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Security, International Trade and Finance Subcommittee  
On The G20 and Global Economic and Financial Risks

# The Eurozone Crisis and the US Economy: What Has Gone Wrong?

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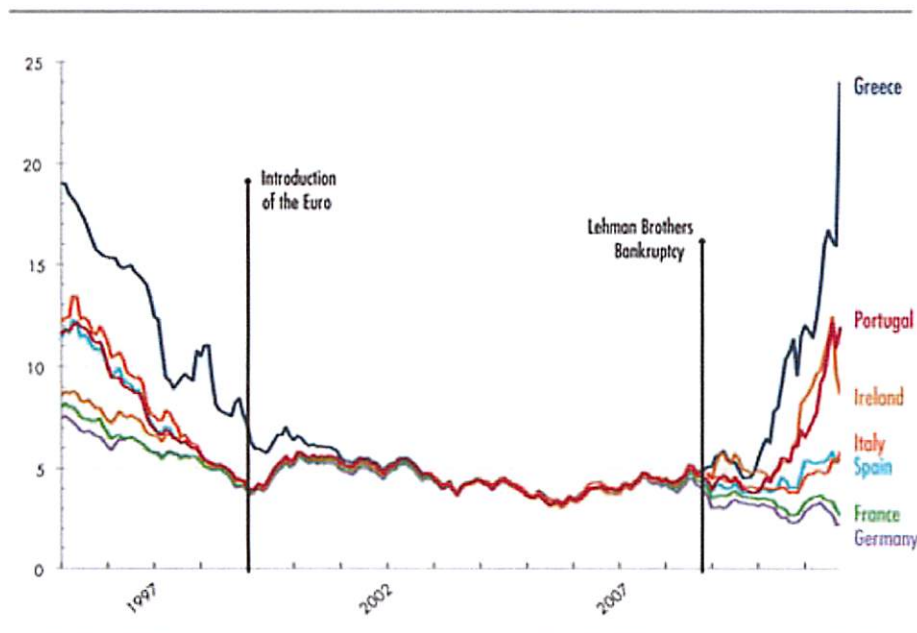
Thank you, Chairman Warner, Ranking Member Johanns, and Members of the Committee for the opportunity to testify.

The first paragraph of an article on how to save the euro in a recent issue of the *Economist* captures a significant part of what has gone wrong with the European economy.

So grave, so menacing, so unstoppable has the euro crisis become that even rescue talk only fuels ever-rising panic. Investors have sniffed out that Europe's leaders seem unwilling ever to do enough. Yet unless politicians act fast to persuade the world that their desire to preserve the euro is greater than the markets' ability to bet against it, the single currency faces ruin. As credit lines gum up and outsiders plead for action, it is not just the euro that is at risk, but the future of the European Union and the health of the world economy.[1]

As we enter the fall of 2011, three years after the Lehman Brothers crisis, Europe and the United States are teetering on the brink of another, potentially more serious, systemic crisis. It is surely fair to ask how we got to this point just a few months after the US recovery had been declared well-established and European leaders had created a fund with resources that were supposed to be sufficient to ensure that Greece, the fulcrum of Europe's debt crisis, would not default on its debt. Figure 1 shows the sharp rise in interest rates on some European governments' debt--especially Greece, Ireland, and Portugal--and a recent jump in Spanish and Italian yields that is emblematic of Europe's intensifying debt crisis.

FIGURE 1  
INTEREST RATES ON TEN-YEAR GOVERNMENT BONDS  
(in percent)



SOURCE: European Central Bank

The crisis in Europe is somewhat mirrored and amplified by a parallel sharp growth slowdown in the United States. After last year's second round of quantitative easing (QE2) and extra fiscal stimulus spawned expectations of 3.5 percent growth, actual US first-half growth of only 0.7 percent has changed everything. During the spring, the Federal Reserve began talking about detailed strategy for exiting high levels of monetary accommodation, while during July's debt-ceiling fiasco, US policymakers wrestled with the need to reduce deficits and debt accumulation. In the end, they left the heavy lifting to a congressional "super committee" that is to report back to President Obama by Thanksgiving. But before the super committee could even meet, the president reversed course in the face of the threat of a double-dip recession and proposed nearly a half trillion dollars in additional fiscal stimulus for 2012 that repeated and expanded measures the last Congress passed in December 2010.

