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Chairman Warner, Ranking Member Johanns, thank you for the opportunity to testify today. My name is J.D. Foster. I am the Norman B. Ture Senior Fellow at The Heritage Foundation. The views I express in this testimony are my own, and should not be construed as representing any official position of The Heritage Foundation.

The European Economic Crisis is no accident. It is entirely the product of fundamental policy mistakes begun long ago and since magnified and papered over time and again. I believe there are two root mistakes that have produced this outcome.

The first is the relatively recent mistake of adopting a single currency without the economic policy infrastructure necessary to protect it. Without arguing the wisdom of the Euro one way or the other, the fact is that if it were purely a matter of economic policy the Euro could have succeeded as envisioned. But there were prerequisites relating to harmonization of labor policy, commercial policy, environmental policy, and so forth, and absent these it was imperative to harmonize fiscal policies. Europe made some progress in some areas and little in others. It was undeniably woefully inadequate.

The second great mistake was the adoption of a generous social welfare state without attending to the pro-growth policies necessary to sustain such a state in light on an increasingly competitive global economy. In the absence of increasing global competition a slow-growth big government economic model is viable; not, in my view, preferable by any means, but viable. In the face of fierce and rising competitive pressures from outside Europe, economic growth through rising productivity and improved economic competitiveness is not merely beneficial, it is essential to national survival.

The Europeans have long been aware of this tension, hence their efforts to cajole, coerce, or otherwise convince the rest of the world to adopt their economic model. An obvious example is their efforts to force Ireland to adopt a higher corporate income tax rate. Rather than adopt the policies necessary to speed their own economies to match those of the competition, Europe tried to slow the economies of the competition. It didn't work.

I very much regret what our friends across the pond must now endure, and what awaits them in the days, months, and years ahead. For them, there are no easy answers. For us, there is little we can do to help, but there are preparations we can make and lessons we can learn.

These causal questions are important and interesting, but the issue of the day is what is happening today, and what effect it will have on the United States. In the testimony that follows, I will attempt to describe briefly the basic dimensions of what continental Europe now faces, and then the transmission mechanisms by which the United States may be affected, and conclude with what the United States can do to prepare.

Europe's Many Layered Problems

Europe's immediate problem is a pending and building liquidity crisis. European banks and other financial institutions are experiencing increasing difficulty accessing short-term credit markets, and depositors are getting very nervous. According to reports, for example, Siemens recently withdrew 500 million Euros from a French bank. Greek banks have been on life support from the European Central Bank for months, and central banks have just recently pumped more billions of dollars into the continental-wide banking system. Confidence, the life blood of financial markets, is failing fast.

The reason, of course, is that these banks hold vast quantities of dubious assets – dodgy government debt. Some, perhaps many or even most, European banks have a solvency problem. As Josef Ackerman, Chief Executive Office of Deutsche Bank recently explained, “Numerous European banks would not survive having to revalue sovereign debt held on the banking book at market levels”. This view was reinforced on September 20 by Joaquin Alumnia, the European Union’s competition commissioner, who noted that “Sadly, as the sovereign debt crisis worsens, more banks may need to be recapitalized”.

In this Alumnia was restating a view presented recently by Christine Lagarde, managing director of the International Monetary Fund (IMF) from which she subsequently beat a hasty retreat under withering fire from the EU establishment. Madam Lagarde had committed the unpardonable sin of speaking the obvious truth, a truth that is likely to be laid bare by an IMF report expected to be out at the end of September reportedly showing banks need a “whopping 273.2 billion (euros)” in recapitalization. A big problem in this regard for credit markets is nobody really knows which bank would and which would not survive today.

The solvency problem, in turn, traces to the sovereign debt problem – some governments have issued debt and run budget deficits to unsustainable levels. And a big reason these debt levels are unsustainable is not merely their sheer magnitudes, but that these countries also suffer from an ongoing growth problem. The growth problem – even in good times they experienced little growth. Now they are contracting, in some cases rapidly. So while their debt is high and rising, the economy on which the debt rests is flat or contracting.

But growth rates tell only a part of the story. The larger story is that the cost structures in many of these countries render them highly uncompetitive economically, even within Europe and certainly outside of Europe. This means they cannot hope to run the trade surpluses necessary to generate the earnings with which to pay their foreign creditors.

The painful immediate conundrum Europe faces is that attempts to address the sovereign debt problem, through tax hikes for example, make the economic growth problem worse thus making current debt levels less sustainable. At the same time, issuing even more debt in an attempt to buy time to deal with the sovereign debt problem typically make the bank solvency problem worse by driving down the value of the outstanding dodgy debt.

And it gets worse. Attempts to address the financial market solvency problem by drawing attention to the need for more bank capital often bring the liquidity crisis to a fevered pitch. This is a Gordian know of enormous proportion and complexity, and one must express a grudging admiration for the European leaders in having managed so well for so long, all the while knowing they could not do so indefinitely.

Taking a step back for perspective, the long-run implications of being highly uncompetitive are catastrophic. Europe will, at some point and in some fashion, overcome the liquidity problem, and the solvency problem, and even the sovereign debt problem. These can be overcome in a variety of ways, all of which are painful to someone and all of which will cause hardship for years to come. But I am confident they can and will be overcome.

