

**THE ROLE OF THE INTERNATIONAL
MONETARY FUND AND THE FEDERAL
RESERVE IN STABILIZING EUROPE**

JOINT HEARING
BEFORE THE
SUBCOMMITTEE ON
DOMESTIC MONETARY POLICY
AND TECHNOLOGY
AND THE
SUBCOMMITTEE ON
INTERNATIONAL MONETARY POLICY
AND TRADE
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THE ROLE OF THE INTERNATIONAL MONETARY FUND AND THE FEDERAL RESERVE IN STABILIZING EUROPE

Thursday, May 20, 2010

U.S. HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON DOMESTIC MONETARY
POLICY AND TECHNOLOGY, AND
SUBCOMMITTEE ON INTERNATIONAL
MONETARY POLICY AND TRADE,
COMMITTEE ON FINANCIAL SERVICES,
Washington, D.C.

The subcommittees met, pursuant to notice, at 2 p.m., in room 2128, Rayburn House Office Building, Hon. Melvin L. Watt [chairman of the Subcommittee on Domestic Monetary Policy and Technology] presiding.

Members present: Representatives Watt, Meeks, Sherman, Green; Paul, Royce, Manzullo, Bachmann, Paulsen, and Lance.

Chairman WATT. This joint hearing of the Subcommittee on International Monetary Policy and Trade and the Subcommittee on Domestic Monetary Policy and Technology of the Financial Services Committee will come to order.

Without objection, all members' opening statements will be made a part of the record, and we will recognize some members for opening statements

And I will now recognize myself for an opening statement.

Today's hearing is a part of our ongoing effort to examine and understand what things can cause a global economic crisis and threaten our economic well-being.

Today, we will look at the sovereign debt crisis in many nations, particularly in Europe. We will explore the root causes and potential solutions to the European debt crisis with particular focus on the policy responses made by the Federal Reserve and the International Monetary Fund (IMF) to help stabilize European financial markets.

In recent weeks, the European Union and the IMF agreed to a financial stabilization package of nearly \$1 trillion, which will be available to all 27 Eurozone countries in the form of loan guarantees and direct bilateral loans if they agree to take strict debt reduction measures.

As the chairman of the Domestic Monetary Policy and Technology Subcommittee of the Financial Services Committee, however, I want to focus the bulk of my attention on the actions of our own Federal Reserve. The Fed has agreed to reopen temporary cur-

rency swap facilities with foreign central banks, including the European Central Bank, the Bank of England, the Swiss National Bank, the Bank of Japan, and the Bank of Canada. These currency swap lines, authorized through January 2011, will provide foreign central banks with access to U.S. dollars in their local markets at fixed local rates in exchange for Euros or local currencies.

We need to understand and shine the light of transparency on why this was necessary, whether it could extend beyond January of 2011, and exactly what exposure, if any, U.S. taxpayers could have as a result of the Fed's action.

As I understand it, these swap facilities are designed to improve liquidity positions in global currency markets and minimize the risk that strains abroad could spread to U.S. markets. Some observers believe that the European debt crisis, if left unaddressed, could threaten the nascent U.S. economic recovery by shattering confidence and disrupting credit flows to businesses and consumers, and that it could put upward pressure on interest rates.

The Fed has emphasized that these currency swaps are not a bailout, that they involve no direct expenditure of U.S. taxpayer funds to European financial institutions, and that under the contracts between the Fed and foreign central banks to swap currencies, the foreign central banks will bear any risk of defaults by European financial institutions.

In addition, it appears that the Fed actually made money, over \$5 billion, from the currency swaps of 2008 and 2009, because foreign central banks pay interest to the Fed when they draw on swap lines. We need to hear more from the Fed about the mechanics of these currency swap facilities and about the potential risk and rewards to U.S. taxpayers from many of the Fed's policy responses to the European debt crisis.

As chairman of the International Monetary Policy and Trade Subcommittee, Chairman Meeks will be presiding over the second panel. While he will take the lead, I also look forward to questioning these witnesses about the IMF's role in stabilizing Europe.

It is no accident that Chairman Meeks and I scheduled a joint hearing of our two subcommittees to examine the sovereign debt crisis in Europe because the global financial system is interconnected, and what happens in Europe or anywhere else in the world, for that matter, affects the United States and vice versa. Our two subcommittees will continue to monitor the situation in Europe and elsewhere and will conduct follow-up hearings as necessary.

I will now recognize the ranking member of the Domestic Monetary Policy and Technology Subcommittee, Mr. Paul, for 5 minutes.

Dr. PAUL. Thank you, Mr. Chairman.

Mr. Chairman, I'm disappointed that yet again American taxpayers find themselves forced to pay billions of dollars in bailouts, only this time we are not bailing out profligate American companies but foreign governments.

Billions of dollars of IMF funding, much of it coming from U.S. taxpayers, will be sent to Europe to bail out Greece and other European countries who might find themselves in financial crisis. Evidently, the lesson of the U.S. Government bailouts has not been

learned. Bailouts do not, in fact cannot, make things better; they can only make things worse.

Governments can pay for bailouts by increasing taxes, which takes money out of the pockets of hardworking poor and middle-class Americans and siphons it off into the bank accounts of failed bankers, or governments can pay for bailouts through inflation, increasing the supply of money out of thin air and devaluing the currency, in this case, the bailout firms who have used this new money to reap all the benefits while the poor and the middle class see increased prices and the purchasing power of their savings reduced. Finally, governments can pay for bailouts through increased issuance of debt, increasing the tax burden of future generations in the hope of finding investors who will purchase bonds, which are increasingly unlikely ever to be paid off.

None of these options lead to long-term stability. They merely attempt to patch up a fragile financial system and put off financial reckoning until the next crisis. Bailouts provide a short-term illusion of continuing prosperity, while underneath the same rotten fundamentals ensure that bailout money is merely throwing good money after bad.

Bailing out foreign governments is just as bad. Why should American taxpayers be on the hook because a foreign government cannot cover its debts?

What makes this situation even worse is that the bailout is being undertaken in a manner which is nearly impossible to stop. Bailout funds coming from the IMF, which receives nearly 20 percent of its funding from the United States, require the approval of IMF members, including the United States, with its de facto veto power. Only the President can prevail upon the U.S. representative at the IMF to vote against this bailout. The people and their constitutionally elected Representatives in Congress are shut out.

Compounding this is the reemergence of dollar swap lines from the Federal Reserve to foreign central banks, which will likely result in the creation of tens of hundreds of billions of dollars of new money. Bailouts never work. They never have and they never will. The only thing they do is burden the taxpayer and delay the inevitable collapse of the bailed-out entity.

Fiscal and monetary responsibility is a tough pill to swallow, but it is essential for the sound functioning of the economy. We need to end the cycle of bailouts and ensure that American taxpayers will not continue to subsidize foreign governments.

I yield back the balance of my time.

Chairman WATT. I thank the gentleman for his opening statement. The gentleman from New York, the chairman of the International Monetary Policy and Trade Subcommittee, is recognized for 5 minutes.

Chairman MEEKS. Thank you, Mr. Chairman.

Before I begin, let me first thank you for—as subcommittee chairman of the Domestic Monetary Policy and Technology Subcommittee—working and putting this hearing together in a timely fashion. This hearing I think is happening at the most appropriate time, and as you correctly indicated, both of our subcommittees continue to monitor the situation as we move forward from both the domestic and international policy sides.

And the reason why this hearing will be helpful to all of us is because it will help us to better understand the extraordinary events occurring in Europe this past month and the associated implication of the international monetary system. Specifically, we look forward to, and this hearing will be focusing on, actions as they pertain to the Fed and swaps, as indicated by Chairman Watt. But also, it will be focused on the actions taken by the IMF as well as the Federal Reserve to help Europe staunch the burgeoning sovereign debt crisis, which began in Greece and threatens financial markets worldwide.

Europe represents a quarter of global GDP and is a major source of demand for U.S. exports. More than 20 percent of the total U.S. goods exports and more than 35 percent of total U.S. services exports go through Europe. The total value of these exports to the EU is more than 5 times the value of U.S. exports to China.

Furthermore, European-owned firms in 2007 employed roughly two thirds of the 5.5 million U.S. workers on the payrolls of all foreign firms operating in the United States. Therefore, strong growth in Europe supports production and jobs in the United States. A prolonged and deep recession in Europe could or would undermine Americans' own economic recovery.

The United States also has very strong financial linkages to Europe. The intensifying European debt crisis has adversely affected U.S. corporate bond and stock issuance. The week prior to the announcement of the stabilizing actions taken by the EU and IMF on May 9th had the lowest number of investment grade corporate bond sales since the week of September 15, 2008, when Lehman Brothers fell.

Additionally, during that timeframe, a large number of initial public offerings of stock were canceled or postponed in the equity markets. Thus, it is not in the interest of the United States, or any other countries, to allow the significant uncertainty in the markets to continue or worsen.