Americans who follow deliberations in Washington, especially about taxes and government spending, can be forgiven some confusion. During much of the second quarter in the lead-up to the July debt-ceiling debate, which was punctuated by threats of America's default on its debt, politicians loudly touted the benefits of living within our means, which meant cutting the deficit, which in turn meant cutting government spending, raising taxes, or both. As Congress returned from vacation, the president offered up a jobs program costing nearly half a trillion dollars that involves cutting taxes and increasing government spending.

Of course, the president followed up his jobs plan with proposals for future tax increases and spending cuts he claimed would provide more than \$4 trillion in deficit reduction over the ten years after 2013 "as the economy grows stronger." [2] It seems unlikely, though, that the tax cuts and higher spending that are supposed to make the economy stronger in 2012 will, when reversed in 2013, somehow not cause it to grow weaker.

We, and many in Europe, are left to wonder whether it is deficit reduction that is good for the economy or euphemistically named things like "jobs programs" that increase the deficit. It is important to ask how, at the time of this writing in September 2011, Europe has reached an acute sovereign-debt crisis while the US economy simultaneously threatens to contract, exacerbating both its own budgetary problems and Europe's sovereign-debt crisis.

### **What Happened in Europe?**

Europe's problems, which are probably more acute than America's, spring from a simple cause: an attempt to forge and maintain an impossible currency union. The European Monetary Union, which includes such disparate economies as Germany on the strong side and Greece, Ireland, Portugal, Spain, and Italy on the weak side, requires the assumption that monetary policy that is appropriate for Germany is also appropriate for Greece. Europe's adoption of monetary union enabled less credit-worthy countries such as Greece to borrow on virtually the same terms as Germany because both were issuing debt denominated in euros and the European Central Bank (ECB) was treating those debts as being of identical quality.

The European Monetary Union was, at first, attractive for all of its members, including Germany. European banks were happy to make euro-denominated loans to government and private borrowers in southern Europe who could suddenly borrow for less, given that the loans were

denominated in euros. If a bank lent money to, for example, the Greek government, it acquired a claim on Greece that it could take to the ECB and use as collateral for further borrowing. The terms for that transaction were virtually identical to the terms available if claims on the German government were used as collateral. Easy credit accelerated European growth, not to mention German exports. As inflation and growth surged in southern Europe, so too did borrowing in those countries.

Adoption of the euro by countries like Greece and Spain meant that they got a German credit rating that enabled them to purchase more Mercedes--on credit. At first, German exporters were pleased. But now, Germans are being asked to help borrowers in these southern European countries repay these loans.

By 2009, some lenders began to notice that Greek budget deficits and government debt were rising rapidly. When Greece revealed late in 2009 that its deficits and debt were substantially larger than previously reported, the first phase of the European debt crisis began. However, the ECB continued to allow banks to use Greek, Italian, Spanish, and any other sovereign debt from the European Monetary Union as collateral for loans. Banks were also not required to hold reserves against their sovereign-debt loans because it was effectively assumed that sovereigns do not default.

The solution to the Greek crisis that emerged in the spring of 2010 was essentially perverse. In exchange for additional loans so that Greece could roll over its debts and pay its debt service, the International Monetary Fund (IMF) and the European Union imposed strict conditions on Greece in the form of higher taxes and sharply contractionary cuts in government spending that caused the economy to slow further, undercutting its ability to service outstanding debt and additional debt.

By the second quarter of 2011, it was clear that Greece would require additional funding to meet its debt service obligations, while similar problems arose for Portugal, Spain, and Italy. Ten years of pretending that loans to southern European governments carried as little risk as loans to the German government left Europe's banks with nearly \$2 trillion worth of claims on those riskier borrowers. For the purpose of "stress tests," it was assumed that these claims were worth 100 cents on the dollar when the marketplace implies substantially lower values. The large sovereign-debt holdings by European banks pose a threat to the solvency of many of those banks that rises in proportion to doubts about governments' ability to service those loans. Given these conditions, if Greece, for example, defaults on its debts, the possibility of defaults by other sovereign governments in Europe may rise, triggering solvency problems for most of Europe's private banks.

Many hope to preempt this disaster scenario by recommending aggressive steps to prevent a Greek default. The problem is that Germany, the country that would have to foot most of the bill, is insisting that Greece adopt additional austerity conditions in exchange for the loan. The austerity conditions, in turn, imply that Greece will be less able to service its debts a year from now, given that the economy is expected to contract at a 5 percent rate if these austerity conditions are imposed.

