American Enterprise Institute
for Public Policy Research

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

# The Euro Crisis and the US Taxpayer

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December, 15 2011

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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.

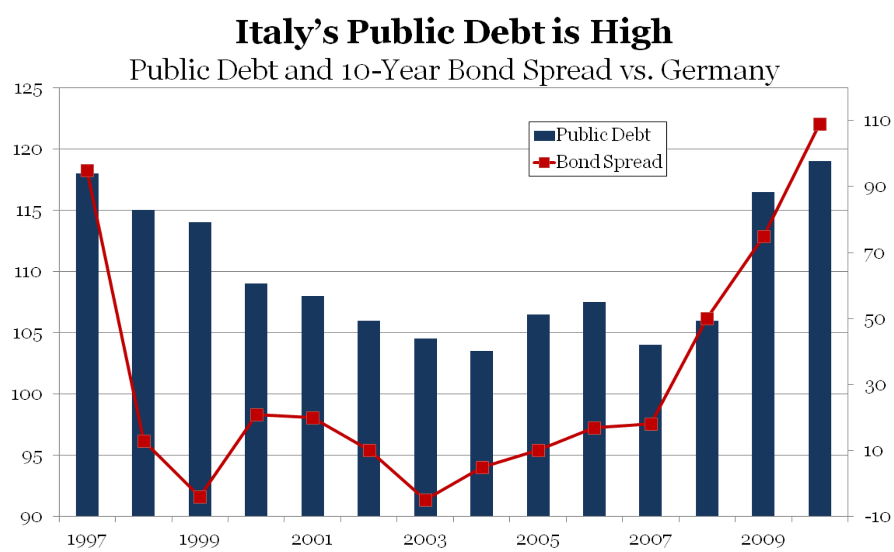
d. There are very clear indications of an appreciable **slowing in German and French economic growth**. It is all too likely that the overall European economy could soon be tipped into a meaningful economic recession should there be a worsening in Europe's banking crisis. A worsening in the growth prospects 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.




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.

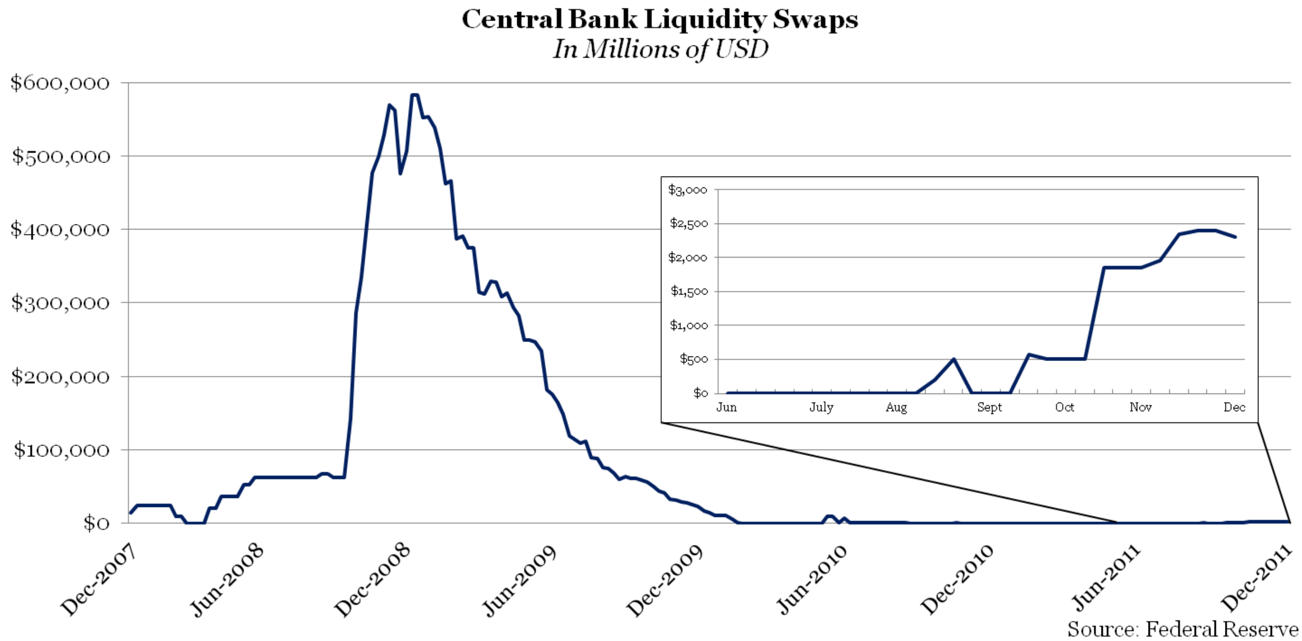
**European Rescue Efforts**

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.

