are going to be increasingly called on to be the large purchasers of those issuances, which has negative implications for economic growth and for the overall economies on the other side, as much as they are helpful in the short-term. But I would think that the approaches to kicking the can actually are going to, in the short-term, ameliorate much further need for U.S. involvement, or Fed involvement, I should say.

Mr. MCHENRY. Because the ECB will actually do what is necessary or will it be the policymakers that are kicking the can down the road?

Mr. ROSNER. Well, the policymakers are kicking the can and the ECB is, at this point, trying to step back from the fold and the pressure of stepping in. I think ultimately they will end up folding and stepping in in a large way.

Mr. MCHENRY. Well, my time is expired. I now recognize Mr. Meehan for 5 minutes.

Mr. MEEHAN. Thank you, Mr. Chairman. Where do you jump in with all of this?

We are talking here about monetary policy sort of in the current situation. Is there anything that is being implicated here by a failure for certain of these countries to really adopt austerity measures that may be able to address some of this, or do we need to continue the sort of IMF support and otherwise to sustain it from a meltdown? Anybody can jump in on that.

Dr. SANDERS. I will start off. Again, to start off at the top, bear in mind that Commerce Bank is in deep problem in Germany, Dexia is gone, Credit Agricole in France. If we have any of these write-downs, it is just going to sink the European banks, which will then result in who is going to come to the rescue. I just don't think this is a solvable solution. Greece, there are riots; Italy, there are riots about austerity.

Mr. MEEHAN. Right.

Dr. SANDERS. I just don't think it is solvable. Again, it is not a liquidity problem; it is definitely a problem of the fact that they are all insolvent. The Titanic sank in a highly liquid environment.

Mr. MEEHAN. Well, then if that is the conclusion, then are we just—if we kick this can down the road, so to speak, when is the day of reckoning? Dr. Lachman.

Dr. LACHMAN. The trouble is that the road is getting shorter. We can't keep kicking this can down the road. My view is that we are going to come to some resolution fairly quickly. It is difficult to see how you can string this along for another year given the state of the economies, given the political resistance to adopting different measures. The point is that a number of these countries are insolvent, but the second point I would make is you are talking about huge amounts of debts in question.

So if we just look at Portugal, Greece, Ireland, we are talking about a trillion dollars. If you add in Spain you are talking about another trillion. If you throw in Italy you are talking about another two trillion. We are talking about $4 trillion that is going to have to be written down at some stage, so that is going to have a huge impact on the European banking system when that occurs. And given the interconnections between the European banking system and the U.S. banking system, it is very difficult to see how the United States avoids a financial crisis if you do get Europe playing out in a bad way.

Mr. MEEHAN. And what would be the specific implications on the United States from that scenario?

Dr. LACHMAN. Well, the specific impact on the United States is that U.S. banks would be put under huge amount of stress, that you would have a credit crunch in the United States, the United States would go into a meaningful recession. That would compound the problems. I think that the way to look at it is like what occurred in the United States during the Lehman crisis.

Mr. MEEHAN. That is what I was going to say. We are right back where we were before, right?

Dr. LACHMAN. The same way as that ricocheted around the world, now what we would be having is we would be having a crisis where the origin was in Europe, the world's third largest economy, a much larger economy than that of the United States. That would have reverberations through the globe and the United States would be impacted.

Mr. MEEHAN. Mr. Elliott, then Mr. Rosner.

Mr. ELLIOTT. Thank you. I just wanted to say, to give you a wider view, I think that the countries that much of the panel here thinks are insolvent aren't necessarily insolvent. Greece, clearly. But Italy, for example, Italy, this year, is going to run a primary surplus, meaning that absent the interest payments, it is actually in surplus. It has had, in the past decade, a number of years in which the primary surplus was 4 percent or 5 percent of GDP.

Mr. MEEHAN. What is that attributable to?

Mr. ELLIOTT. Basically, in the last decade or so they have managed their deficits much better than they had historically, and certainly far better than us. In the last decade, they had deficits—and these aren't primary, these are actual deficits as we normally look at—they have had deficits lower than Germany over that decade, lower than France. So my point about the politics earlier is assuming that Italy is insolvent essentially assumes their political system is so bad they can't find a way to pair a few more points of GDP off of their deficit; and they have shown in the past they can, even under worse political environment.

Mr. ROSNER. Two things. First of all, just in response to this, you have to remember that we are talking about the problems in Europe that we are talking about with the backdrop of the past 3 years having had decent growth in the Eurozone, and that is over. They are heading into recession. Even the core is going to be suffering that.

Second, though, I think it is important to remember the more recent European bank authority stress tests and the agreement that the banks raise core capital to 9 percent by next summer are being done in a way that is even more damaging to growth and is going to put more risk——

Mr. MEEHAN. Because there is going to be less capital out in the European market?

Mr. ROSNER. Well, because rather than forcing them to, in short order, regardless of the dilution, issue equity to raise real capital, we are giving the banks enough time that they are going to try and get there by reducing their books, by de-leveraging; and that deleveraging is going to create further problems, kicking the can further and shrinking growth further, as opposed to forcing dilutive equity raises, which should be forced. That is where the capital should be coming from, the markets, regardless of price right now.

I would point back to our crisis. Had we forced Freddie Mac to raise equity in January and February 2008, and not accepted their arguments that those would have been highly dilutive capital raisings, we might not have ended up where we ended up. Instead, we allowed it to string along, and that had a zombie institution that was fundamentally increasingly taking risks, with less economic returns on those risks, to cover up or try and hide the problem.

So we are now partaking in a game of allowing the European banks to get their house in order by reducing credit availability to the Eurozone, instead of forcing them to dilute shareholders'——

Mr. MEEHAN. That is going to have an impact as well on the overall ability for that economy to——

Mr. ROSNER. Absolutely, which is why I find it so offensive that we are supporting policies that put the burden on taxpayers rather than on equity holders, preferred holders, subdebt, unsecured creditors, rather than in manners that allow them to negatively impact the economy in another way, which is the de-leveraging.

Mr. MEEHAN. Mr. Ely, you have some thoughts?

