Testimony by Bert Ely

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of the

House Committee on Oversight and Government Reform

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

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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

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[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-

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[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.

Biographical sketch for Bert Ely

Bert Ely has consulted on deposit insurance and banking issues since 1981. In 1986, he became an early predictor of the S&L crisis and a taxpayer bailout of the FSLIC. In 1991, he was the first person to correctly predict the non-crisis in commercial banking.

Bert continuously monitors conditions in the banking industry as well as monetary policy. In recent years, he has focused increased attention on banking problems, the crisis in housing and housing finance and the entire U.S. financial system, and the resolution of the Fannie Mae and Freddie Mac conservatorships. More recently, he has been advising clients on the implementation and consequences of the Dodd-Frank Act.

Bert has testified on numerous occasions before congressional committees on banking issues and he often speaks on these matters to bankers and others. He is interviewed by the media on a regular basis about banking and other financial issues.

Bert first established his consulting practice in 1972. Before that, he was the chief financial officer of a public company, a consultant with Touche, Ross & Company, and an auditor with Ernst & Ernst. He received his MBA from the Harvard Business School in 1968 and his Bachelor's degree in economics in 1964 from Case Western Reserve University.

Bert Ely
Ely & Company, Inc.
P.O. Box 320700
Alexandria, Virginia 22320

Telephone; 703-836-4101
Email: bert@ely-co.com
Website: www.ely-co.com

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Name: Bert Ely

1. Please list any federal grants or contracts (including subgrants or subcontracts) you have received since October 1, 2009. Include the source and amount of each grant or contract.

None.

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

None.

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.

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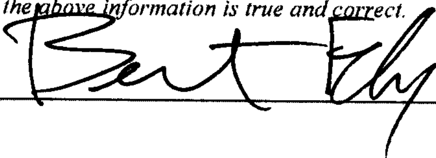

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