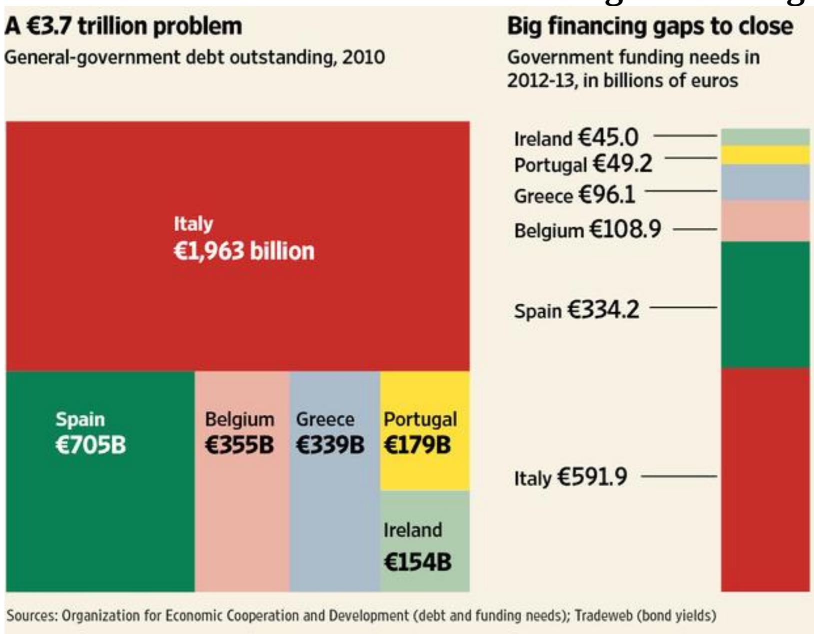
    c. In November 2011, the US Federal Reserve announced that it would be providing temporary **US dollar currency swaps** to help alleviate the dollar funding problems of the European banks. It acted in coordination with the European Central Bank, the Bank of England, the Bank of Canada, the Bank of Japan, 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.




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

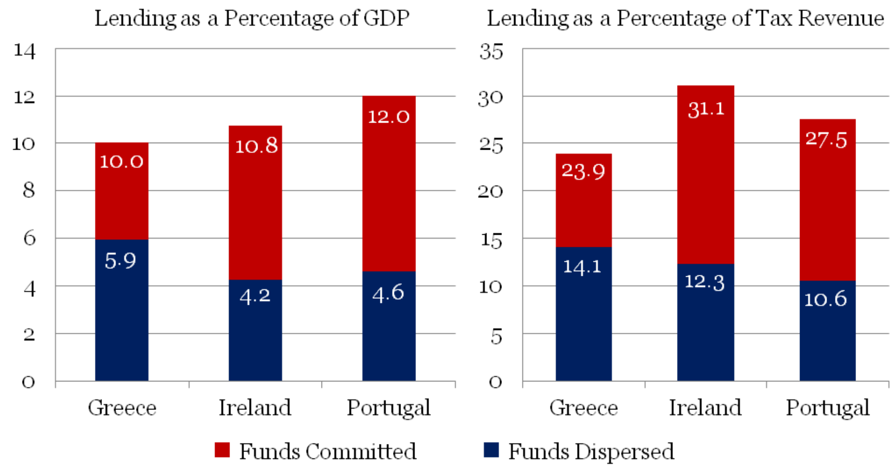
**Still Ahead for the Eurozone: Heaving Borrowing**




## 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.

# IMF Lending to Eurozone Nations




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.

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

Name: DESMOND LACHMAN

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.

I am a Resident Fellow at the American Enterprise Institute but I am testifying in a personal capacity

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: 12/13/11

# Biography of Desmond Lachman


Desmond Lachman

Resident Fellow
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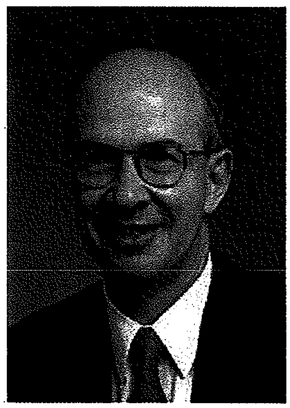


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Biography

Desmond Lachman joined AEI after serving as a managing director and chief emerging market economic strategist at Salomon Smith Barney. He previously served as deputy director in the International Monetary Fund's (IMF) Policy Development and Review Department and was active in staff formulation of IMF policies. Mr. Lachman has written extensively on the global economic crisis, the U.S. housing market bust, the U.S. dollar, and the strains in the euro area. At AEI, Mr. Lachman is focused on the global macroeconomy, global currency issues, and the multilateral lending agencies.

Experience

- Adjunct Professor, Georgetown University, 2010
- Adjunct Professor, Johns Hopkins University, 2009
- Managing Director and Chief Emerging Market Economic Strategist, Salomon Smith Barney, 1996-2003

- Deputy Director, Policy Development and Review Department, International Monetary Fund, 1994-96
- Senior Adviser, European Department, 1990-94; Division Chief, Western Hemisphere Department, 1984-90, International Monetary Fund

Education

Ph.D., economics, Cambridge University
B.A., University of Witwatersrand