Given these important economic linkages between the United States and Europe, it is critical that the United States provide support to Europe in its efforts to quickly stabilize the financial markets, prevent contagion, and promptly address sovereign debt issues. In particular, supporting the IMF in its assistance to Greece and, as necessary, to other affected European countries, appears to be the best and most preferable means to effectuate United States support.

I look forward to the testimony from today's witnesses. In particular, I look forward to learning about the EU's financial stabilization fund and the support provided by the IMF. I also seek to better understand how Greece and other European countries ended up in this situation and whether the proposed plans are appropriate.

Lastly, and of particular importance to me, I hope to learn what impact this focus on Europe by the IMF will mean to its efforts in helping developing countries around the world.

I yield back the balance of my time.

Chairman WATT. I thank the gentleman. The gentleman from California, Mr. Royce, is recognized for up to 7 minutes.

Mr. ROYCE. Mr. Chairman, last year, during a pretty fierce budget debate that we had in this committee, the Obama Administration quietly requested an additional \$100 billion loan from us to the IMF, and while I and other Republicans raised concerns about this, opposed this measure, over our objections, that provision passed and our exposure to the IMF grew.

I took issue with this very provision then, and I do today, for several reasons. First, we have near-trillion dollar deficits as far as the eye can see, and things continue to get worse. The government has lent, spent or guaranteed about \$8.2 trillion to prop up our economy in the last 2 years. While we were overleveraged pre-crisis, this drastic spike in taxpayer liabilities is a Trojan horse that has put us on a Greek-like course.

Just last month, the Federal budget deficit, at \$82.7 billion, hit an all-time high for April. It was \$53 billion higher than economists had predicted. As Chairman Bernanke has repeatedly said to us, this path is unsustainable.

Second, the IMF has a poor track record when it comes to dealing with sovereign debt crises. Over the years, the IMF has developed into a dependence-inducing crutch used by weaker countries to avoid making the tough decisions necessary to get their fiscal houses in order. More than 70 nations have already depended on IMF aid for 20 or more years. They just keep rolling over and increasing the debt. Twenty-four countries have received IMF credit for 30 or more years. In many ways, the IMF has been as much part of the problem as part of the solution.

Lastly, the possibility of contagion puts potential U.S. liabilities through the roof. Just within the IMF-EU proposal, U.S. exposure is roughly \$54 billion. Looking at the global debt issues, things could get much worse. According to recent CDS spreads, 8 of the 10 riskiest sovereign debts in the world reside outside of the EU. Where will the IMF be when those countries move to the brink of default?

Given these factors, the United States needs to look at reducing its exposure to the IMF. No loan, however large, will solve Europe's problems. It will simply delay and weaken the appetite for necessary change.

The promise of a never-ending European welfare state is at the heart of the crisis. For decades, governments overcommitted and failed to pay for these entitlement programs, which led to a sea of debt. The irony that an institution of which we are the greatest contributor is going to rescue countries drowning in debt is apparent.

Now is the time for us to address our own budgetary crisis and put our economy back on a path toward prosperity. The longer we delay, the closer we will get to being the "United States of Europe."

I yield back the balance of my time. Thank you, Mr. Chairman.

Chairman WATT. I thank the gentleman for his statement, and we're pleased to welcome as our first and only witness on panel one, Governor Daniel K. Tarullo of the Board of Governors of the Federal Reserve, who will be recognized for 5 minutes. We generally don't enforce that for Fed witnesses as rigorously as we do against some other folks, but there will be a lighting system there

to prompt you: green for 4 minutes; yellow for 1 minute, and red after the 5 minutes is over; but we'll be generous.

Without objection, your entire written statement will be made a part of the record, and we would encourage you to summarize your testimony in as close to 5 minutes as you can.

So Governor, you are recognized.

STATEMENT OF THE HONORABLE DANIEL K. TARULLO, GOVERNOR, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Mr. TARULLO. Thank you, Mr. Chairman, Mr. Meeks, Mr. Paul, and Mr. Royce.

Let me, in my oral remarks, make points on three topics: first, the nature of the European sovereign debt problems and the European response; second, the kinds of risks that their problems pose for the United States; and third, as you requested in your letter inviting us to testify today, the actions that the Federal Reserve took last week.

First, with respect to the European sovereign debt problems, these have evolved over some number of years as aggregate debt levels have increased. Once the European Monetary Union was created in 1999, many investors appeared to assume that there was an implicit guarantee protecting the debt of Euro area members, probably resulting in an underpricing of risk associated with some sovereign issuers.

When it became clear last fall that the Greek fiscal deficit was several times larger than previously thought, investors began to focus on the sustainability of these levels of debt. Spreads on Greek debt widened, and it became increasingly clear that Greece was losing access to market funding.

Despite a fiscal consolidation plan announced by the Greek government and, at the beginning of the month, a \$110 billion Euro EU-IMF program, market pressures were not contained. By then, concerns of investors had also arisen about the sovereign debt provisions of other so-called peripheral European countries.

Pressures were felt in dollar funding markets, with some signs of dollar shortages in the interbank market bringing back unpleasant memories of the recent global financial crisis. In response to these growing problems, European leaders announced, on May 10th, the package of stabilization measures with which you are familiar.

My second topic is the potential risk posed for the U.S. economy. In assessing these risks, I think it's useful to analyze in terms of two kinds of transmission channels, through financial markets and through the so-called real economy. The two are obviously connected, and sufficiently serious problems in one will exacerbate problems in the other. But as I say, it's a good analytic starting point for thinking about risks to our own economy.

An important component of the real economy transmission channel is trade. If European growth slows down, U.S. exports will suffer, with potential effects on output and employment here at home. Similarly, if the Euro depreciates significantly, U.S. exports that compete with European products around the world will be adversely affected.

If we look, though, at the likely effects of a moderate slowdown in European growth, the impact on U.S. growth would likely be discernible but relatively modest. Larger effects are likely to be felt only if there are significant problems in financial markets, which would amplify the real economy effects with much greater impact on wealth, lending, and production in the United States.

The large U.S. institutions that do significant business in Europe appear to have manageable levels of exposure to the peripheral European sovereigns. However, if sovereign problems in peripheral Europe were to spill over and cause financial difficulties more broadly, U.S. banks would face larger losses on their considerably larger overall credit exposures.

Increases in uncertainty and risk aversion could lead to higher funding costs, resulting in forced asset sales and reductions in collateral value that might lead U.S. financial institutions to pull back abruptly on their lending. This would obviously come at a particularly bad time, as we are just beginning to see signs that lending standards for smaller companies and households could soon be relaxed in our own economy.

In the worst case, which I add we do not expect, broad uncertainty could result in a generalized unwillingness to extend funding. Forced asset sales could lead to further declines in collateral with further funding pressures, resulting in the freezing up of financial markets such as was seen following the bankruptcy of Lehman Brothers in the fall of 2008.

My third and final topic, what actions did the Federal Reserve take last week? Well, the Federal Reserve has a limited but important role here, one that addresses directly the potentially serious liquidity problems I mentioned a moment ago.

Last week, as you noted, Mr. Chairman, we re-established dollar liquidity swap lines with the European Central Bank and a number of other central banks. These lines are similar to those which the Federal Reserve put in place during the recent financial crisis.

Swaps are a well established tool of international monetary relations among central banks. In the current situation, the dollar liquidity swaps provide a backstop to counter significant dollar funding pressures in foreign markets. The swap is a temporary arrangement whereby a foreign central bank exchanges its currency for dollars at the prevailing exchange rate. There is an agreement to reverse this transaction within a short period of time, in no case more than 3 months.

Under the terms of the swap agreements, all of which are posted on the Federal Reserve site, our dealings are only with the central bank, not banks, financial institutions in the other country to which the central bank may lend the dollars.

Also, in accordance with the terms of the agreement, we do not bear the risk that the foreign currency may depreciate during the term of the swap, since the foreign central bank is committed to repay us with the same number of dollars that they originally took in the swap for the same number of euros or yen or whatever their foreign currency may be. We charge an interest rate well above what a normal market-level interest rate would be, and this indeed is intended to ensure that our swap facility is a backstop to fore-

stall serious liquidity problems, not to be a normal source of dollar funding.

To date, there has been fairly modest use of the swap lines established on May 10th. Last week, there was an 8-day, \$9 billion swap drawn by the European Central Bank. Because it was 8 days, that will be repaid today, the 20th. There have since been 2 smaller swap drawings, both 84-day drawings, one of a little over \$1 billion with the European Central Bank, and one a little over \$200 million with the Bank of Japan. So, as of the end of the business day today, we'll have outstanding about \$1.2 billion in the swap arrangements.

Each Thursday at four o'clock, the Federal Reserve will post on its Web site a list of all outstanding swap arrangements.

The policies announced last week in Europe, with the supporting role played by the swap lines, have stopped deterioration in dollar funding markets in Europe, but dollar funding markets remain strained as investors await further clarification of the stabilization, regulatory, and fiscal measures to be adopted within Europe.