## **Impact of Europe's Debt Crisis on the United States**

Americans are exposed to the European debt crisis through money market funds, among other channels. The rapid slowdown of US economic growth, along with the elevated uncertainty tied to July's debt-ceiling fiasco, caused many households to sell stocks during August. Typically, investors move such funds into "cash equivalents" or money market funds, which pay virtually no interest but are meant to be highly liquid should households need to reinvest the funds or to purchase goods and services. As Europe's debt crisis intensified during the summer, US money market funds were, in effect, lending heavily to European banks that in turn were significantly exposed to shaky sovereign-debt issuers like Greece, Portugal, Spain, and Italy. The result was that Americans who wanted to avoid more risk by exiting stocks and entering money market funds were effectively lending to Greece and Portugal. This discovery led money market funds to sharply reduce their exposure to European sovereign debt as depositors began to exit for fear that the funds would be vulnerable to a Greek default and other European sovereign-debt problems.

The search for safety outside money market funds drove risk-averse American investors into US Treasury bills, bonds, and notes. As a result, the yield on four-week and three-month Treasury bills was driven to zero or below by late August, while the yield on one-year Treasury bills was driven to an incredibly low six basis points. So desperate were American households, and undoubtedly some firms, for a risk-free cash repository that in some cases they were willing to pay the US government one or two basis points for the privilege of lending to the government for a short period. Those who wanted more yield bought ten-year notes and thirty-year bonds, pushing yields on ten-year notes below 2 percent, even lower than they had been after the Lehman crisis, and yields on thirty-year bonds down to 3.25 percent or below. Other investors seeking safety and expecting higher inflation bought gold, pushing its price over \$1,900 per ounce at some points.

It is worth commenting on the simultaneous increase in the price of gold and the drop in interest rates on thirty-year bonds. Because gold pays no return, buyers are essentially betting on an increasing price of gold to reward them. If inflation continues to rise, as gold buyers expect, purchasers of thirty-year bonds will be at risk since they will be paid back in dollars with less purchasing power. As a result, the most popular fixed-income instrument, whose returns rival that of gold during 2011, have been US Treasury inflation-protected securities (TIPS). So eager are investors for a safe haven that the real yield on TIPS has been driven well below -1 percent. That means buyers of TIPS are willing to pay the US government more than a percentage point for the privilege of owning a long-term, inflation-protected asset.

But why are some investors betting on inflation by purchasing gold while others are willing to bid up prices on long-term Treasuries that would be harmed by higher inflation? The answer may be that the extremely high level of uncertainty in financial markets implies a wide range of possible outcomes, including both higher inflation and deflation. Gold is a somewhat illiquid way to play the inflation scenario, while longer-term Treasuries are a bet on the deflation outcome. Investors who remember Japan's deflationary experience after 1998 and the resulting drop in long-term interest rates to below 1 percent may buy Treasury bonds, while those who fear debasement of paper money may buy gold. Gold buyers are also concentrated in countries

like China and India where local-currency, long-term government securities are not available and gold is the preferred safe-haven asset.

### **No Place to Hide**

The systemic mess the United States and Europe--and eventually, the rest of the world--are facing in the fall of 2011 is greater than the sum of its parts. The US economy slowed down even after substantial monetary and fiscal stimulus had been applied. The slowdown was surprising and also disconcerting to policymakers who had to entertain the notion that the policy levers they were pulling were no longer effective. Just as these disquieting realizations were arising in the United States, the European debt crisis reintensified as Greece teetered on the edge of default and the crisis environment spread to the rest of southern Europe. These conditions raise some serious questions.

### **Why Isn't the US Stimulus Working?**

The short answer is this: monetary policy is not stimulating the economy because the United States is in a liquidity trap. At first, the Fed's QE2 was followed by higher interest rates as markets expected further growth. But as growth failed to materialize, interest rates came back down, stock markets weakened, and funds went back into cash. Viewed another way, the Fed's QE2 initially induced investors to put more money into riskier assets like stocks, but when growth failed to materialize, the funds left those riskier assets for cash. It was additionally disconcerting that one of the first cash destinations, money market funds turned out to be essentially lending to European borrowers who were even riskier than US borrowers. As a result, funds flowed into the Treasury markets, pushing short-term Treasury yields to zero or below. Those fearing eventual currency debasement and inflation bought gold.

The Fed's latest attempt to offer additional stimulus is somewhat bizarre. After its August meeting, the Fed indicated strongly that it would hold short-term interest rates at zero for another two years. That amounts to promising that the economy will not recover for two years because if it did, short-term interest rates would rise as cash balances sought higher returns on investments in the equity markets, which would improve as the economy improves. Those seeking a positive return on investments must bet either on higher inflation and buy gold or on higher growth and buy stocks.