Mr. ELY. If I could just put another angle on this. The problem in many of the European countries, particularly the weaker ones, isn't just the current level of debt and the debt-to-GDP ratio, but it is the ongoing deficits, many of which reflect structural barriers in the economy, entitlement programs, early retirement, and so forth. So these countries are in a situation where it is not only at a high debt level, but it is a debt level that is continuing to rise, so these countries not only face the challenge of rolling over existing debt, but also having to borrow more and more in order to finance the continuing——

Mr. MEEHAN. That was the implication of my question about austerity. Is that what you are talking—that is the language I used, austerity, but are you——

Mr. ELY. Right. Now, it gets worse than that. When the austerity starts kicking in and unemployment starts rising, you have a shrinking GDP, you are going to have shrinking government receipts, increased spending. So the financing needed in an absolute sense goes up, and what we are starting to see in some of these countries now are increasing interest rates on government debt as they try to roll it over, and the question then becomes one of when will some of these countries hit the wall and they simply can't roll all their debt.

We got a little bit of a wake-up call on that a couple weeks ago when Germany could not sell all of some 10-year debt that it came to market with, and where I think the real crunch comes is when a country has debt coming due and it simply can't roll it over at any interest rate; the markets won't buy it. This is essentially the same as a bank not being able to roll over its funding. And then that is when the real crunch hits and you get an honest to God government debt default.

Mr. MEEHAN. When we get default, we get hyperinflation, what will be the result?

Mr. ELY. Well, I don't think we can have hyperinflation because governments don't pay their bills in currency anymore. But I think what happens is that governments, I would think, would be in a situation where they just would have to cut back on the payments they make, whether they cut back on social security or pension payments or whatever. And again going to a point that I think Josh referenced earlier, that is when you start to see the riots. So I think that that is a very, very serious concern, when these countries simply can't not just roll over their debt, but also finance the ongoing deficits.

Mr. MEEHAN. Mr. Chairman, I yield back.

Mr. McHENRY. This was an amazing exchange and fascinating, fascinating discussion.

Mr. Rosner, you mentioned in your testimony and you have mentioned a number of times you believe many of these European banks are insolvent, so to that point the ECB actually levied a penalty in order to force European banks to pay off the swap line, the Fed swap line. Would that be an indication of insolvency, that they are using short-term paper for long-term debt?

Mr. ROSNER. It could be, but it could be just, on the other side, that could be just liquidity. Depends on the funding of assets. It depends on the assets. So it is unclear, which is, again, part of the reason it would be nice to understand who was drawing, so we could then actually trace it back, take a better look at the assets that they have, if we got those disclosures, to see what they are funding.

Mr. McHENRY. But at a time when the Fed——

Mr. ROSNER. And, by the way, it would be nice to be assured that the Fed knows who is drawing on the swap lines and what the assets are that the ultimate borrower from——

Mr. McHENRY. Actually, to that point, Mr. Elliott, do you agree that the disclosure of those swap lines would be helpful?

Mr. ELLIOTT. I am of mixed minds about it because the thing is our swap is with the European Central Bank. That is our credit risk. It is up to them what they do with that. Now, the reason I might agree that it would be useful is, to the extent that we are deliberately helping them with their policy, I could see a desire to know what they are doing. But I don't know what we need the level of detail that is being asked for in terms of that.

Mr. McHENRY. Even with our U.S. banks have risk, counterparty risk associated with that?

Mr. ELLIOTT. I mean, that we would want to know in general, obviously. We would want our banks to have reasonable information about the situation of their counter-parties. But there are multiple ways to get that information, it doesn't necessarily have to be knowing whether and when they have been using the swap line.

I might also add the dollar is the world's currency. The fact——

Mr. McHENRY. And we are hopeful to retain that.

Mr. ELLIOTT. I would love to retain that too. The fact that there are European banks who have trouble getting enough dollars in this environment, as Joshua was saying, might be a problem of solvency, but it might very easily not be. I would worry that, again about the stigma issue, that in this environment that investment managers who want to keep their jobs by just not taking chances would look at the information and say, oh, good, those guys use the swap line; I better just stay away from them because staying away from them won't hurt me that much and being there, if it turns out they go under, means I lose my job.

Mr. McHENRY. Well, we are only disclosing—I think the Fed discloses 2 years after the fact on this, so is it a year, is it 6 months? But it certainly——

Mr. ELLIOTT. I don't have a problem with something like 2 years. I thought you were talking about in this case with the ECB——

Mr. McHENRY. Well, we don't even know with the disclosure of $600 billion with this swap line, at the height of the crisis, we don't even know where that went. That is really the crux of this discussion; that is the reason why that came up.

Mr. Rosner.

Mr. ROSNER. Yes, I just wanted to say whether the Fed discloses the information or not, I can't imagine why the Fed wouldn't and shouldn't demand of the ECB to know who is ultimately drawing upon those lines so the Fed can see whether their swap lines, which were intended to provide liquidity in dollar funding markets, were being used to prop up insolvent institutions. Whether that is disclosed broadly or not to the public is an area that I think deserves debate. I know where I fall on it, but I can understand the arguments on both sides. That the Fed should not want that information for their own analysis, for their own prudential purposes doesn't make sense to me.

Mr. MCHENRY. So here is a broad question. What is the American financial system's exposure to Europe? Because the question is if we have an extraordinary exposure, then we have an extraordinary policy desire to bail them out in order to save our institutions.

Mr. ELLIOTT. The BIS figure, Bank for International Settlement, says that our banking system, not insurers and pension funds, but the banking system has about $2 trillion of credit exposure of various kinds to the Eurozone, or 2.7, I think, and 2 to the U.K. or I may have the two reversed. I usually roll the U.K. into this because it is so closely tied in with the Eurozone.

Mr. MCHENRY. Even though they are trying to extricate themselves.

Mr. ELLIOTT. Exactly. If you combine those, that is about $5 trillion. But, again, that doesn't count some other parts of our financial system.

Mr. ELY. Could I add to that?

Mr. MCHENRY. Sure.

Mr. ELY. Talk also in terms of what I will call direct exposure, as Doug was talking about, and then what I am going to call an indirect or macro exposure, and that is that if Europe really blows up, and I certainly hope it doesn't, but if it really does blow up and they get an enormous economic contraction in Europe, that is going to have dramatic global effects on the macro economies, certainly on the United States; and then you ask what kind of new problems does that create for the U.S. financial system and the banks, for instance, with regard to house prices.