In closing, Mr. Chairman, I would say that the United States is in a very different position from that of the European countries whose debt instruments have been under such pressure, but their experience is another reminder, if one were needed, that every country with sustained budget deficits and rising debt, including the United States, needs to act in a timely manner to put in place a credible program for sustainable fiscal policies.

Thank you very much, and I would be pleased to answer any questions you may have.

[The prepared statement of Governor Tarullo can be found on page 46 of the appendix.]

Chairman WATT. Thank you, Governor, for your very comprehensive statement. I will now recognize the members of the committee for 5 minutes of questioning each, and I will recognize myself initially for 5 minutes.

In your testimony, Governor, you indicated at pages six and seven that the Fed's role here is "limited though important" and I wonder if you could kind of expand on that, the importance of it in particular. I understand the limited nature of it; you explained what you have outstanding and what you could potentially have outstanding, what about the importance of it?

Mr. TARULLO. The importance, Mr. Chairman, I think is best understood by thinking about the experience we went through a couple of years ago, where dollar funding became constrained not because of the underlying credit situation of a particular financial institution but just because there is such widespread uncertainty in markets that those who provide funding become reluctant to provide funding for anything more than the shortest terms to almost anyone who might have exposures, in this case, to sovereign debt. A couple of years ago, it was to subprime or other kind of mortgage securities.

From our point of view, that kind of freezing up of dollar funding markets is what produces these kind of amplified negative effects on our real economy, stopping lending at home because everybody begins to husband their liquidity sources at that moment. What I describe as our limited role is limited to providing expensive dol-

lars—that's why we charge a higher rate on them, to make sure that they're only used to stop a really serious liquidity situation from developing. But, it is important precisely because there is assurance given that through the mechanisms of the European Central Bank and other central banks, in such circumstances, dollar funding will be available so that we don't have that kind of freezing up by institutions in search of dollars that are unavailable.

Chairman WATT. Let me see if I can squeeze in two other questions quickly. First of all, we tried to address—well, in the regulatory reform bill there is some language that says, if the House bill were passed as the final bill, that this kind of swap arrangement would require some heavier vote in the Fed, a higher level. What was the vote by which—or was there a vote by which this was done at the Fed and did it exceed that level, even though it's not applicable at this current moment?

Mr. TARULLO. Mr. Chairman, we had a meeting of the Federal Open Market Committee (FOMC) on Sunday, May 9th. At that meeting, the situation in Europe was discussed, as was the possible reactivation of the swap lines, and by unanimous vote, the FOMC granted the Chairman the authority to reactivate the lines.

Chairman WATT. So I assume we didn't require anything in the statute more than a unanimous vote.

[laughter]

Chairman WATT. So that answers my question. Okay.

You talked about the swap agreements freezing your risk of currencies' values going down. Obviously they—and that protects you against that, and then you'll get interest. But I assume these agreements also freeze you from the prospect of currencies going up for that period of time too. Is the risk—is that interest commensurate with, say—or would you ever be doing this to try to see if you could make money on it anyway, other than the interest?

Mr. TARULLO. We're not speculating in foreign exchange here, Mr. Chairman. Our purpose is, as I said, to provide a backup source of expensive but nonetheless available liquidity if needed. The interest rate that we set on the swap line is meant, as I said, to discourage its use as a normal source of dollar funding.

We arranged to have, in essence, the same number of dollars and euros or dollars and yen exchanged at the end of the swap, and we are getting the interest on the use of those dollars during that period. One would anticipate, although there's no guarantee of this, that in a situation in which one polity is borrowing the currency of another that its own currency is probably depreciating, as we have seen some euro depreciation. There is, in theory though, the possibility that the currencies could go in the other direction.

Chairman WATT. My time has expired, and I recognize the gentleman from California for 5 minutes for his questions.

Mr. ROYCE. Thank you very much, Mr. Chairman.

You mentioned the liquidity of euro debt markets. Do you think this is a liquidity problem rather than a solvency problem right now?

Mr. TARULLO. I would say a couple of things about that, sir. One, the problem that we, the Federal Reserve, are addressing is the potential emergence of serious liquidity problems within the Euro-

pean financial system, which could in turn have an impact on our own financial system.

There are obviously questions within Europe about the sustainability of the debt situations of some of the sovereigns, beginning with Greece.

Mr. ROYCE. Yes, that's what I wanted to ask you. Adding additional liquidity into the European market, does that make it more likely or less likely that these excessive debt issues are going to be addressed?

Mr. TARULLO. I wouldn't say, Mr. Royce, that drawing on a swap line makes it any more or less likely that the fiscal problems as such are going to be addressed. Remember, these are temporary lines that unwind.

Mr. ROYCE. Yes.

Mr. TARULLO. They're only meant to stop the very bad kinds of things from happening and so—

Mr. ROYCE. But at times I wonder, if you remove the urgency, can you create moral hazard? And let me go down this line of argument with you for a minute, Daniel.

The more leeway we give EU governments in making the necessary changes to reign in their excessive debt, the more likely other countries around the world will take our actions to mean that they can delay those necessary changes. That's the worry I have.

In many ways I think—some people argue, some economists argue we saw this during the financial crisis. The Fed took extraordinary steps to bail out Bear Stearns, but lo and behold, according to some, that sent the message to Lehman Brothers and to other, much larger institutions, that the Federal Government would not let a major bank fail. And what we saw was that in negotiations then for additional capital or for merger, there was a delay, arguably, as people looked for the same deal that JPMorgan got with respect to the prior bailout at Bear Stearns.

So it sends the message, and I wonder if we run the risk of repeating that hypothetical moral hazard problem that some economists argue was created there with this IMF-financed backstop. Do we delay that sense of crisis that the legislature has to act now, that the left government in Greece has to produce this solution because there is no backstop, or instead do we create this false sense of security?

Mr. TARULLO. Let me try to distinguish our actions from, I think, the broader questions which you are raising. Our actions are addressed to forestalling a serious liquidity crisis in the short term, which has the potential for very negative effects in our own economy. I don't think that—

Mr. ROYCE. I understand your argument there.

Mr. TARULLO. With respect to your broader question, I think there is always going to be a question about the degree to which the availability of a stabilization package or some form of assistance in a particular circumstance might create a more—

Mr. ROYCE. I'm running out of time, so I—in your opening statement, you mentioned the Fed's plan to reopen dollar swap lines with the Banks of Canada, England, and Japan, the ECB bank, and the Swiss National Bank, but as I said earlier, many of the world's riskiest sovereign debt resides outside of the reach of these

central banks, and I worry about the extent of the Fed's willingness then to assist these countries because I wonder where this will end.

Venezuela, Argentina, Pakistan, the Ukraine, you look at the probability of default according to CME—the Chicago Mercantile Exchange did a little study on this: 48 percent for Venezuela; 46 percent for Argentina, this is during the next 5 years; Pakistan, 42; Ukraine, 35; and Iraq, 28. As we put this off, the debt problem grows and the overleveraging grows. If the pressure comes home to bear sooner rather than later, perhaps it's better in the international economy to have these things faced before they compound as they're now compounding.

Mr. TARULLO. I would say, Mr. Royce, as I said in my prepared statement, quite apart from our swaps, which are for the very limited purpose I indicated, there is a recognition that the broader stabilization package in the European Union is not itself a solution, and there is a need to address the fiscal consolidation issues within the European Union.

Some of the urgency that you feel is being reflected in the way in which markets are looking at the elaboration of the program right now.

Mr. ROYCE. Thank you, Mr. Chairman.

Chairman MEEKS. [presiding] The gentleman's time has expired. And I will now recognize myself for 5 minutes.

Let me first thank you, Governor, for your testimony today, and for the great work that I think that you and the Federal Reserve are doing in these most challenging of times in which we now live.

Let me ask this question first of all: I think you mentioned in your opening statement that the Fed has posted on its Web site the contracts that detail the swap arrangements with foreign and central banks, including the European Central Bank, and that is, I think, great for the transparency that presents itself around these agreements. My question to you is, I'm wondering if you might explain the process around how the decisions are made with which foreign central banks to sign agreements and what the selecting criteria are and what is utilized, how are you doing that?

Mr. TARULLO. With respect, Mr. Meeks, to the swap arrangements which have just gone into effect, I think the criteria essentially arose around the question of where might there be these kinds of serious liquidity problems, in what set of financial institutions might they conceivably arise. And, as you'll note, what we did was to put in place swap arrangements with the G7 plus Switzerland, covering basically a broad part of the global financial system and the interconnected financial institutions within that system.

With respect to some of those countries, it really is a matter of a backstop being available if needed. It may well not be needed. Some of the swap arrangements that were in place during the financial crisis of the last couple of years weren't drawn on. So to some degree, their very presence provides markets with the assurance that in more serious circumstances, the liquidity will be available.

I would just say that in general, our criteria are obviously going to include the understanding of the situation, the potential vulnerabilities, and, of course, the kinds of dealings that are going on at that moment which lead to the need for it.