The Fed has sought to push down immediate and longer-term interest rates with Operation Twist, whereby it is concentrating its purchases in the Treasury market on ten-year notes and thirty-year bonds at the expense of shorter-term bills and notes for which interest rates are already virtually zero. Lower interest rates--even lower longer-term ones--are not likely to produce much growth in an economy with virtually no demand for credit from qualified borrowers.

Fiscal stimulus is not working because the constraints of rising deficits and resulting debt mean that it is by definition temporary and must be reversed after implementation. Last December, the Obama administration announced temporary tax cuts. Enactment boosted incomes, but termination a year later will slow their growth. Obama's early-September 2011 proposal for a \$450 billion stimulus package for 2012 was followed in mid-September by another package

proposal that promised more than \$4 trillion in deficit reduction--nearly ten times the stimulus proposal--over the next decade. The impetus for Obama's 2012 stimulus was the end of the 2011 stimulus, which not only did not work to boost the economy but also will cause a slower economy once it ends. In other words, because the 2011 stimulus did not work, the president is claiming that we need another one in 2012 that will be reversed in 2013.

### **Why Doesn't Europe Either Let Greece Default or Bail It Out?**

The question of Greek debt has to be addressed very soon. If Greece unilaterally defaults, fears of defaults elsewhere in southern Europe may produce a run on European banks that hold claims on those countries, leading to a full-blown financial crisis in Europe. It probably would be better for the ECB--or the ECB, European Union, and IMF, collectively--to offer unconditional guarantees on sovereign European debt. This would mean the euro would likely end up as a relatively soft currency, so the German government, which would have to fund much of the sovereign-debt bailout, has so far refused to agree to this plan. Given the cumbersome nature of the European Monetary Union and its institutions, it appears likely that an agreement will not be reached and that some kind of Greek default, probably preceded by capital controls, will occur before the end of this year. The fallout, sharply lower European growth and sharply elevated financial -turmoil, will be negative for the United States and the rest of the world.

### **What Should the United States Do?**

This fall, while Europe is awaiting Greece's impending default, it appears that American policymakers will repeat July's debt-ceiling fiasco: ambivalence about whether tighter or easier fiscal policy is better for the United States (that is, are we supposed to raise deficits or reduce them?) will be rendered moot by the super committee's likely inability to find an additional \$1.5 trillion (or more, if any stimulus measures are enacted) in deficit cuts over the next ten years. If that is the case and US fiscal policy essentially continues on its current path through the end of the year, while Europe is in a default mess the United States will be experiencing fiscal drag equal to about two percentage points of gross domestic product, exacerbating any global slowdown caused by a failure to resolve Europe's debt mess.

No easy or obvious ways exist to bypass this bad outlook that has grown out of the inability of European and US economic policymakers to make hard decisions over the last several years. The signs that such an outcome is becoming more likely include a slowdown in inflation and a threat of deflation as more households and businesses seek the relative safety of cash equivalents like Treasury bills and rein in their spending in anticipation of substantial financial turbulence and slower growth. That development, coupled with the surge in demand for liquid assets that usually accompanies an acute financial crisis, will require central banks to print a lot more money to avoid a self-reinforcing deflationary disaster that raises the real debt burden at the root of the problem faced by banks and governments in Europe and banks and households in the United States.

One encouraging sign is that we may already have seen an initial step towards preempting deflation. On September 15, the Fed, in conjunction with the central banks of Europe, Great Britain, Switzerland, and Japan, arranged to supply dollars to Europe's banking system. The flow

of dollars to Europe's banks has dried up as other banks and US money market funds feared their exposure to large quantities of sovereign debt issued by southern European countries. The swap lines, as they are called, will be available to help with year-end funding needs by supplying the dollars European banks need to finance their dollar loans and other dollar liabilities. At the least, this step represents a solid move toward financial coordination among central banks that may help ease what appears to be an upcoming global financial mess.

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## **Notes**

1. "How to Save the Euro," *The Economist*, September 17, 2011, [www.economist.com/node/21529049](http://www.economist.com/node/21529049) (accessed September 20, 2011).
2. White House Office of the Press Secretary, "Fact Sheet: Living Within Our Means and Investing in the Future: The President's Plan for Economic Growth and Deficit Reduction," September 19, 2011, [www.whitehouse.gov/the-press-office/2011/09/19/fact-sheet-living-within-our-means-and-investing-future-president-s-plan](http://www.whitehouse.gov/the-press-office/2011/09/19/fact-sheet-living-within-our-means-and-investing-future-president-s-plan) (accessed September 22, 2011).