Will we have rising unemployment? So we have to be cognizant not only of what I will call the direct balance sheet risk, but then the indirect, but potentially very expensive, macro economic indirect risk.

Mr. ELLIOTT. Some of which we are already seeing as the dollar continues to strengthen, right? The dollar strengthening is going to have a negative impact on the export markets; it will, on the other side, have positive impact on some of our domestic asset prices, as capital flows back into the country. So it is very hard to quantify.

I would just point out that when we keep throwing out this multi-trillion dollar number, that we also have to remember that that is a total exposure. You need to net out of that private capital and private capital structures, which I think at some point we are there with a priority of capital for an understanding that that was risk capital. That capital may end up being wiped out and needs to be backed out of those assumptions, because I am not sure it is necessarily prudent for us to consider that obligations that the Government really needs to consider, as opposed to private creditors and shareholders to consider.

Mr. MCHENRY. Dr. Lachman, do you want to follow up with that?

Dr. LACHMAN. Back to a point that Mr. Rosner raised, which I think is crucial. The idea that the European banks do have an enormous hole in their balance sheets. The IMF has estimated that number is at least something like $300 billion, and what that is producing, because of the way in which they are letting the banks get to the capital ratio of 9 percent by June, is they are going to have a capital production, they are going to be reducing credit to the tune of something like $2 trillion over the next year.

When you have that kind of credit contraction at the same time that you are asking the countries to engage in massive fiscal tightening, it is the equivalent of tightening monetary policy, tightening fiscal policy in the middle of economic weakening. That is a recipe for deep recession, and that is the reason that I don't think this can work.

Mr. MCHENRY. Dr. Sanders.

Dr. SANDERS. To build on what Dr. Lachman said, the ECB announced, I believe it was yesterday, that they are going to modify capital requirements for the banks in Europe. Why? Because they see credit contraction being very serious, as we just saw here. And so what that probably means is they are going to require less capital, which again just makes the financial institutions more risky, which will eventually put American taxpayers at more risk. This is kind of a never-ending game.

Mr. MCHENRY. Well, they were thinly capitalized going in, because Basel said if you are holding sovereigns, there is no risk associated with it. It is kind of a fascinating situation. So there are so many questions about this.

Dr. Lachman, you mentioned the exposure through money markets. We had one money market, one fund that broke the buck. Most investors don't quite understand what a money market fund is, it is not FDIC insured. And part of what happened in the crisis is actually making that worse in people's mind, that there will be some government savior of the money market fund. What is that exposure to the European financial system, all money market funds to their European financial system?

Dr. LACHMAN. The estimates made around about June by the Fitz rating agency suggested that U.S. money market funds had around about 45 percent of their funds on deposit with European banks. The money market industry is something like an industry of $2.7 trillion, so if you take 45 percent of $2.7 trillion, you are well over a trillion. What has occurred in recent months is that they have brought down that exposure to 35 percent. But that is still a very large exposure.

Mr. MCHENRY. Mr. Rosner.

Mr. ROSNER. It was, as recently as, if I recall, 12 or 18 months ago, over 60 percent, but a lot of that was peripheral economies in Europe. There is almost no exposures to peripheral economies at this point by U.S. money market funds, it is almost all the core, with some smattering, until recently, of Spain and Italy.

Dr. LACHMAN. Yes, but I don't take much comfort in that argument, because if the banks in the core are exposed to the periphery, then so are the money market funds exposed to the periphery if they have deposits on with the core.

Mr. ROSNER. I agree completely with that point and would suggest that I made it just to point out that this is not a peripheral problem, as it is constantly being fund; it is a problem of the core banks as much as it is a problem of anything else.

Mr. MCHENRY. So, okay. Mr. Elliott, you mentioned in your opening three out of four chance basically that the Euro will survive, to paraphrase you. Give me your view on Greece remaining in the Euro. Give me your percentage chance that they are still in the Euro a year, whatever the timeframe is you want to choose.

Mr. ELLIOTT. Sure. And just to clear up any potential confusion, the three in four probability that I put out, which is obviously a quantification of an intuition, because this is very, very hard to know. But what I meant was more than just the Euro surviving, but that there would be no defaults beyond Greece. So I meant it stronger than you may have seen that.

Mr. MCHENRY. Oh, okay.

Mr. ELLIOTT. And then in terms of Greece staying in the Euro, I actually think it is pretty likely that Greece will stay in the Euro in that there are a lot of advantages, even with defaulting, which they clearly are going to do, whatever it is called, there are a lot of advantages to staying within the Euro. Now, I know Dr. Lachman very much disagrees with that, but there are pros and cons. Most of the people I talk to feel that Greece will actually try very hard to stay in the Euro.

Mr. MCHENRY. Okay, but since Greece has become a modern country, the last 150, 170 years, they don't really have a great track record on paying people back. That is just history.

Mr. ELLIOTT. They are defaulting. There is no question they are defaulting. I am saying that is a different thing from pulling out of the Euro.

Mr. MCHENRY. So it is a matter of what they call it and when it happens is what you are saying?

Mr. ELLIOTT. Yes. I don't think there is anybody on this planet at this point that thinks the Greeks are going to pay back 100 Euro cents on the Euro on their debt. We know that is not going to happen. And then, as has been pointed out, there has been this rather dangerous thing of trying to arrange it so it doesn't technically act as a default, which I think has done terrible damage to the credit default swap market.

Mr. MCHENRY. And everybody agrees on that on the panel? Does anybody disagree that the harm in the credit default swap market is serious when we have this type of action? Okay.

So about Greece, so everybody agrees they are going to default, is that true? Okay. Now, it is a question of what they call it when it happens. Is that really the question?

Mr. ELLIOTT. And how much.

Mr. MCHENRY. Okay.

Mr. ELY. And if I could add to that, to what extent are the issuers of CDS going to have to take a loss. And then you get into—this is where another set of dominoes could start toppling, in terms of where is the CDS risk on the German debt and how are those losses going to hit, and who are they going to hit; and I assume it is not just banks, but insurers and insurance companies and other types of institutional risk takers. And that is unknown, from what I can tell.