Chairman MEEKS. The currency swap facility, which was established in 2007 to address dollar liquidity pressures resulting from the global financial crises, peaked the number of swaps outstanding in December 2008 with a total notional value surpassing \$580 billion. And we were told that some economists believe that the new swap program could peak with total values as much as \$100 billion, large but still, I guess, relatively, I think, modest sums compared to the Fed's total balance sheet. Do you have your own estimates of peak notional values of total swaps outstanding for the new program? And do your estimates support the statement that even at the peak, the total value of outstanding swaps will represent only a relatively modest sum compared to the Federal Reserve's total balance sheet?

Mr. TARULLO. Mr. Chairman, let me say a few things. First, as you noted, the peak drawings during the financial crisis were about \$580 billion, all of which has been unwound, an indication, I think, of the capacity of these arrangements to function and to function smoothly and effectively.

Second, we don't have a specific estimate as to what may be needed. One's hope, of course, is that the institution of the arrangements, their availability, means that they won't have to be drawn on to a considerable extent. But they might, and we have confidence in the arrangement that would lead to swaps being put in place and then being unwound.

Third, on the general question of how much, we are always in a position to make our own decisions about whether to go through with a particular swap drawing, even within the confines of a particular agreement. We do retain the discretion to shape it as necessary. So from our point of view, this is, as I say, a prudent measure that is well established in central bank practice, has been used recently, and that we have the ability to control going forward.

Chairman MEEKS. My last question that I'm going to try to get in, it's a short question, because some of the economists worry that putting more U.S. money into circulation at a time when the Federal Reserve is looking at ways to eventually shrink its balance sheet would only add to inflationary pressures down the road. Do you agree with that statement? What mitigating actions is the Federal Reserve taking to prevent detrimental inflationary pressures from swap lines in the future?

Mr. TARULLO. With respect to the swap lines, Mr. Chairman, they unwind within that relatively short term, so the reserves are not sitting on the balance sheet for a prolonged length of time. And of course at the present time, inflation is extremely subdued.

Chairman MEEKS. Thank you. The gentleman from Illinois, Mr. Manzullo is recognized.

Mr. MANZULLO. Thank you.

Mr. Tarullo, when the Maastricht convergence criteria was struck, the annual deficit could not exceed 3 percent of GDP, and total national debt could not exceed 60 percent of GDP. Were there exceptions made to that criteria so as to enable countries to use the Euro?

Mr. TARULLO. We'll go back in time, Congressman, because I think you're basically raising the question of what has gone wrong

here with the EU and the requirements for state member participation.

Mr. MANZULLO. That's a good—that's a better question than mine.

Mr. TARULLO. I think, if you recall, there were two kinds of problems back in the late 1990's, which many economists observed, about the beginning of European Monetary Union.

I think a lot of people acknowledged the benefits that could be gained, but there were two kinds of questions. One was whether this was an optimal currency union, meaning whether it actually covered the kind of area with the kinds of economic diversity that made for a workable currency union. There are questions about whether there are enough fiscal stabilization transfer payments and the like to allow for the fact that there would be variance in economic performance across the euro zone.

The second question was exactly the one that I think we are all addressing today, which is whether in a monetary union with a single currency, there would be the potential for some member states of that currency union to be borrowing in ways that resulted in the underpricing of risk because there was some sort of implicit guarantee in the common currency. And as you indicated, there were requirements.

Mr. MANZULLO. Were there exceptions made to those requirements?

Mr. TARULLO. Yes. There was an exception—

Mr. MANZULLO. Did Greece meet the requirement when it came in, do you recall?

Mr. TARULLO. When it came in, 2001, I believe they did.

Mr. MANZULLO. They did meet the requirement. Okay.

Mr. TARULLO. But I think there's widespread acknowledgement in Europe that the mechanisms for ensuring fiscal sustainability and fiscal responsibility have not been adequate, and that's why you see the debate right now in Europe with proposals being offered by member states and by the Europe—

Mr. MANZULLO. Do you see the United States going the same way, with the increase that we have in our annual deficit and government debt?

Mr. TARULLO. Right now, I think we need to be clear, we're in a very different situation, that the proportion of GDP accounted for by the interest payments we pay on our debt is substantially lower than those of the countries we're talking about today.

Mr. MANZULLO. What is it now?

Mr. TARULLO. It's a couple of percent, and of course, it is the case that in fact the response of markets has been to go to U.S. Treasuries. The flight to quality has been toward United States Government obligations, indicating that we still are a safe haven for finances in periods of stress.

Mr. MANZULLO. But—

Mr. TARULLO. Having said that, Congressman, and I think you were going to supplement if I didn't. There is no question, as Chairman Bernanke has said, and as I would repeat today, that for the United States going forward, a very important economic policy aim needs to be to put ourselves on a more fiscally sustainable path, which is and I think ought to be an imperative for us all. But

it is not as if we are today in the same situation as Greece or some of the other countries we're talking about.

Mr. MANZULLO. I see many statistics that talk about the possibility that we could really exceed Greece's debt ratios because of the excessive spending that's going on in this country, and my concern is, who will bail out the United States as we push ourselves more towards the European economy or the European style of government?

Mr. TARULLO. Congressman, I think that it is well within our capacity as a country to fix our own fiscal problems, and I think that Members of Congress, the Administration, and some of us on the Federal Reserve, have made essentially the same points.

We are the world's largest and most important economy. We are in a position to deal with our own problems. And, as I said, I think it's imperative that we do so.

Mr. MANZULLO. Thank you.

Chairman MEEKS. The gentlewoman from Minnesota, Ms. Bachmann.

Mrs. BACHMANN. Thank you very much, Mr. Chairman, and thank you so much, Governor Tarullo, for coming here today to speak with us. I just wanted to tag on to the Congressman from Illinois and ask, you talked about the fiscally sustainable path for the United States, and I'm just curious to know, from the Federal Reserve's perspective, what would that fiscally sustainable path be? What would it look like?

Clearly, Greece has gone out of a safe harbor zone and they're not on a fiscally sustainable path. What does a fiscally sustainable path look like in the United States?

Mr. TARULLO. I think conventionally, the understanding of a fiscally sustainable path would be one in which you don't have your total outstanding debt continuing to rise. That is, you have a deficit, which when taking into account growth and the servicing costs associated with it, has gotten your debt leveled off so that you're not in a continuing period of increase, which then suggests to markets that you're not going to continue to increase your debt burden over time, and that has the consequent effects upon interest rates.

So I think that, in the broadest terms, is how to understand fiscal sustainability over the medium to long term.

Mrs. BACHMANN. Paul Volcker had just made the statement at Stanford, I'm sure that you're aware of, where he said we have to turn this thing now, we can't wait any longer. With America's current fiscal situation, we can't keep the spending levels up; we can't keep the debt levels up; we have to do something and we have to turn this quickly because the time clock is turning.

And I think that's something a lot of us sense, just kind of like an hourglass when you turn it up. We're seeing that the sands are coming toward their end here on America's opportunities to be able to turn around the fiscal situation. How long do you think that we have to turn this around?

Mr. TARULLO. I wouldn't put a timeline on it. What I would say is that it is important sooner rather than later to begin developing a credible plan for achieving a fiscally sustainable budget. And by that, I mean it's important that we have presented to investors, those who buy Treasuries, those who invest in other arenas as well,

the credible steps that will be taken in order to address these problems over the medium term. While I don't think it's appropriate for me to inject myself into the actual process of coming up with that, as a central banker, I would say that it behooves us to do something sooner rather than later.

Mrs. BACHMANN. The Federal Reserve is in the currency swaps now, and I don't know if you commented on this earlier, if you looked at any other additional policy steps, but what I really want to know is, is the Federal Reserve likely to take future actions regarding Greece or any other European nations that might get into trouble? Is the Federal Reserve looking at doing any future actions or is this it? Are we drawing the line?

Mr. TARULLO. We don't have any other actions under consideration.

Mrs. BACHMANN. I guess what I'm concerned about is the moral hazard that we're creating, because if we're coming out and—I guess the only analogy I can look at is Fannie Mae and Freddie Mac. There was an implicit guarantee of the government-sponsored entity, and everyone had the idea that if Fannie and Freddie ever got into trouble that the United States will bail them out from that. That's, as a matter of fact, what we did.

Now we're doing that with Greece. What would lead any other European nation to think otherwise, that the United States wouldn't be there to bail them out if, God forbid, Spain's economy would be such that it would require a bailout, or Portugal or Italy or Ireland or the United Kingdom? Why would we bail out Greece and not any of those other European nations?

Mr. TARULLO. The Federal Reserve swap actions are not a bailout for anyone, and certainly not a bailout for Greece. This is a matter of providing short-term liquidity, and by short term, we are talking no more than 3 months of swapped lines and frequently less, just in order to stop dollar funding markets from freezing.

This is not a matter of a bailout, this is a matter of—

Mrs. BACHMANN. I think the way that my constituents back home view this is that if the American taxpayer is on the hook for up to \$50 billion, they feel that is a bailout, because from their perspective, the money is coming out of their pocket; \$50 billion dollars is still—in today's parlance, that may not seem like a lot of money, but people back home look at \$50 billion and they see that this only may be the beginning of a riptide of the United States bailing out country after country after country essentially with borrowed money, and they're worried about the direction that we're going because they see that the United States is at a tipping point financially.