In contrast, the inability to compete globally presents problems of an entirely different nature. Greece is, unfortunately, an excellent example. Greece achieved an artificially high standard of living largely by borrowing from abroad. This also led to increases in wages and prices that far outstripped productivity growth, leaving Greek producers uncompetitive within and without Europe. However, in the good old days being able to borrow from abroad made up the difference in terms of income. Greek borrowing is today on a very short leash, the economy is contracting rapidly, and with their artificially elevated wage and price structures Greece cannot hope to generate the net exports and earnings needed to service its existing debt.

This leaves Greece with two very unpalatable options. One option is to let a deep, prolonged depression drive down wages and prices to the point where Greece's workers and companies can generate a trade surplus. Greece would quite possibly look enviously at Japan's lost decade.

The other option is to make the adjustment the old fashioned way – to devalue. And there's the rub – as a member of the monetary union, Greece lacks a currency to devalue; which is why the arguments about how difficult or painful it would be for Greece to break out of the Euro are irrelevant. There is no less painful alternative as long as Germany refuses to work so Greece can enjoy the fruits of German labor. As Financial Times columnist James Mackintosh wrote in Wednesday's paper, "Fixed exchange rates force economic adjustment via wages and prices; Greece needs dramatic wage deflation to regain competitiveness against Germany. The political impossibility of slashing pay packets enough is a reason it may have to leave the Euro, even though living standards will fall either way."

The Implications for the United States

With this as overview, the fundamental transmission mechanisms of the European Economic Crisis for the United States economy are as straightforward in outline as they are murky in detail. There are two such mechanisms, one through financial markets and a second through trade flows.

Five years ago, one might have viewed the European financial crisis, that is, the existential threat to European financial institutions and markets, as mostly a European affaire. To be sure, American financial institutions hold some of this dodgy European debt, as well. There have even been stories that super-safe money market funds have loaded up on scary levels of high-yielding Greek debt. But, on balance, one would have thought a financial contagion in Europe would be stopped at water's edge. Five years ago, the Europeans thought the same thing about the then-rumored U.S. subprime mortgage fiasco about to unfold.

The issue is global financial interconnectedness. This is where matters get murky. No one, including the participants and including the financial regulators, really knows or understands all the connections, or all the weaknesses. We know in great detail, for example, how much foreign debt by country each of our banks own. But for years the Europeans have assured the world their true exposure to sovereign debt risk was limited because they had hedged their positions with credit default swaps (CDS). Note, however, that CDS do not eliminate risk but merely shift it. To whom? No one really knows.

Suppose, for example, you are the CEO of a well-run U.S. bank. You have carefully assessed your exposures to the European sovereign debt crisis and have built up a proper capital cushion. Your exposures to Europe all appear to be through credible institutions which themselves appear to have adequate capital. But what are their other assets? How much of these CDS do they own? How much capital do they have when they have to make good on their CDS exposure? They may not really know. You don't know. And so you as CEO don't really know how safe your bank really is.

European leaders will not be able to kick the can down the road indefinitely. Matters worsen almost daily. Italy's debt was recently downgraded. Economies are contracting. Greece is fighting for one more breathe in the form of the next tranche of oxygen from the IMF.

As these events unfold, the essential consequence for the United States economy is a large dose of bad uncertainty. Bad uncertainty is analogous to bad cholesterol. It builds up and creates economic blockages. In the economic sphere, this shows up as decisions delayed or downscaled, decisions that under normal times would produce the actions that produce growth. Europe is clearly adding to the headwinds facing the economy today.

At some point, this house of cards will come tumbling down, taking much of the European financial system with it. Fortunately, this part of Europe's problem can and I believe will be halted in its tracks fairly quickly by recapitalizing the banks. The questions for the Europeans will be – whose capital and how much? For the United States, too, the immediate threat will then pass.

As the financial crisis fades, as it will, Europe will be left with the remaining fundamental economic problems of a dysfunctional monetary union, uncompetitive economies in many cases, and recession. This, again, is where matters get murky. The monetary union may evolve in any one of a number of paths, none of which appear particularly germane to the U.S. situation; likewise the policies necessary to restore all the nations of Europe to a state of international competitiveness.

The depth and length of the recession in each country will vary, but none will be immune. Many of these countries suffered poorly performing economies before the crisis. For the United States the implications if not the magnitudes are clear – a major U.S. trading partner will be in a slump, and so U.S. exports to Europe will suffer.

If the U.S. economy were in good shape, a drop in exports would simply be another headwind to be overcome. In 1997, during the Asian economic crisis, the U.S. experienced an event similar in nature if not magnitude, but the U.S. economy was reasonably strong and accelerating and so the headwinds from the Asian crisis were essentially imperceptible in the aggregate.

Unfortunately, rather than strengthening, the U.S. economy today is flat on its back, and facing the very real possibility of yet another recession even without the headwinds of Europe. President Obama's economic policies have failed utterly and completely. Mounting a sustained, robust, job-creating U.S. recovery under the circumstances will prove very difficult.