Mr. MCHENRY. Dr. Lachman.

Dr. LACHMAN. I think when you are discussing Greece defaulting on its debts and having a disorderly default that might involve writing down the debt by 70, 80 cents on the dollar, what you also have to take into account is the contagion effect that that is going to have through the rest of the periphery. The European Central Bank, for the past year and a half, has been trying to fight the idea of default. Because they know that if Greece defaults, what you are going to have is the Greek banking system wiped out, you are going to have capital controls, you are going to have runs on banks, and all the rest that will set an example for depositors in Portugal, in Ireland, and so on.

So it is very likely that if you do get a disorderly Greek default, you are going to get real pressure on the rest of the periphery that is going to cause a chain of defaults, and that is the reason that the European Central Bank has been putting up this fight, which I am pretty sure that they won't when—in the case of Greece it is really a matter of time; we are talking about months, if not weeks before this event is going to occur.

Mr. MCHENRY. Now, I have heard the one theory that they just need a current account balance, then it is absolutely in their national interest to simply walk away from their debt, as long as they can cash-flow their government, in essence. Is that similar to your point of view?

Dr. LACHMAN. But it is a question that Greece is not in a position to pay the debt, that what is occurring is that over the last 2 years Greece's GDP has contracted by 12 percent, the unemployment rate is at 18.5 percent. Their economy is literally now in free-fall. That is eroding their tax base. They can't meet the budget target, so they have to do more austerity, and the people are out in the streets.

Greece is not in a position to take more fiscal measures, and at that stage it is very difficult for the IMF to keep throwing more and more money at a country that is palpably insolvent. That is the point at which Greece defaults, and we are not far away from it. There is a new government; there are going to be elections in Greece around about February, middle of February, end of February. I would expect that round about that time that you will see Greece leaving.

Mr. MCHENRY. So, with my accent, that would sound like doom and gloom, but you make it sound more upbeat. I am only joking.

So, Mr. Elliott, you believe the IMF doesn't need further capitalization. There is this authorization within Dodd-Frank that has been discussed that Treasury could authorize another $100 billion for the IMF and they have that legal right; the administration would just simply have to make that decision. But your view is that the IMF is fully capitalized enough to take on what you would view as sort of the crest of this crisis in your scenarios.

Mr. ELLIOTT. That is my view in the sense I believe this has to be basically solved in Europe. I think it is very useful to have the IMF bring in enough funds to be a serious player, but I don't think that takes it beyond its present resources.

Mr. MCHENRY. What is that dollar amount?

Mr. ELLIOTT. Well, they have $390 billion now that is available and they will have more if the various central banks within Europe do contribute to the IMF.

Mr. MCHENRY. Does anyone on the panel disagree? Dr. Lachman.

Dr. LACHMAN. I think that if you look at the amount of money that the IMF would have to provide to Italy and Spain if they did the same thing as they did to Greece, Portugal, and Ireland, you would be talking about $750 billion for Italy alone, you would be talking about another $400 billion for Spain. The IMF simply does not have that kind of money.

I totally agree with Mr. Elliott that the onus of sorting this out should be Europe, it should not be the U.S. taxpayer. What the Europeans are trying to do is they are trying to loan money to the IMF, get a claim on the IMF and have the IMF loan money to Italy, which would put the U.S. taxpayer on the hook for 17.75 percent of whatever the size of the loan is. I think that that should not be permitted.

Mr. MCHENRY. Now, the opportunity for China to inject themselves in the IMF and put forward the equivalent amount in order to take on that sort of crest, another $200 billion, let's say. Is that sort of in your range of options that are likely?

Dr. LACHMAN. Well, that could very well occur, but you have the same problem as you do with the Europeans lending to the IMF: if the loans are made in a form that China has a claim on the IMF and the IMF then goes and uses that money to lend to Italy, the U.S. taxpayer is exposed to that loan to Italy as a shareholder having 17.75 percent in the IMF. The way that those loans should be made is they should be made through an administered account where the IMF is just a conduit and it doesn't expose the shareholders to any risk of those loans.

Mr. MCHENRY. Mr. Ely.

Mr. ELY. Yes. One of the things that I think we have to do is step back a little bit and realize that, whether it is through the IMF or other lending facilities, you essentially have governments, either directly or through the IMF, becoming funders of these really deeply indebted countries. In other words, the private market pulls back, governments step into the void and fill it.

But as I mentioned earlier in an earlier reply, you still have these ongoing deficits in these countries, so all this does is kind of keep the ship afloat for a little bit longer. We are kind of bailing faster, but the ship still has big holes in it and is sinking.

So the question is do you have enough time for these liquidity provisions to enable these governments to make the structural reforms they need and get back on track? And I don't think the liquidity can keep things afloat long enough for these countries to make those changes. Plus, we are seeing backsliding in Greece, for instance, as has mentioned earlier. So the question is are we really solving anything or are we just digging a deeper and deeper hole with now the taxpayers, not just the United States, but elsewhere, increasingly at risk as we try to protect creditors by the governments being, if you will, taking out, if you will, paying off private sector creditors that have lent to these countries.

Mr. MCHENRY. All right. Thank you.

I now yield to Mr. Meehan, and we will finish after that, just so the panel is aware of our timeframe. After his line of questioning, we will finish.

Mr. MEEHAN. I thank you again for your very interesting testimony.

Mr. Ely, what you were just discussing, wasn't Dr. Lachman, didn't you, in your testimony, more or less suggest that the combination of austerity and the growing challenges in Greece make them incapable of taking on more right now? We are starting to see this, potentially, then, those same demands, as we talked about austerity, if you move them into Ireland and Italy and other kinds of places, this just becomes a cascading effect. Is that what we are seeing?

Mr. ELY. I will let Desmond speak for himself, but I think that is a very serious risk in the most indebted of the countries who are experiencing the greatest degrees of austerity with all the negative consequences, that of rising unemployment and declining tax receipts and increased government spending. It just means that the current deficit in these countries just continues on, and that means that they have to borrow more, their debt-to-GDP ratio goes up. The question is how high can it go before they simply can't roll over existing debt and fund next month's deficit.

