ECONOMY TODAY
Joint Economic Committee Republicans
Kevin Brady, Vice Chairman

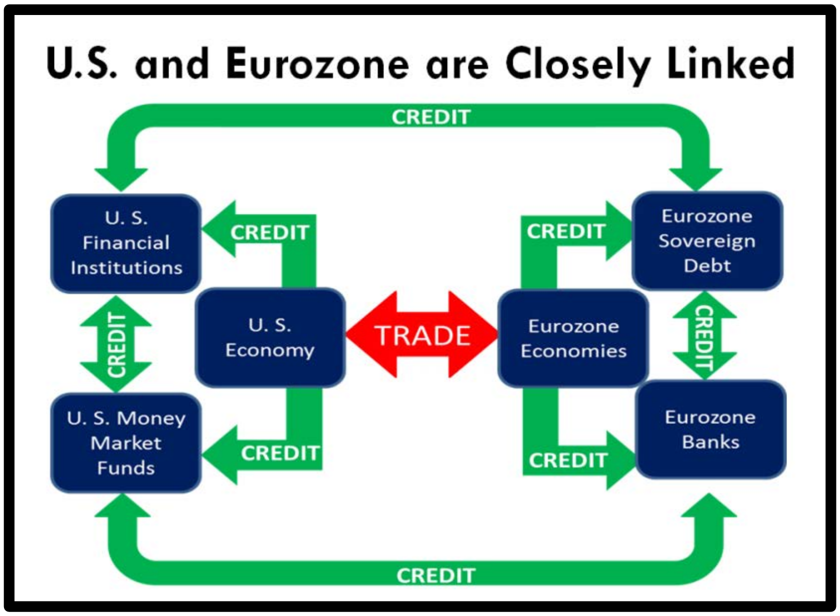
WHY EUROPE MATTERS: *STARK WARNING FOR THE UNITED STATES*

Europe's sovereign debt crisis should serve as a warning to U.S. to get spending under control.

December 1, 2011

Recent Actions by the Federal Reserve and Other Central Banks

- **The Federal Reserve announced that it was extending its foreign currency liquidity swap lines.**
  - The swap lines are designed to give the Federal Reserve the ability to offer liquidity in foreign currencies to U.S. financial institutions if necessary. It will also allow other central banks to provide their financial institutions with U.S. dollar liquidity.
  - The other central banks that the Federal Reserve authorized arrangements with include: Bank of Canada, Bank of England, Bank of Japan, Swiss National Bank and the European Central Bank. Each of these central banks has created similar reciprocal agreements with each other.



  - These swap lines are a contingency measure designed to assure that central banks have the capacity to offer funding in foreign currencies if needed.

- **The swap lines are not a bailout.**
  - Any dollars provided to other central banks are repaid to the Federal Reserve in dollars with interest. The action continues existing swap arrangements along with the new arrangements through February 1, 2013.

The U.S. Economy is Closely Linked to the Economies of the Eurozone

- In 2010, **the U.S. exported $285 billion of goods and services to the Eurozone member-states**, while the Eurozone member-states exported $331 billion to the U.S.

- In 2010, **U.S. Foreign Direct Investment (FDI) in the Eurozone was $1.37 trillion**; Eurozone FDI in U.S. was $937 billion.

- As of March 31, 2011, **U.S. banks had a direct credit exposure of $175 billion and a potential exposure (including credit commitments, derivatives, and guarantees) of another $550 billion** to governments, businesses, and households in Greece, Ireland, Italy, Portugal, and Spain.

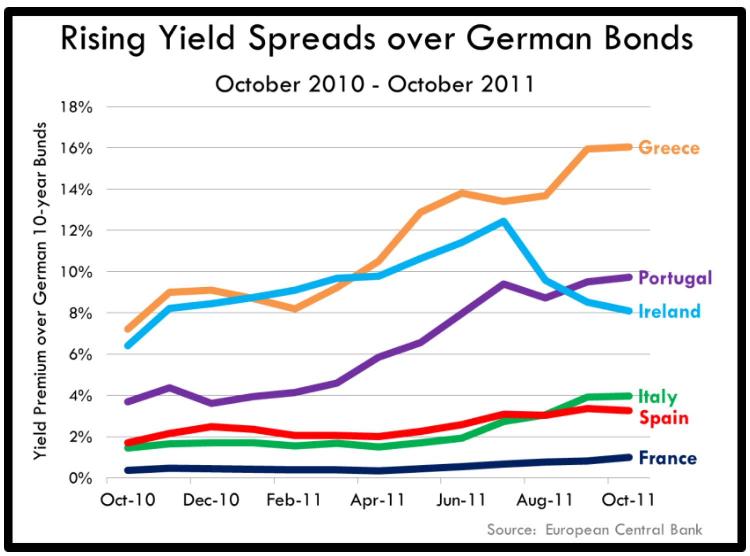
- **The top 10 U.S. money market mutual funds have a $224 billion exposure to commercial paper issued by European banks**.

A recession in the Eurozone is likely to slow real GDP and employment growth in the United States.

What Caused Financial Crisis in the Eurozone?

- ***The Eurozone crisis has a number of interrelated causes.***

- **The Greek government borrowed too much at very low interest rates to fund excessive government spending and then deceived investors, the EU, and other member-states about Greece's financial condition.**
  - Greece was the first member-state to lose the confidence of investors and sought an EU-IMF bailout on April 23, 2010. Greece received a €110 billion (about $158 billion) loan package on May 2, 2010.