What the United States Can Do to Prepare

There is very little the United States can do to help the Europeans through their troubles. There is, perhaps, some harm the U.S. government can inflict, and Treasury Secretary Geithner appears to have done his best to inflict some in his recent lectures to the European leadership at their recent finance meetings in Poland. No doubt his counterparts are wondering to themselves the old refrain, "with friends like this, who needs enemies."

One rather nebulous issue for the United States arising from Europe's troubles is that once again the United States, despite all its troubles, is perceived as a safe haven for capital. Thus enormous capital inflows from abroad have propped up the dollar exchange rate to an extent, and driven down domestic interest rates. Given the current weakness in the U.S. economy and the Federal Reserve's current policy of maintaining very low interest rates and its expected attempts at driving down long-term rates in particular, these interest rate pressures may actually be benefiting the U.S. economy today. On the other hand, there will be a flip side – at some point these capital inflows will become outflows, pushing up interest rates at an inopportune time.

As there are two definable threats to the United States economy, preparations should focus on dealing with those two threats. Above all, the key to preparing for the financial threat is capital. Capital reserves act like levees in the face of a flood, protecting financial institutions from the onrushing river of failing confidence. Presumably, America's financial regulators and supervisors are keeping a close eye on bank capital reserves. However, in light of what may be in the offing, it is reasonable to question the prudence of banks and other financial institutions paying out dividends at this time, dividends that if retained would add a few sandbags to the levees.

The second threat is from the expected drop in exports to Europe and the effects this will have on the U.S. economy. Little or nothing can be done about the drop in exports, but much could be done to strengthen the economy to absorb the blow better. All of these actions fall under the guiding principle of "do less harm".

To Grow, or Not to Grow, That is the Question

The fundamentals of our economy remain sound. The natural productive tendencies of America's workers, investors, and entrepreneurs remain undiminished. The economy is poised to grow.

Why, then, does it hold back?

There are, of course, the unusual headwinds, such as the follow-on effects of Japan's devastating earthquake and tsunami. But the economy faces and overcomes such headwinds even in the best of times. Headwinds there are, to be sure, but they do not explain the economy's lethargy.

The economy suffers from two categories of troubles. The first are structural troubles, which today primarily reflect a housing sector still in deep disequilibrium in many areas of the country.

There is very little substantively that government can do to return housing markets to normal, and heaven knows Congress and the President have tried just about everything. And that is part of the problem. Government's well-intentioned meddling has delayed and distorted the essential requirement for normalization – price discovery. On balance, these policies have set back the housing recovery by months, perhaps a year or more. There is an important lesson here.

The second category of trouble is what might be termed environmental -- not the natural environment, but the economic environment. Most relevant for our discussion is alternatively a shortage of confidence or an excess of bad uncertainty. Those who could make the decisions and take the actions that would grow the economy lack the confidence to do so. Even today, the economy abounds in opportunities for growth. But turning potential into reality requires action, and action requires confidence—confidence in the future, confidence in the specific effects in government policy, and confidence that government can properly carry out its basic functions, like agreeing to a budget.

America suffers a confidence shortage, and Washington is overwhelmingly the cause.

Confidence, in turn, is lacking because of an excess of uncertainty: Uncertainty about the future, but also uncertainty about the effects of government policies – tax, regulatory, monetary, trade. Uncertainty is natural, of course. The future is always uncertain. But there is good uncertainty and bad uncertainty, much as there is good cholesterol and bad cholesterol. Good uncertainty, for example, presents opportunities for profit. Bad uncertainty arises largely when investors and entrepreneurs have very real questions about the consequences of government policy.

Tax policy provides a good example of bad uncertainty. The President's repeated insistence on raising taxes on high-income workers and investors slows the economy even without the policy being enacted. It does so by raising the uncertainty about the tax consequences of various actions. It does not stop all such actions, but it stops some, and therein lies the difference between growth and stagnation.

The President's insistence is a twofer in terms of bad uncertainty. The specific is that taxpayers don't know what their tax liability will be. The general is that suggesting raising taxes on anyone in the face of high and possibly rising unemployment suggests a gross lack of understanding about how an economy works. That's a source of bad uncertainty that afflicts the entire economy, not just those threatened with higher taxes.

In this environment, Congress need not enact bad policy to weaken the economy. Threats suffice to do real damage.

Unfortunately, President Obama's recent and urgent deficit-building jobs plan was so weak Senate Majority Leader Harry Reid (D-NV) refused even to attempt to bring it to the Senate floor. And his subsequent deficit reduction plan was so full of gimmicks and misrepresentations even his allies on the left had to stifle their reactions. Clearly, President Obama has chosen to campaign for re-election on a far left populist message that sacrifices economic strength and job growth for ideology, leaving the U.S. economy to fend for itself as events in Europe unfold.

The American economist Joseph Schumpeter once observed, "the problem that is usually being visualized is how capitalism administers existing structures, whereas the relevant problem is how it creates and destroys them." The next few years are very likely to bear this out.

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