Dr. LACHMAN. I would say that the problem certainly extends beyond Greece, that countries like Portugal and Ireland are in not that much better shape than Greece. Italy and Spain, their positions are stronger than that of Greece, but they conceptually have to do the same sort of thing that Greece had to do, which is tighten the budget by a large amount. We are talking about 2 percent of GDP in Italy in 2012, again in 2013, again in 2014. And as Josh Rosner was pointing out, they are having to do it in the context where there is a credit crunch and where there is a deterioration in the external environment. So it remains to be seen whether countries like Spain and Italy can withstand many years of fiscal austerity, declining growth, rising unemployment, calls for more austerity. The social fabric generally doesn't hold up well to this.

It is just of note that already relatively, early in the crisis, we have seen five governments fall in the five affected countries, so I am not sure that they can stick to this road of austerity and very poor economic outlook for a very long time, when it would be perceived that the reason that they are doing it is to keep the banks in France and Germany afloat.

Mr. ELLIOTT. May I make one quick point?

Mr. MEEHAN. Sure.

Mr. ELLIOTT. Each of the governments that fell was replaced by a government that was more favorable to the austerity measures.

Mr. MEEHAN. I just really have two other questions. We have talked a lot about this in the context, as I have been following this, Europe having to deal with its internal crisis and its relationship back to the United States because of our involvement with supporting the IMF and, therefore, assuming some of this responsibility.

I also take from this that we are worried about the recessionary implications on our own economy if we have problems in Europe. How about other thriving economies, the Asian economy, South America? Are we watching them being isolated in any way or are they similarly going to be impacted by this and effectively we are seeing the front end of a global recession? And please jump in.

Mr. ROSNER. I think it is an important point to raise because I think that is another piece of it. Large portions of the Chinese economy are funded through European banks. Europe is obviously China's largest export market. Much of the South and Central American economies are funded also through European banks. So it definitionally is a global crisis. How deep it impacts various parts of the globe are obviously going to be different and dependent on the outcomes here. But it certainly is worth considering as far more than just a European crisis, especially since many of those economies to which we export, to the degree that we do, get their funding from Europe.

Mr. ELY. If I could just add to that. I think it is not just a funding issue, but particularly for China it is ultimately a social unrest potential because, again, they export so much to Europe and, of course, the United States, and if we have a slowdown in both the United States and Europe, that is going to have a negative impact on China and on its level of employment.

And I have always been concerned about China being somewhat of a tinderbox. It is amazing how often we read of local disturbances in China, so there is a fabric there that is not as socially strong as it is in this country. So I think we do have to be worried about those secondary and tertiary effects, and particularly in China, since it is such an export-driven economy.

Mr. MEEHAN. My last questions relate to points that I wasn't really able to fully understand. As I was listening to American exposure, it largely was discussed in the context of our participation in the IMF. How about some of our other institutions, and how does that relate back to the typical American investor, the guy who buys into a money market fund, whose retirement is dependent, to some extent, on these kinds of things?

So my questions relate to how does the everyday American who has some portfolio of investments going to be impacted by these things and do we have impacts on our pension funds or any other kinds of insurers like we had with AIG that aren't really being considered or being discussed as much, but may have genuine exposure? This is the last question that I have.

Mr. ELY. I will take a stab at that. Ultimately, individuals are the owners of the economy. There are various levels of financial institutions, and you have rattled off insurance companies, pension funds, and so forth. To the extent that there are capital losses borne by American financial institutions, that is going to reverberate back to individuals either in terms of losses in their own portfolio, a hit on, let's say, corporate pension funds, union pension funds.

It could be across a broad range of financial intermediaries, but ultimately that loss is going to come back to individuals and families in this country, it is unavoidable. There is no someone standing behind the curtain that is going to absorb those losses; they come back onto us, everybody in this room.

Mr. ELLIOTT. And if I could emphasize a point Bert made earlier that I am sure we all agree on, the indirect effects will be larger. If you think about what it would be like to go through another recession after we are still in this very slow recovery, that is going to be an even bigger effect than the direct market impacts.

Dr. SANDERS. And I want to add one other thing. I do agree with Mr. Elliott, but if you look at my Figure 11 in my presentation, the Fed is literally out of bullets. We are not going to have really a great ability for the Fed to step in and provide any sort of intervention, or the Government issuing more treasuries. This doesn't affect GDP anymore; we are kind of numb to further Government intervention. So now we are in a rock and a hard place.

Mr. MEEHAN. Well, on that bright note, Mr. Chairman, I yield back.

Mr. MCHENRY. I thank my colleague, Mr. Meehan. Thank you so much.

Now, I said that was the end of the questions. I have one more, if you don't mind, and we will just start with Mr. Ely and go across. Tomorrow we will have President Dudley of the New York Fed, we have the individual of the Federal Reserve Board downtown here who deals with international markets, we also have a representative from Treasury. I know it is a long commute from them; they are even closer than the Fed and certainly closer than New York. But what questions would you ask tomorrow? What question, if you had to boil it down, would you ask in tomorrow's hearing?

Mr. ELY. The question I would ask is, ladies and gentlemen, how is this going to play out over the next 6 months to a year? Now, I don't expect you to get a very candid answer, but I think that that is the question. What are various scenarios as to how this situation will play out over the next 6 months to a year and what are going to be the feedback effects on the U.S. economy?

Mr. MCHENRY. Mr. Rosner.

Mr. ROSNER. I provided specific questions in my testimony.

Mr. MCHENRY. Yes. What is your number one?

Mr. ROSNER. Well, what comfort do they have that 17 countries, each with different political dynamics at home, are going to be able to come to a solution and what is the purpose of their policy tied to that, short-term, medium-term, long-term? What is the Fed's policy purpose here in an environment where, while most of the 17 leaders actually do have some agreement as to what they would like to see have happen, they have very different social dynamics in their home countries with their population of constituents, making it difficult to achieve that. So what is the purpose of Fed policy and Treasury policy in the short-term, in the medium-term, in the long-term as it relates to the single currency?

Mr. MCHENRY. Okay.

Mr. Elliott.

Mr. ELLIOTT. I think if I had one question, I would ask them to talk about the solvency versus liquidity question. Do they believe that the weaker countries in Europe, X, Greece, are suffering from a liquidity problem or is it a solvency problem? And I assume they are going to say liquidity. And then the followup question would be how do you come to that conclusion.