And now we're in the situation where we're—whether it's the currency swaps or whatever it is, it's still coming out of their pocket.

Mr. TARULLO. With respect to the IMF program, that's not something I can address, because it's not something we have any real authority over.

With respect to the swaps arrangements, I think that one can be assured, based on long-established practice, the kinds of safeguards we have on market risk, the dealing only with central banks, that this is something that is intended to and I hope will keep problems

from spreading more into our own country and not putting our own taxpayers at risk.

Mrs. BACHMANN. But is this—

Chairman MEEKS. The gentlelady's time has expired.

Mrs. BACHMANN. Thank you, Mr. Chairman. And thank you so much for answering the questions, Governor Tarullo. Thank you.

Chairman MEEKS. The gentleman from Texas, Mr. Green, is recognized for 5 minutes.

Mr. GREEN. Thank you, Mr. Chairman. I thank the witness for appearing today, and I thank the ranking member and you for making this hearing possible.

Mr. Governor, I would like to talk to you about the status of investments in America. We have Treasury notes, the stock market is an investment, the dollar is an investment. Do we find that foreign entities and foreign personalities are investing in America?

Mr. TARULLO. Certainly, Congressman, we have a substantial amount of inward investment, both direct investment and portfolio investment, including over time a significant amount of investment in U.S. Treasuries, yes.

Mr. GREEN. In my readings, and this is from the newspaper, you probably have empirical evidence, but my readings indicate that people are still buying America, that America is still a good investment, that this is a place where people are still bringing their assets, they want their assets in America. Is this an accurate assessment?

Mr. TARULLO. It has certainly been true over time, and in the very short term, which is to say recent weeks, I think what we have seen is a substantial sense that U.S. Treasuries continue to represent the safest kind of investment to make because we have seen a significant inflow into U.S. Treasuries even as the European problems have evolved.

Mr. GREEN. And the U.S. dollar compared to the euro, my understanding is that the euro is currently not as strong as it was a year ago and that the dollar has gained strength. Without knowing the exact amounts, is that a fair statement?

Mr. TARULLO. That is absolutely true, Congressman. As you know, the dollar depreciated against the euro over the course of several years earlier in this decade, but in recent months, there has been a significant appreciation of the dollar vis-a-vis the euro.

Mr. GREEN. The reason I ask is because I want to give an accurate assessment of our country, and I don't want to paint a picture of the country simply falling apart, if we don't just cut in a Draconian way, the country is just going to fall off the edge, go over the precipice. I do believe that we have to be fiscally responsible, and I do believe that is something that requires our attention and that we must do it, but I don't want to paint a picture that is unfair as it relates to the strength of our country and the view that our country has, the way it's viewed in the world.

America is still viewed as a great investment by other countries around the world. They still buy our Treasuries, they still invest in our dollar. It's still the place to have your capital if you have capital that you can place someplace; is that a fair statement?

Mr. TARULLO. I think that is a fair statement. Yes, Congressman.

Mr. GREEN. Okay. Now let's talk for a moment about the circumstance with Greece. It is so true, as Dr. King made known to us, that life is an inescapable network of mutuality tied to a single garment of destiny. What impacts one directly impacts all indirectly, but we have found in this latest crisis, economic crisis, that the connectivity is a lot stronger than many of us realized.

AIG had connections that were important to the world's economic stability. A country like Greece is important to economic stability in the world. So, if you would—and you may have visited this issue prior to my coming in, and my apologies, I have been trying to monitor from my office and do a number of other things, but just briefly if you would, give us or me an indication as to how important the Greece scenario, the worst-case scenario would be to us if there is something that goes awry and we have to deal with the worst-case scenario, meaning a bankruptcy circumstance or a collapse.

Mr. TARULLO. Congressman, I would say that the most serious kind of case is not one that involves Greece as such. What has happened over the last few months is that concerns about fiscal sustainability in Greece have extended to some other so-called peripheral European countries, which has in turn called into question the positions of financial institutions and others who may be investors in those peripheral countries. This is what happens when markets begin to inquire further into whether a position that they thought was a sustainable position might actually have some added exposure.

I think from our point of view, we can't pretend that we can insulate ourselves, much less the Europeans, from the consequences of the aftermath of some of the problems that they're enduring right now. That is not something that is either appropriate or possible for us to do. What we can do and what we tried to do with our swap arrangements was to foreclose the situation in which generalized uncertainty led to a generalized unwillingness on the part of banks and money market funds and others to provide funding to all the transactions that go on every day—

Mr. GREEN. I'm going to intercede. My time is up, and the chairman has been generous. Maybe you can get to it at a later time. I yield back, Mr. Chairman. My apologies.

Chairman MEEKS. Thank you. The gentleman from Texas, Mr. Paul, is recognized for 5 minutes.

Dr. PAUL. I thank the chairman. I want to follow up on the discussion about whether or not this is a bailout because, as we stated earlier, most Americans see this as a bailout.

We obviously are committing funds. I estimate it must be close to \$60 billion that we have committed in one way or the other, and if it wasn't a bailout, they wouldn't need us. What is the purpose?

If they didn't need help, if they didn't need to be bailed out, they could just go in the market and borrow money. But they lost all their credit rating and nobody wants to loan money to Greece, so they have to be bailed out. And I think that is a proper term.

But you say, no, well, we're going to get them on their feet again, and they're going to pay us back and we're going to make a profit at it. But it's the other side of this—what about the people who don't get bailed out and get help?

Think about all the small companies in this country. Think of the people who were just about under with their mortgages, if they just had had help for 6 months to get back on their feet again. But no, they don't get the help. The big banks and the countries get this. And this is why the people see this as so unfair.

I see it as a very unfair system as well, but one that is not constitutionally oriented, because if we commit monies, especially on these swap funds, swap arrangements, currency swaps—these are monies, I know it's traditional, I know it's accepted, but Congress doesn't appropriate this money. They don't authorize this money, and it's big money. It's really big money, so I don't see how we can avoid calling this a bailout.

There was a time in 1979 and 1980, when our dollar was in trouble, and other countries came and the IMF bailed out our dollar and made these arrangements, but it's always because it's too big. If we don't bail out the big guys, if we don't bail out these sovereign nations, if we don't bail out these banks because we're really bailing out banks here; they're the ones who have made these loans.

So I would like to have you further defend this idea that it isn't a bailout, and I would like to know, also, what kind of collateral we're going to get on these swap arrangements. They say we have collateral. Well, what kind is it going to be? We have collateral with all this money we gave our banks. It was these illiquid assets, these derivatives, these housing markets that nobody else wanted. We have these assets and they're all on the books at the Fed, but this is so unfair because it's done with increasing the money supply and it's a burden on the taxpayer.

So, once again, see if you can convince me that this is not a bailout. Convince the American people. Try to talk to somebody who didn't get help on their mortgage or a small businessman who was out of business and didn't get treated as well as we treated these foreign nations and these foreign banks who have made loans to these governments.

Mr. TARULLO. Congressman, let me say first that the Federal Reserve is not providing any money to Greece. We're not providing any liquidity. We're not providing any other assistance. What we have done is to say that we will in short term swap arrangements provide dollars to the European Central Bank.

Dr. PAUL. And you get what?

Mr. TARULLO. And we get euros at the prevailing exchange rate for those dollars. And then the arrangement gets unwound at the end of it. If it's an 8-day arrangement, as one maturing today—

Dr. PAUL. Why is that necessary? Why don't they just use the euros if it's equal, if it's an equal trade?

Mr. TARULLO. It's necessary, Congressman, because you have institutions in Europe which have lent dollars, for example, and which are in need of funding in dollars. It may be, and often is, a perfectly good transaction to have entered into. But as conditions become very tight because there's a lot of uncertainty about the availability of dollars, then, as we saw a couple of years ago, even an institution which has been well run and has been careful in taking on exposures may not be able to get that dollar funding in the

short term. But that is why we offer this liquidity swap only at a penalty rate.

Dr. PAUL. And where do we get the dollars to give them for their euros?

Mr. TARULLO. It is created as a reserve and then unwound when it comes back, as they did during the financial crisis. But I just want to say one other thing, Congressman, which is that the reason we're doing this is precisely so that we forestall the potential for the generalized freezing up in credit markets, which will constrain or would constrain our own large institutions, which in turn would constrain their ability to lend to American businesses and American households.

And I would say that at this moment, when after a period of watching lending standards tighten for quite some time and then simply not relax at all, particularly for small businesses, we're finally seeing some indications that those standards may be relaxing, that we may be able to start increasing lending to small businesses again. And I think this is the moment where we really do not want a substantial external shock to our financial system to undo the progress that we're making in that direction.

Dr. PAUL. If I may ask one quick question, what happens if the euro loses 50 percent of the value? Are the taxpayers, is the dollar at risk there? Do we lose something then?

