Committee on Oversight and Government Reform
Witness Disclosure Requirement – "Truth in Testimony"
Required by House Rule XI, Clause 2(g)(5)

Name: DESMOND LACHMAN

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1. Please list any federal grants or contracts (including subgrants or subcontracts) you have received since October 1, 2008. Include the source and amount of each grant or contract.

NONE

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2. Please list any entity you are testifying on behalf of and briefly describe your relationship with these entities.

NONE

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3. Please list any federal grants or contracts (including subgrants or subcontracts) received since October 1, 2008, by the entity(ies) you listed above. Include the source and amount of each grant or contract.

NONE

I certify that the above information is true and correct.

Signature: [signature]

Date: 4/12/11

Bio of Desmond Lachman

Desmond Lachman is a Resident Fellow at the American Enterprise Institute, a Washington based think tank. He has also taught economics at Georgetown University and at Johns Hopkins University. At the AEI, Mr. Lachman has written extensively on global currency issues, the Eurozone sovereign debt crisis, the US housing market, and the multilateral lending agencies.

Before joining the AEI, Mr Lachman was a managing director and chief emerging market strategist at Salomon Smith Barney in New York, where he closely monitored the 1998 Asian crisis and the 2001 collapse of the Argentine Currency Board. He previously served as Deputy Director in the International Monetary Fund's European Department as well as in its Policy Development and Review Department. At the IMF, Mr. Lachman was actively involved in Sweden's 1992 exchange rate crisis and he was also very active in staff formulation of IMF policies.

He holds a Ph.D in economics from Cambridge University.

(Testimony for House Committee on Oversight and Government Reform)

Lessons for the US from the European Sovereign Debt Crisis

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Introduction

1. The European sovereign debt crisis offers a cautionary tale to the United States about the very high costs that could be associated with continuous delays in fashioning a credible medium-term plan to address the deep budget problems at the US federal and state levels. For many years, markets provided ample funding at very low interest rates to the Greek, Irish, and Portuguese governments, despite the clearest of evidence that major economic imbalances were building in those countries. In so doing, markets repeated the all too often made mistake of thinking that "this time the large imbalances are different" and that a day of reckoning would not come.

2. When markets finally did turn against the European periphery towards the end of 2010 they did so abruptly and they caused interest rates to rise sharply for the Greek, Irish, and Portuguese governments. This has now plunged those economies into deep economic recessions and has raised unemployment rates to record levels. Despite massive official bailout packages for Europe's peripheral countries from the IMF and EU, markets are now pricing in a very high probability that these countries will default in the next three to five years. This could constitute a major shock to the European banking system, which has a very high exposure to the periphery. It could also pose a serious challenge to the global economic recovery.

Major Imbalances in Europe's Periphery

3. In 1999 when the Euro was launched, the European Stability and Growth Pact required that member countries contain their budget deficits to no more than 3 percent of GDP and maintain their public debt to GDP ratios below 60 percent. Despite these strictures, by 2009 Greece and Ireland registered budget deficits of around 15 percent of GDP, while Portugal and Spain registered budget deficits in the region of 10 percent of GDP (Figure 1). It is now expected that Greece and Ireland's public debt to GDP ratio will reach over 160 percent and 120 percent, respectively by 2012, even under optimistic assumptions about economic growth and budget adjustment (Figure 2).

4. The emergence of major economic imbalances in the various countries in Europe's periphery can be traced to different underlying causes. In the case of Greece and Portugal these imbalances owed mainly to years of profligate government spending in the context of sclerotic economies burdened by deep structural rigidities. In the case of Ireland and Spain, today's imbalances owe mainly to the bursting of massive housing market bubbles that made those in the United States pale.

5. A notable feature of the European debt crisis is that until very recently markets failed to discipline profligate governments in the European periphery and these governments were able to borrow at interest rates only marginally higher than those required of the German government. Markets also provided the financing that made possible massive housing market bubbles in Ireland and Spain. Markets failed to exercise their desired disciplinary function in the mistaken belief that "this time was different" and that eurozone membership would automatically make countries in the European periphery converge to the strong economic performance of the German economy.

Europe's day of reckoning

6. When markets did finally turn on the European periphery, they did so in an abrupt and dramatic fashion (Figure 3). The Greek and the Irish

governments were effectively shut out of the capital markets as interest rates spiked by between 300 and 700 basis points. Greece and Ireland were forced to seek IMF-EU bailout packages of EUR110 billion and EUR65 billion, respectively. More recently, last week the caretaker Portuguese government was also forced to seek a EU bailout as external funding for the Portuguese government totally dried up. Despite the massive IMF and EU bailout packages, markets are still demanding very high interest rates on the periphery countries' sovereign debt. These high interest rates imply that the market is attaching a very high probability to the likelihood that these countries will default on their sovereign debt within the next three to five years.

7. The reason for the market's present deep skepticism about the prospects for restoring fiscal sustainability in the European periphery is that the market correctly perceives that Europe's periphery lacks the policy instruments to put its public finances back on a sustainable path. Locked in a euro straight jacket, Greece, Ireland, and Portugal cannot resort to inflating their way out of their large public debt. Nor can they attempt to devalue their currencies so as to make their exports more attractive abroad and thus offset the negative impact of the fiscal retrenchment being imposed on them by the International Monetary Fund.

8. As a condition for their bailout lending, the IMF and EU are requiring of Greece, Ireland, and Portugal budget adjustments of the order of 10 percentage points of GDP over the next three years. Countries in the periphery are now finding that attempting to dramatically tighten their budgets without being in the position to weaken their currencies to boost export growth is a recipe for steep economic recessions in these countries. Sadly, Greece and Ireland are already finding this out. Over the past two years, GDP has contracted in Greece and Ireland by 8% and 12%, respectively, and their unemployment rates have both climbed beyond 14% (Figures 4).

9. The seemingly intractable economic problems in Greece, Ireland, Portugal, and Spain constitute a serious risk to the European banking system. Although these economies constitute a relatively small part of the overall European economy, their cumulative sovereign debts exceed $2 trillion. The major part of this debt is held by German, French, and