Mr. MCHENRY. Dr. Sanders.

Dr. SANDERS. I would ask the question, if you had one bullet left, would you use it for the American economy? Not to shoot ourselves, I mean to help us out. [Laughter.]

Or would you use it for Europe? And then for the Treasury, which I would be most interested in hearing, I want to hear their assessment. And I agree with Dr. Lachman, I have the same calculation, $4 trillion is really the tab to really bail out Italy and those peripherals. And if we are talking about $100 billion of the additional $200 billion, is that like throwing the money away or is this going to end up being a much, much, much bigger amount? And I don't want to say that will never happen. Come on, we have already seen a lot of bad things happen.

Mr. MCHENRY. Dr. Lachman.

Dr. LACHMAN. I would just suggest a couple of questions. One of them would be the variant of Mr. Elliott's solvency versus liquidity problem. I would phrase it differently. I would phrase it why do you expect imposing fiscal austerity on countries at a time of economic weakening and at a time of major credit crunch in Europe is not going to lead to a big recession that is going to unravel the public finances of the countries involved?

A second question I would ask is why do they think that a policy approach to Italy and Spain that they have tried and has failed in Greece, Portugal, and Ireland, is going to work this time around. And I guess the most important question I would want to ask would be how are they going to be safeguarding U.S. taxpayers' money from these loans that the Europeans are making to the IMF, which is putting the U.S. taxpayer on the hook if that money is then used to lend to Italy and Spain.

Mr. MCHENRY. Okay. Quite a number of questions.

What is clear about this hearing, and I thank you so much for being here. This is very helpful, very useful information, and a very wide-ranging discussion. I appreciate the panel's willingness to engage in that conversation. What is clear is there are enormous number of questions that experts have about Fed policy and about this administration's policy and American taxpayer exposure to the European financial crisis that they are facing.

Dr. Sanders, in your opening, this was about excessive government spending and excessive debt, as well as what Mr. Rosner said, this was about over-lending and over-borrowing. One is more focused on the government; the other is more focused on the banking and the institutions.

But the economic risk is real to the American taxpayer. It is a question of the magnitude of that risk. Our exposure to Europe is real, both to the American taxpayer and these institutions, such as the IMF, as well as to the American worker and their ability to get a job and to have a growing economy.

But there is some consensus here about the likelihood of a Greek default. The question is what does that look like, when does that happen, and what is that raw cost in terms of currency. But obviously a mixed assessment on the survival and the ability of the Euro to survive in the medium and long-term; there is not consensus there.

But this has been very helpful and very instructive. I appreciate your time.

Members will have 7 legislative days to submit opening statements.

With that, this meeting is now adjourned.

[Whereupon, at 12:09 p.m., the subcommittee was adjourned.]

[Additional information submitted for the hearing record follows:]

Money Market Funds Continued to Reduce Eurozone Holdings in November

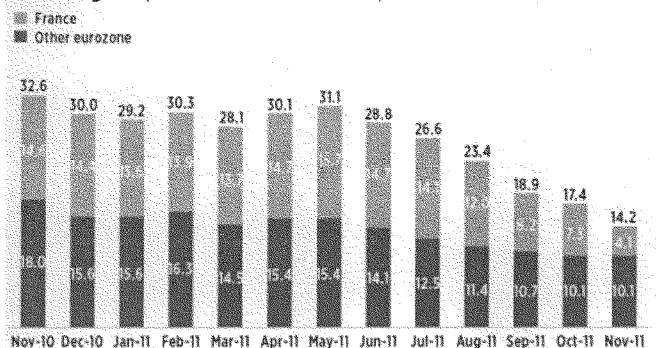
By Sean Collins and Chris Plantier

DECEMBER 16, 2011

Over the last year, U.S. money market funds have significantly reduced their holdings of debt securities issued by banks and other businesses headquartered in the 17 countries that use the euro as their currency. That trend continued in November.

Prime Money Market Funds' Holdings of Eurozone Issuers

Percentage of prime funds' total assets, end of month



Note: Data exclude prime money market funds not registered under the Securities Act of 1933.

Sources: Investment Company Institute tabulation of publicly available Form N-MFP data prior to May 2011; ICI tabulation of data provided by Crane Data thereafter.

For the first time, ICI is issuing estimates of money market funds' European holdings in dollar terms. We estimate the total exposure of money market funds (including prime and government and agency funds) to European-domiciled issuers to be less than $800 billion in November. However, as explained below, a sizable fraction of those assets represents repurchase agreements with the U.S. operations of European-headquartered banks, and another portion represents securities issued by entities in European countries outside the eurozone. Taking these factors into account, we estimate that U.S. prime money market funds' holdings of eurozone securities fell to $204 billion by the end of November.

As we have discussed in previous posts, portfolio managers of U.S. money market funds have effectively zeroed out their direct holdings in the countries most affected by the eurozone government debt crisis. These funds have also gradually trimmed their holdings of issuers in other eurozone countries that might be negatively affected by the debt crisis. As a result of these portfolio adjustments, U.S. money market funds hold virtually no securities issued in Italy, Spain, or the other eurozone "periphery" countries.

Funds' exposure to French-domiciled banks continued to fall sharply in November. Prime money market funds reduced their holdings of French issuers to 4.1 percent of their assets under management in November, down from 7.3 percent in October and the peak level of 15.7 percent in May. As the chart shows, holdings of non-French eurozone issuers remained roughly steady at 10.1 percent in November. Altogether, securities of eurozone issuers accounted for 14.2 percent of total assets of U.S. prime money market funds at the end of November, down from 17.4 percent in October and 31.1 percent in May.

Dollar Estimates of U.S. Money Market Funds' Exposure

An overall decline in prime money market fund assets since May accounts for some of the shift away from the eurozone. From May to November, prime fund assets declined by $214 billion. During that period, prime funds' holdings of French assets fell by an estimated $200 billion, while other eurozone assets declined by an estimated $109 billion. At the same time, money market funds have increased their holdings of European issuers outside the eurozone. In November, the top three European countries for U.S. prime money market funds' holdings were the UK, Sweden, and Switzerland, none of which use the euro as their currency.