Mr. TARULLO. The European Central Bank is still obliged to pay us back the number of dollars that they drew originally. Market risk rests with them, not us.

Dr. PAUL. We're holding the euros.

Chairman MEEKS. The gentleman's time has expired. And before we close this panel, I will go to the chairman of the Domestic Monetary Policy Subcommittee, if he has anything.

Chairman WATT. Mr. Chairman, I have used my 5 minutes, and I apologize to the Governor for having to run out. I had another commitment that I had to attend to, but I thank him for being here.

And there's, I think, a series of votes coming that might intervene between—in fact, they're getting ready to start right now, that might intervene between this panel and the second panel.

We should note that some members of the subcommittees may have additional questions to submit in writing. And without objection, the hearing record will remain open for 30 days for members to submit written questions to this witness and to place his responses in the record.

So we thank the Governor for being here, and this part of the hearing is over. We'll go into recess until we can have the series of votes, and then we'll go to the second panel.

Mr. TARULLO. Thank you, Mr. Chairman. And thank all of you for your interest.

[recess]

Chairman MEEKS. [presiding] The hearing will come to order and we will resume the testimony.

First order of business, what I would like to do is, without objection, enter into the record the testimony of Mr. Martin A. Weiss, who is a specialist in international trade and finance from the Congressional Research Service; and the testimony of Mr. Amar

Bhattacharya, who is the G24 Secretariat. So without objection, their testimony will be made a part of the record.

We have for our second panel some very knowledgeable and astute individuals. First, Ms. Carmen Reinhart, who is a professor of economics at the University of Maryland. She is the director of the Center for International Economics, and she received her Ph.D. from Columbia University. Professor Reinhart held positions as chief economist and vice president of the investment bank of Bear Stearns in the 1980's where she became interested in financial crises, international contagion, and commodity price cycles. Subsequently, she spent several years at the International Monetary Fund. She was a research associate at the National Bureau of Economic Research, a research fellow at the Center for Economic Policy Research, and a member of the Council on Foreign Relations.

Her papers have been published in leading scholarly journals and her work is frequently featured in the financial press around the world. Her latest book, entitled, "This Time is Different: Eight Centuries of Financial Folly," documents the striking similarities of the recurring booms and busts that have characterized financial history.

Welcome, Ms. Reinhart.

And we also have with us Mr. Edwin Truman, who has been the senior fellow at the Peterson Institute for International Economics since 2001, served as Assistant Secretary of the U.S. Treasury for International Affairs from December 1998 to January 2001, and returned to the U.S. Treasury as Counselor to the Secretary in May 2009. He directed the Division of International Finance of the Board of Governors of the Federal Reserve System from 1977 to 1998.

Mr. Truman has been a member of numerous international groups working on economic and financial issues and he has published on international monetary economics, international debt problems, economic development, and European economic integration. He is the author and coauthor or editor of several books, including, "Reform the IMF for the 21st Century: A Strategy for the IMF Reform", "Chasing Dirty Money: The Fight Against Money Laundering", and "Inflation Targeting in the World Economy." He has a B.A. from Amherst College and a Ph.D. from Yale, both in economics.

And finally, we have Mr. Peter Morici, who is a professor at the Robert H. Smith School of Business at the University of Maryland. The professor is recognized as an expert on economic policy and international economics at the University of Maryland. And prior to joining the University, he served as Director of the Office of Economics of the U.S. International Trade Commission.

He is the author of 18 books and monographs and has published widely in leading public policy and business journals, including the Harvard Business Review and Foreign Policy. He has lectured and offered executive programs at more than 100 institutions, including Columbia University, the Harvard Business School, and Oxford University, and his views are frequently featured on several networks—CNN, CBS, BBC, FOX, you just name them, and he's on all of them. He's on national broadcast networks not only here in

the United States, but indeed in this small place that we call the Earth, he is everywhere.

Thank you for being with us.

And we will hear now from Ms. Reinhart. Your entire written testimony, as indicated earlier, will be submitted into the record, so please summarize. You will have 5 minutes to give testimony. You will see after 4 minutes, a yellow light will come on letting you know that you have 1 minute to go. We will be a little liberal on time if you need it, but let's try to stick to the time.

Welcome, Ms. Reinhart.

STATEMENT OF CARMEN M. REINHART, PROFESSOR OF ECONOMICS AND DIRECTOR OF THE CENTER FOR INTERNATIONAL ECONOMICS, UNIVERSITY OF MARYLAND

MS. REINHART. Thank you, Chairmen Meeks and Watt, and other members of the subcommittees for the opportunity to comment on the IMF's role in helping Europe deal with its economic crisis.

I was also asked to remark on whether the external support for Greece and other EU member nations exacerbates moral hazard and on the adequacy of the proposed fiscal austerity measures.

It's not surprising that questions have arisen about the legitimacy of IMF involvement in a program aimed at aborting a sovereign default in Greece and possibly other high-income countries. The last of the peacetime sovereign defaults among high-income countries took place during the Great Depression of the 1930's, well before the founding of the IMF in 1944.

Item five of the purposes of the IMF in its articles of agreement reads, "to give confidence to members by making general resources of the Fund temporarily available to them under adequate safeguards, those funds providing them with the opportunity to correct maladjustments in their balance of payments without resorting to measures destructive of national or international prosperity."

Whatever the concerns about the solvency of Greece and other EU nations may be, these countries also face a classic maladjustment in their balance of payments that arise from a substantial loss of international competitiveness. They are IMF member countries, and as such a part of the IMF's original mandate.

As my recent work documents, the wealthy economies are no strangers to IMF programs. The United States had two IMF programs in the 1960's, and the U.K. holds the record with 11 IMF programs. Portugal had a program as late as 1986. These programs, however, did not attempt to deal with solvency issues and were modest in size, as was customary in the pre-1995 Mexican peso crisis bailout model.

The need for Greece on fiscal austerity and other European economies to slash government spending is not some artificial imposition by the IMF or the European Union. Once investors decide that a country is living beyond its means, it will have a hard time meeting its debt obligations. Spending cuts become a reality of arithmetic, but fiscal austerity doesn't pay off quickly.

A large and sudden contraction in government spending is almost sure to shrink economic activity as well. This means tax collections fall and unemployment and welfare benefits rise, undermining efforts to reduce the deficit. Even if new borrowing is re-

duced or eliminated, it takes time to whittle down large debt, and international investors are notoriously impatient.

A restructuring of Greek sovereign debt may not be inevitable, but it certainly seems probable. A country such as Greece could seek to negotiate with its creditors to reduce its debt, but that path, essentially a partial default, is also no panacea. Argentina's economy contracted by about 15 percent after its default in 2001 and was shut out of international capital markets for a while.

On moral hazard, as in other situations, questions now arise about the tradeoff between exacerbating moral hazard and limiting contagion. I think it is safe to conclude that the combination of bailouts and forbearance are well entrenched in the expectations that financial market participants have for the foreseeable future. However, on contagion, it is relevant to recall that Thailand has an even smaller gross domestic product than Greece, but in 1997, Thai financial problems ignited the Asian crisis.

There are three main mechanisms for this contagion. First, many governments have common lenders, including international banks and hedge funds. If these institutions suffer large losses in one national market, they will pull back lending to the others. Second, trouble in one country acts as a wakeup call to investors who scour their global holdings for similar risks elsewhere. When they look hard enough, they will find something to worry about, triggering even more funding withdrawals. Third, Greece, casts a long shadow on the European continent because 15 other countries share a common currency. Greece debt problems called into question whether the euro will survive.

The large EU-IMF package was intended to send a strong signal that the EU is committed to go to great lengths to avoid a breakdown of the euro. It is intended to provide a broad-based coverage beyond Greece in the spirit of the TARP legislation in the fall of 2009.

Like the U.S. bailout package, an important feature of the plan was to continue that—Greek bonds as rating agency downgrades had never taken place. This kind of forbearance, shown to toxic assets in the United States over the last 2 years—moral hazard is an issue that cannot be understated.

At best the EU-IMF initiative can buy some time for policymakers in other countries that have come under duress to implement difficult austerity measures and to move to restructure private debts. It does not change Greece's or anyone else's levels of outstanding debts, and their even more worrisome profile in the period ahead.

[The prepared statement of Professor Reinhart can be found on page 42 of the appendix.]

Chairman MEEKS. Thank you.

Mr. Truman.

**STATEMENT OF EDWIN M. TRUMAN, SENIOR FELLOW, THE
PETERSON INSTITUTE FOR INTERNATIONAL ECONOMICS**

Mr. TRUMAN. Thank you, Chairmen Meeks and Watt, and members of the subcommittees. I appreciate the opportunity to appear before you to discuss the role of the Federal Reserve and the Inter-

national Monetary Fund in stabilizing Europe. I will concentrate primarily on the International Monetary Fund aspect.

The Greek tragedy, which is now on center stage, was largely of the Greek authorities' own crafting. However, it also emerged as an aftershock of the global economic and financial crisis of 2007–2009 and has set off a European crisis.

