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.

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Prior Employment:

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Center on Federal Financial Institutions, Founder and President	2003-2006
ABN AMRO, Inc., Managing Director	2000-2001
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None

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I am testifying solely on my own behalf

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: 12/14/2011