Some commentators have suggested that U.S. money market funds' exposure to Europe totals almost $1 trillion. This calculation is based on a number of misconceptions:

- First, the only way to reach an estimate of $1 trillion is to apply estimates based on prime money market funds' European exposure to the total assets for all money market funds. Commentators cite Fitch Ratings Service, which on November 22 estimated that European bank securities comprised 34.9 percent of the assets of the 10 large money market funds in its sample at the end of October. But, as Fitch clearly states, the funds in its sample are all prime funds—and prime funds account for only $1.45 trillion, or just over half, of total money market fund assets. To approach a $1 trillion estimate, Fitch's percentage estimate must be applied to the $2.68 trillion assets of all money market funds, including Treasury funds, U.S. government agency funds, and tax-exempt funds—all of which have far less exposure to European securities than prime funds.

- Treasury and government agency money market funds do hold some securities issued by European-domiciled issuers—primarily European-headquartered banks with U.S. operations. We estimate the total exposure of money market funds (including prime and government and agency funds) to European-domiciled issuers to be less than $800 billion in November.
- However, much of that exposure—some $355 billion—represents short-term repurchase agreements (repos) with European-headquartered banks. The vast majority of these repurchase agreements are collateralized by U.S. Treasury and agency securities that the European banks must pledge.
- Finally, much of the European exposure of prime and government money market funds is to issuers outside the eurozone, notably to banks in the UK, Sweden, Switzerland, and Norway. Market participants generally view European banks outside the eurozone as somewhat more insulated from the eurozone debt crisis.

Taking all these factors into account, we estimate that the total exposure of U.S. prime and government money market funds to eurozone issuers is $305 billion, of which almost half is in short-dated repurchase agreements.

Prime Money Market Funds' Holdings by Home Country of Issuer

	Percentage of total assets	
Country	**May 2011**	**November 2011**
World Total	**100%**	**100%**
Europe	**53.0**	**37.2**
Eurozone	31.1	14.1
France	15.7	4.1
Germany	7.1	5.1
Netherlands	5.8	4.4
Belgium	0.8	0.3
Austria	0.2	0.2
Spain	0.7	0.0
Luxembourg	0.1	0.0
Italy	0.7	0.0
Non-eurozone	21.9	23.1
UK	11.5	10.8
Switzerland	4.2	5.2
Sweden	4.1	5.5
Norway	1.3	1.3
Denmark	0.8	0.3
Americas	**35.0**	**45.9**
USA	27.3	35.1
Canada	7.7	10.8
Chile	0.0	0.0

Asia and Pacific	**11.3**	**16.2**
AUS/NZ	6.7	8.1
Japan	4.6	7.9
India	0.0	0.0
Singapore	0.0	0.1
Korea	0.0	0.0
Supranational	**0.1**	**0.1**
Unclassified	**0.7**	**0.7**

Note: Calculations are based on a sample of 95 funds, representing an estimated 87 to 95 percent of prime funds' assets for May and November, respectively.
Source: Investment Company Institute tabulation of data provided by Crane Data

Sean Collins is ICI's Senior Director of Industry and Financial Analysis and Chris Plantier is an ICI Senior Economist.

This item was originally posted on December 14. We revised this post on December 16 to incorporate new information on repurchase agreements, to incorporate new testimony on this issue, and to clarify the discussion on recent commentary based on analysis from Fitch Ratings Service.

THE WALL STREET JOURNAL. | OPINION

OPINION | DECEMBER 3, 2011

How Regulators Herded Banks Into Trouble

Blame the Basel capital standards for over-investment in mortgage-backed securities and now government debt.

By PETER J. WALLISON

For many in the U.S., the worrisome events occurring in Europe recall the 2008 financial crisis. If Greece or some other country should fail to meet its debt obligations, the result could be much like the 2007 mortgage meltdown in the United States. Many banks and other financial institutions in Europe, and some in the U.S., may be weakened by the loss in value of the sovereign debt they hold. Why is all this happening again?

The important factor in both the American and European cases is what is known to scholars as a common shock—a sharp decline in the financial condition and regulatory capital of a large number of financial institutions because a widely held asset has suddenly lost its value.

In the U.S., this shock came when the 10-year housing bubble deflated and U.S. financial institutions were weakened by a sudden loss in value of the mortgage-backed securities (MBS) they were holding, especially those based on subprime mortgages. Mark-to-market accounting did the rest, requiring banks to write down the value of their MBS assets until they appeared unstable or insolvent.

In Europe, the problem is similar and so is its source. Europe's banks, like those in the U.S. and other developed countries, function under a global regulatory regime known as the Basel bank capital standards. Basel is the Swiss city where the world's bank supervisors regularly meet to consider and establish these rules. Among other things, the rules define how capital should be calculated and how much capital internationally active banks are required to hold.

First decreed in 1988 and refined several times since then, the Basel rules require commercial banks to hold a specified amount of capital against certain kinds of assets. Under a voluntary agreement with the Securities and Exchange Commission, the largest U.S investment banks were also subject to the form of Basel capital rules that existed in 2008. Under these rules, banks and investment banks were required to hold 8% capital against corporate loans, 4% against mortgages and 1.6% against mortgage-backed securities. Capital is primarily equity, like common shares.

Although these rules are intended to match capital requirements with the risk associated with each of these asset types, the match is very rough. Thus, financial institutions subject to the rules had substantially lower capital requirements for holding mortgage-backed securities than for holding corporate debt, even though we now know that the risks of MBS were greater, in some cases, than loans to companies. In other words, the U.S. financial crisis was made substantially worse because banks and other financial institutions were encouraged by the Basel rules to hold the very assets—mortgage-backed securities—that collapsed in value when the U.S. housing bubble deflated in 2007.

Today's European crisis illustrates the problem even more dramatically. Under the Basel rules, sovereign debt—even the debt of countries with weak economies such as Greece and Italy—is accorded a zero risk-weight. Holding sovereign debt provides banks with interest-earning investments that do not require them to raise any additional capital.

Accordingly, when banks in Europe and elsewhere were pressured by supervisors to raise their capital positions, many chose to sell other assets and increase their commitments to sovereign debt, especially the debt of weak governments offering high yields. If one of those countries should now default, a common shock like what happened in the U.S. in 2008 could well follow. But this time the European banks will be the ones most affected.