- **The economies of the Eurozone were too diverse for a common monetary policy to make sense for all of its member-states over time.**
  - Interest rates that were appropriate for the slowly growing economies of France and Germany were too low for the rapidly growing economies of Ireland and Spain.
  - An excessively loose monetary policy for the economic conditions in Ireland and Spain inflated unsustainable housing bubbles fueled by excessive household borrowing. Their collapse inflicted large losses at Irish banks and Spanish cajas (non-bank savings institutions), sending the Irish and Spanish economies into recession.
  - Ireland's attempt to guarantee all of the liabilities of insolvent Irish banks caused investors to lose confidence and forced Ireland to seek an EU-IMF bailout on November 21, 2010. Ireland received a €68 billion (about $97 billion) loan package on November 29, 2010.

- **<u>Over the last decade, Germany made pro-growth reforms to its labor market.</u>**
  - Germany cut the duration of unemployment benefits and terminated benefits to any unemployed worker that refused to accept a job offer and reformed its government old-age pension system by lowering the average wage replacement rate from 70% to 67%, raising the retirement age from 65 to 67, and introducing private retirement savings plans to make up the difference for younger workers.
  - These reforms boosted German productivity by 8 percent from 2000 to 2008.
  - In contrast, Greece, Italy, Portugal, and Spain (after 2004) dithered about implementing pro-growth reforms. Productivity was essentially flat in Italy, Portugal, and Spain during 2000 to 2008, while productivity was flat in Ireland from 2002 to 2008.
  - Consequently, German exports soared from 31.3 percent of GDP in 2000 to 47.7 percent of GDP in 2008. Exports in troubled countries were basically flat when measured as a percentage of GDP.
- **Before the euro, a part of the adjustment to this loss of relative competitiveness would have occurred externally through an appreciation of the Deustche mark relative to the other currencies.**
  - This adjustment would result in lower real wages in Greece, Ireland, Italy, Portugal, and Spain through an increase in the price of imported goods and services, helping to restore the competitiveness of these economies.
  - Since the introduction of the euro, all of the adjustment must now occur internally through a reduction in nominal wages (sometimes referred to as an internal devaluation) and the liberalization of domestic markets that lowers costs.
  - Investors lost confidence in Portugal over the government's failure to implement pro-growth reforms. Portugal received a loan package of €78 billion (about $112 billion) from the EU and the IMF on May 16, 2011.

What Has the EU Done in Response to the Crisis?

- **In response to the crisis, the EU created a special investment vehicle, the European Financial Stability Facility (EFSF), on May 9, 2010, to issue up €440 billion in bonds, jointly and severally guaranteed by the Eurozone member-states, to fund loans to, or purchase bonds issued by, Eurozone members-states.**
  - At present, investors are losing confidence in both Italy and Spain. The European Central Bank (ECB) is currently purchasing Italian and Spanish government debt from banks and investors to prevent bond interest rates from spiraling to unsustainable levels that force a default.
- **As mentioned earlier, the ECB has expanded its swap arrangements with other central banks.**

What are the Risks of Contagion Effects?

- **European banks have a large exposure to Eurozone government debt. So far, European banks have recognized significant losses on Greek government debt as well as residential mortgage loans in Ireland and Spain. A few large European banks – including Dexia – have already failed this year.**

- **In general, European banks have less equity capital and rely more heavily on bonds, commercial paper, and interbank loans to fund their loans and investments than American banks.**

  - Because of these risk factors, some European banks are incurring difficulties in rolling over their external debts. According to the *Financial Times*, European banks have a $241 billion funding gap (i.e., maturing unsecured senior debt is greater newly issued unsecured senior debt).

  - Consequently, many European banks are becoming dependent on short-term, secured loans from the ECB.

- **If other Eurozone member-states default on their government debt, or if the Eurozone slips into a recession, European banks are likely to suffer additional losses, reduce their loans to businesses and households, and sell assets.**

  - Some European banks may fail, and member-states may be forced to inject billions of euros to resolve bank failures.

  - Under such circumstances, a financial panic could start in Europe and spread to the rest of world, triggering a recession in Europe and a slowdown in the rest of the world.

How Likely Is a Fiscal Union and How Effective Would It be In Solving the Crisis?

- **So far, Eurozone member-states have resisted surrendering their fiscal sovereignty to the European Union.**

  - However, with the apparent support of French President Nicolas Sarkozy and Italian Prime Minister Mario Monti, German Chancellor Angela Merkel is seeking to conclude bilateral agreements with the other Eurozone member-states before the next European summit on December 9, 2011.
  - Bilateral agreements would bypass the long and difficult process to negotiate and approve amendments to the EU treaties.
  - In exchange for German assistance, these agreements would give Germany the right to review and approve the national budgets of other member-states.

- **Whatever its merits over the long term, the creation of a Eurozone fiscal union either formally through a treaty or informally through bilateral agreements would be unlikely to avert a financial crisis or a recession in Eurozone member-states in the short term.**

A Highly Fluid Situation

- **The situation remains highly fluid as economic forces continue to collide with political realities and national pride.**

- **Members should expect a continued rollercoaster ride over the next several months.**

An Important Warning to the United States

The situation in Europe should be a stark warning to the United States. Sustainable levels of debt and deficits become quickly unsustainable in the face of increased borrowing costs. Policy makers must act sooner rather than later to bring government spending down to sustainable levels. Failure to do so will require even more drastic action in the future.