The challenge is to manage the European crisis so as to minimize the negative fallout on the fragile global economy and financial system and to reduce the severity of other aftershocks, which inevitably will occur over the next several years. How successfully the Europeans, the United States, and other systemically important economies deal with that challenge will determine the strength of our own and the global economic recovery now underway.

The major policy instrument available to the United States to contain the European crisis and its aftermath is the International Monetary Fund. The United States should continue to provide maximum constructive support for the Fund in carrying out its responsibilities for the promotion of global growth and financial stability.

I will summarize the rest of my testimony this afternoon with eight points:

First, the program of Greek economic and financial stabilization and reform, approved by the IMF executive board on Sunday, May 10th, is ambitious and demanding. It may fail, but it is in the collective interest of the United States and the international community to give the people of Greece and the authorities of Greece time to implement at least the first phase of their program.

Second, the European Union authorities delayed too long in providing a framework to support economic reform and to provide the necessary financial support for Greece. Consequently, the financial contagion has spread to other countries in the euro area and perhaps beyond.

For possible future use, the EU authorities are now putting in place a European Stabilization Mechanism and have taken other steps to contain the crisis, including unconventional action by the European Central Bank.

The IMF may be called upon to cooperate with the ESM using the Greek program as a template. A positive response by the United States to such a request, on appropriate terms, is fully consistent with the Fund's core mission. Meanwhile, the Federal Reserve has reactivated some of the swap arrangements that were deployed to contain the recent financial crisis and its impacts on financial markets, in my view, appropriately.

Third, the IMF is not and should not be viewed as an institution that lends only to emerging market and developing countries. The mission of the Fund is to provide prompt and persuasive policy advice and to help design and finance economic reform programs for all its members.

Fourth, beyond its traditional role with respect to macroeconomic policies, which is much needed to restore and maintain economic growth in Europe, a key area of IMF policy advice for Europe is on strengthening their banks that now face the high probability of another round of substantially impaired assets and the risk of sovereign defaults.

Fifth, all IMF-supported programs involve a balance between painful policy adjustments that adversely affect economic growth in the short run and necessary, temporary financial support. The correct balance between adjustment and financing is a matter of intense disagreement, but both are required.

Sixth, the contribution of IMF lending to the perpetuation of moral hazard is greatly exaggerated under current, and most, circumstances.

Seventh, I am not greatly concerned that the IMF will be called upon to lend more to European countries, will run out of resources to lend, or will leave non-European members of the IMF in the financial lurch.

And last, citizens of the United States have a great deal to gain from successfully containing the European crisis. However, if the United States and the global economy are to recover decisively and enter a period of sustained expansion, more needs to be done beyond simply containment. U.S. policies should be oriented towards further substantive and financial support for the Fund in order to provide more confidence in the global economic outlook and in the restoration of financial stability.

Thank you very much. I look forward to your questions.

[The prepared statement of Mr. Truman can be found on page 56 of the appendix.]

Chairman MEEKS. Thank you.

Mr. Morici.

STATEMENT OF PETER MORICI, PROFESSOR, ROBERT H. SMITH SCHOOL OF BUSINESS, UNIVERSITY OF MARYLAND

Mr. MORICI. Thank you for having me.

I think, as the flash crash and events of the last week have demonstrated, Greece's financial circumstances have the potential for a dramatic impact on Europe and in turn on the United States, not merely through our banks but our equity markets as well.

The problems in Greece really emerge from several interrelated problems in Europe, and they are not really of Greece's making alone. With economic integration, folks in Greece, Spain, Portugal, and elsewhere came to expect social benefits comparable to those in places like Denmark, Holland, and Germany, but they simply don't have the economies to pay for it.

In the United States, social benefits are not the same in Mississippi as in New York, but they're not that different. We essentially tax Manhattan to subsidize Mississippi. In Europe, the Germans enjoy gold-plated benefits as they lecture the Greeks about Teutonic austerity and the Greeks simply are trying to provide benefits consistent with the expectations of their populations that they simply can't afford.

What this means is essentially the Europe Currency Union, the common euro, requires a fiscal union where they share the costs of the safety net, but it also doesn't mean higher taxes necessarily, because probably the Europeans have taxed themselves to the point that is detrimental. But rather it means that not only must the Greeks have less, the Germans must have less too.

The Europeans have taxed themselves and provided benefits to the point that they have virtually zero population growth in several

countries, and their economic growth has been woefully slow for the last several years, actually, the last several decades. The bottom line is fiscal unity must be matched by—currency unity must be matched by fiscal unity, and these bailouts aren't going to do much good unless we do that. And it's also going to require wholesale public sector reform to bring the social safety net in line with that necessary to encourage individual risk-taking and entrepreneurship.

Right now, the way things stand is the Germans are confronted with the choice of either subsidizing the Greeks, either directly by taxing themselves and transferring money, or subsidizing them indirectly by having the European Central Bank print euros, buy Greek debt and pretend that they will someday be repaid.

Make no mistake about it. These austerity programs are far beyond what can succeed. Greek debt is essentially in default. So the Europeans are basically faced with, in the north, taxing themselves to subsidize the south, but also in the process, reducing their own social benefits or enduring inflation, which will do the same.

The lesson for the United States has been largely misunderstood, I believe. The U.S. budget doesn't make a whole lot of sense. The drama we had in Sacramento recently looks a lot like what we had in Athens last week. The problem here isn't so much the scope of the safety net, it's that our public sector is so inefficient. It really is.

Consider healthcare, for example. We spend almost 20 percent of GDP on healthcare. The Germans spend 12 percent. Arguably, their healthcare system is as good as ours. Half of that is paid for by the federal government or the federal and state governments. That should tell us something.

Universities are comical institutions of inefficiency. Municipalities have become the same in recent years as they took advantage of the taxes they gained in the property boom to basically multiply bureaucrats. Ask yourself, are your municipal services any better or different they were 20 years ago? Go count noses at city hall.

I don't mean to cast this in terms of a liberal versus conservative, more versus less government. But in the United States, we are probably facing the same financial catastrophe, but for the fact that we print the world's money simply because our public sector is not functioning properly.

That, I believe, is part of why we're seeing the kinds of elections we're seeing right now. It's not a Republican or a Democratic issue; it's a citizen issue.

Now in the United States, we can't fail, because we print the world's money. For now, the world accepts the dollar as the coin of the realm. However, we're not that far away from the day when we'll have printed so darn much of it that we will suffer inflation instead of outright default, and we may not be that far away from an alternative to the dollar emerging. And I would be happy to address how that could happen during the question period, as I am out of time.

[The prepared statement of Professor Morici can be found on page 37 of the appendix.]

Chairman MEEKS. I thank all of you for your testimony, and now, I will recognize members for 5 minutes of questioning. I will yield myself the first 5 minutes for questions.

And I will start out, I guess, with Ms. Reinhart. In 2010, March 2010, the prime minister of Greece vocally criticized unprincipled speculators for making billions of dollars every day by betting on a Greek default. My question is, what are your opinions about the role of speculators in this current European debt crisis and what related recommendations do you have for our financial regulatory efforts? What implications do you think that these speculator actions have for international finance reforms efforts and the necessity of having some universal coordination?

Ms. REINHART. Mr. Chairman, I have in the past commented that speculators are like vultures. They begin to circle when something is dying, but they don't create the problem. They play upon an existing problem, and the existing problem here was the surge in Greek debt.

The speculator issue aside, I do think that regulatory reform of one kind or another will be more attuned to taking into account hidden debts, which also is an important lesson from Greece. That is, not only the debts that we see but off-balance-sheet items that we don't see. And I think that was an issue, especially with the Goldman Sachs debacle.

So I don't think that the speculator issue is a new one to this crisis. It crops up every time there is a crisis. But I do think that the issue of tackling or paying more attention to leverage in general and opaqueness of balance sheets, hidden debts are things that are very much on the agenda.

Chairman MEEKS. Let me just follow that up with, it seems as though there were early warnings that—and this is for anyone; anyone can answer this. There were early warnings about the past Greek sovereign debt levels. The IMF saw that, but yet we still have the crisis. The crisis was still created even though it was seen earlier.

Now some are talking about, therefore we have to improve, the IMF has to improve its surveillance process. And there have been several ideas that have been put out there.

I think the last G-20 launch of the mutual assessment process, that's one of them. And there have been other suggestions, which include an enhanced, multilateral approach involving the IMF and the enrichment of the systemic content of the bilateral or country-level surveillance by introducing thematic country reports.

So my question to all of you would be, do you agree with any of those recommendations or do you have other recommendations? How could we improve IMF surveillance procedures so that we may be able to prevent a crisis before it happens?

Mr. MORICI. You can't improve IMF surveillance procedures so this won't happen. Angela Merkel is running around trashing naked shorts. I am not a big fan of naked shorts, if you have watched me on TV, but they're not what's causing this problem. What's causing the problem is that Greece spent too much money and no one has faith in this \$1 trillion patch.