In the U.S. and Europe, governments and bank supervisors are reluctant to acknowledge that their political decisions—such as mandating a zero risk-weight for all sovereign debt, or favoring mortgages and mortgage-backed securities over corporate debt—have created the conditions for common shocks.

But that is not all that can be laid at the door of regulators. Examiners and supervisors operating "by the book" tend to disregard the judgments of bank managements in favor of regulator-approved methods of assessing credits and carrying reserves. As banks begin to conform to regulator preferences, natural diversification declines and all banks start to look pretty much alike. Then, like genetically altered plants, they are vulnerable to a pathogen—like MBS backed by subprime mortgages—that sweeps through the population.

This does not mean that all regulation is counterproductive. Yet the way it is currently pursued under the Basel rules will—through encouraging future common shocks—make the financial system more, rather than less, vulnerable to systemic breakdowns. To create a stable financial system, regulators should encourage asset diversification and do away with the Basel risk-weighted capital system.

Congress then should repeal Dodd-Frank, which authorizes the Federal Reserve to supervise all "systemically significant" nonbank financial firms, thus spreading dangerous conformity to insurance and finance companies, hedge funds and others. Stability can come only when we stop rewarding herding behavior, and penalize it instead.

Mr. Wallison is a senior fellow at the American Enterprise Institute.

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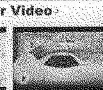
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OPINION | DECEMBER 9, 2011

How the U.S. Can Help Europe: Just Say No

The greatest threat to our economy is not the debt crisis across the pond, but the one right here on American soil.

By JIM DEMINT

If the United States wants to help Europe find a way out of its current debt crisis, we must be a strong, world economic leader, not merely the lender of last resort.

American taxpayers sent $40 billion to Greece last year, through the International Monetary Fund, to stave off an economic collapse. But the bailout did not prevent Greece's day of fiscal reckoning. It only delayed it. Austerity measures are still needed throughout Europe's socialized economy and the debt contagion has not been stopped. Financial chaos has spread from Greece to Ireland, Portugal, Italy and Spain, and it now threatens the very future of the 17-member euro zone.

Undeterred, President Obama last month told the press after breaking from a closed-door meeting with European leaders, "the United States stands ready to do our part to help them resolve this issue." He would do better to focus his attention stateside. The most dangerous threat to the U.S. economy is not across the pond. It's in the swampland of Washington, D.C.

The very problems that have roiled Europe's economy are coming to a slow boil in the U.S. Just as European leaders must limit deficit spending, reform unfunded entitlement programs, and resolve the underlying systemic problems in their financial systems, so must the politicians in Washington. Yet the Obama administration is burning taxpayers at each end of the dollar by bailing out failed socialist policies abroad and, at the same time, forcing them into place here at home.

Although every country's finances are unique, the U.S. is unquestionably in the danger zone.

Greece's economy reached its tipping point and was bailed out when government debt topped 137% of its gross domestic product. Despite all the measures that have been taken to aid it, Greece's debt-to-GDP-ratio is even higher now, at 160%. Ireland was bailed out at 74% of GDP and is now at 80%. Portugal was bailed out at 94% of GDP and is now expected to top 100%. The bailouts have arguably made the European debt crisis worse, not better.

Total U.S. debt, including entitlement liabilities, reached 100% of GDP when Congress increased the debt ceiling in August. Our $15 trillion debt now rivals the size of the entire U.S. economy.

When he first took office, President Obama promised to cut the

Martin Kozlowski

federal deficit in half by 2013. But instead he's increased it by more than $4 trillion. Indeed, under his direction, the U.S. government spent about $1 trillion on a Keynesian-style stimulus that failed to create the jobs promised, will spend trillions more creating a European-style health-care entitlement with ObamaCare, and has more Americans on welfare than ever before.

With President Obama in the White House, liberals have succeeded in their longstanding quest to make America more like Europe. Problem is, their idealized version of Europe's collectivist government is now in shambles. If the U.S. continues to mimic our European allies we'll fall to pieces, too.

It is under these circumstances that high-level members of the Obama administration, including the president himself, are negotiating with international leaders over how best to solve the European debt crisis. This week, Treasury Secretary Tim Geithner met central bankers and European leaders days ahead of this Friday's emergency EU summit in Brussels, where a last-ditch rescue effort is expected to be announced. France and Germany are pushing for EU rule changes to enforce stricter budget discipline on member nations in exchange for further bailouts. The International Monetary Fund, which the U.S. funds at a higher percentage than any other nation, is expected to aid the rescue. The only question is how big a role the IMF and U.S. taxpayers will play.

This year the U.S. sent about $67 billion to the IMF, which represents 17.7% of the IMF's yearly budget—nearly three times more than any other nation. On top of that, taxpayers provided an additional $108 billion credit line to the IMF in 2009.

In 2010, the IMF sent nearly $40 billion in assistance to Greece, which did nothing to prevent the country's economic collapse in 2011. On Monday, the IMF approved another $2.95 billion worth of bailout funds for the struggling country.

If this is what President Obama meant when he said the "United States stands ready to do our part," it's time for him to part ways from his European friends seeking the same kind of assistance that has been provided to Greece.

American policy makers must send an unmistakable signal that the era of bailouts is over once and for all.

Earlier this year, I offered an amendment to repeal the IMF's authority to use the additional $108 billion credit line to provide any more bailouts. It was overwhelmingly rejected by the Democrat-controlled Senate. Forty-four senators voted for it; only one was a Democrat.

I will soon give my colleagues another chance by forcing a vote to stop Mr. Geithner from supporting any more taxpayer-funded bailouts of the European economy, as well as nullifying previously expanded IMF bailout authority.

Members of the Obama administration must focus all of their efforts on strengthening the U.S. economy and balancing our budget, rather than on continuing to borrow from China to pay for Europe's out-of-control debts.

President Obama and Mr. Geithner have lectured European leaders on the need for them to take decisive action to stabilize their economies. They should practice what they preach and set a positive example for the world to follow.

Lending isn't leading. Balancing the budget would be.

Mr. DeMint, a Republican, is a senator from South Carolina.