The IMF has told this government repeatedly its deficits are too large and must be fixed. We have been surveillanced beyond limit, but we don't act.

At the end of the day, the members of the IMF are sovereign governments, and they cannot be compelled by an international body to act any differently than they choose, except if they need cash at the moment. So the IMF's leverage at any point in time is strictly limited to the leverage provided by short-term finance. Once that goes away, they'll go back to what they're doing.

How many times has the IMF made reference to China's undervalued currency? Does China move? No. It's a sovereign government. It does as it pleases. I'm sorry—I don't mean to point. Does this body balance the Federal budget? No. This is a sovereign body; the IMF is not.

Mr. TRUMAN. I think I agree with Peter to the extent that you're not going to do away with crises, but you can reduce their incidence and variance, and I think there is a role for better IMF surveillance.

I think in the European case, maybe as in ours, there is a tendency, was a tendency in Europe, to say the IMF doesn't know what it is doing and it should stay out of our business. And one of the issues in this crisis was precisely that because Europe delayed in bringing the Fund in even though the Fund has a much better record at imposing policy conditionality than does the European Union, Europe tended not to look at IMF advice.

So I think the lesson from this is that the Fund can do more, should do more, and should be more pointed in its criticisms. Certainly, Peter is right; the Fund doesn't have much leverage, but the bully pulpit actually provides quite a lot of leverage. That's what we have seen in this crisis. And I think there are mechanisms to improve the process.

Chairman MEEKS. My time has expired, but I'll allow—if you want to quickly respond, Ms. Reinhart.

Ms. REINHART. I would just quickly add that I share the view of the former speakers. I would say that we can do better in terms of surveillance, particularly monitoring debts, but I am skeptical about the ability to enforce, especially during the boom period when no one is willing to listen to the IMF or others that warn of dangers. That should apply to us now too.

Chairman MEEKS. I may have a follow-up question to that, if we get to a second round. My time has expired.

I now recognize the gentleman from New Jersey, Mr. Lance, for 5 minutes.

Mr. LANCE. Thank you very much, Mr. Chairman.

As I understand it in the testimony, if we distill it to its essence, the IMF is bailing out Greece based largely upon the fact that Greece provides social services to its citizens that it cannot afford, given the level of productivity in Greece. Professor, would that be a distillation with which you would agree?

Mr. MORICI. That is one essential element. The other essential element is that you're generally—providing social services it cannot afford. So the point that it shrinks its pie, look at the level of unemployment benefits and employment support the German government provided during the recession. Think of what Manhattan

could provide for itself if it wasn't taxed, the financial sector wasn't taxed to provide to the rest of the country.

My view is that it's very easy to blame the Greeks, the Portuguese, the Spaniards, and so forth, but it's more of a continental problem.

Mr. LANCE. So be it. Let us assume that it is a continental problem. Why should we here in this country participate in helping bail that situation out? Is it not at least primarily the responsibility of the European continent?

Mr. MORICI. Yes, however, I think you would find that the balance sheets of our banks would be very threatened, much as their balance sheets were threatened when we had our mortgage crisis, that if there is a sovereign debt crisis in Europe, it would find its way back to our major banks.

Mr. LANCE. To our major banks, not to community banks across America. This is—

Mr. MORICI. Community banks are already in pretty tough shape because the TARP wasn't used to assist them. We didn't have a resolution trust as we did during the savings-and-loan crisis. Instead, this Administration chose to prop up General Motors and do other things, and it was not inclined—which I advised in the Senate that they not do. And it was disinclined to set up a resolution trust type of mechanism because the major Wall Street banks didn't want it. They're busy having a good time restructuring those loans on their own and making cash of them, so the community banks are already in very tough shape.

Mr. LANCE. Thank you. Mr. Truman, do you wish to comment?

Mr. TRUMAN. Well, I would like to add a nuance to your phrase of "bailout" so we can understand what we are talking about. A bailout would be when you have a bill due, or I have a bill, let's put it my way and say, I have a bill to pay and you say, "Ted Truman, I'll pay it for you, and you don't have to pay it anymore." In the case of an IMF loan, what we're saying is, we will lend you the money, you, Greece the money, to pay that debt. And you will pay us back, which has happened in every IMF program that has ever been written.

So the financial transaction is only one of buying time for the debtor so that it can raise the money both to pay back the IMF and to pay their other debts.

Mr. LANCE. Are you confident that we will be paid back—not we, the IMF will be paid back from Greece in this situation?

Mr. TRUMAN. Yes, I am confident because "we," meaning the American taxpayers, have been paid back every time. There are a few, three, countries which have debts that haven't been paid, and there has been a write-down of other types of debt that have nothing to do with this type of—

Mr. LANCE. Well, thank you. You're on the record that you're confident that we will be paid back, that the IMF will be paid back from Greece.

Ms. REINHART. I would like to add—

Mr. LANCE. Are you confident that we would be paid back?

Ms. REINHART. Yes.

Mr. LANCE. Thank you. Are you confident, Mr. Morici?

Mr. MORICI. I'm confident that the IMF will be paid back because it has, I think—Carmen, correct me if I'm wrong—\$150 billion in the \$1 trillion at play. So they'll get paid back before the others do.

The real danger, as Mr. Tarullo said, we'll get paid back our dollars from the ECB. We may well be in a position where the ECB doesn't get paid back and the euro, they'll never be—they're going to have to print a lot of euro to pay us back. The real question will be whether the swaps will be worth anything if the euro fails.

Mr. LANCE. Thank you very much. I yield back the balance of my time.

Chairman MEEKS. The gentleman from North Carolina, Mr. Watt, is recognized for 5 minutes.

Chairman WATT. Thank you, Mr. Chairman.

Professor Morici, I was fascinated by both your question, what should it tell us, and your comment that the public sector is not functioning properly. I happen to agree with the second part of it, but I don't know what it would tell us.

I'm accustomed to constituents writing me and telling me that the public sector is dysfunctional and so forth and so on. They're usually talking about the U.S. Postal Service, which has been privatized, or Fannie and Freddie, which were shareholder entities at least at some level. So I'm not sure what any of that tells us. It might tell us that Germany's healthcare is 12 percent and ours is 20 percent because theirs is socialized and ours is privatized. Ours is in the private sector.

It might tell us that. I'm not arguing with you. I'm just telling you some of the things that might tell us. We can beat up on the public sector all we want, but it was, as I recalled, the private sector that really screwed up, that resulted in the financial services meltdown. Otherwise, we're blaming somebody that shouldn't be blamed unless you're taking the position that they didn't have any blame.

Yes, the public sector is not functioning properly, but I'm not sure that the private sector is doing all that great either.

Mr. MORICI. You are responsible for what the public sector pays for the services it finances.

Chairman WATT. Say that again, so I make sure I understand.

Mr. MORICI. I don't mean to put it in those terms, but—

Chairman WATT. Go ahead.

Mr. MORICI. This government is responsible for what it pays for the private, for the services it provides citizens, and what I am saying is this government is paying too much for the services it provides, and it is now a large enough share of the economy, for example through healthcare—

Chairman WATT. I understand that, but I don't know how that answers the question. And again, I actually agree with you.

Mr. MORICI. We can go down this path. You can ignore this problem.

Chairman WATT. No, I don't want to go down this path because all that will do is be counterproductive. Let me ask you another question.

Mr. MORICI. I didn't—

Chairman WATT. You mentioned the possibility of there being some alternative currency that would become the predominant cur-

rency of the world. As I recall, that currency was going to be the euro when the European Union decided that it would get together and be the dominant force that we had all thought that it might be. It seems to me that it is the euro that is now in trouble.

What exactly would be that alternative currency that you're talking about? Would it be the overvalued Chinese currency? Would it be the euro, which is now in trouble? What alternative currency are you talking about?

Mr. MORICI. I think the yuan could eventually replace the dollar, given the way we're conducting our affairs.

Chairman WATT. And given the fact that it's not trading fairly, you say out of one side we shouldn't be beating up, you think we shouldn't be beating up on the Chinese to make it a fair currency.

Ms. Reinhart, maybe you can help us. Yes?

Ms. REINHART. Mr. Chairman, I would like to say that right now, I think talking about any other currency is really pie in the sky. The renminbi is not a convertible currency, no countries issue their debts denominated in renminbi, no countries peg to the renminbi. It is not traded. I think, for the sake of realism, we have to assume that the reserve currency for the foreseeable future is the dollar.

One thing in connection with that however, I would like to highlight that we shouldn't get complacent. That should not—

Chairman WATT. Oh, yes. Well, I agree with that in that we're becoming less and less a force in the world economy.

Mr. MORICI. Mr. Watt, if you would permit me, I think it's—

Chairman WATT. Yes, sir. Go ahead. I didn't mean to cut you off. I won't ask another question.

Mr. MORICI. The dollar did not—I implied, I believe I said that we should not presume the dollar will continue to be the reserve currency. That's essentially what I said.

Chairman WATT. You raised the prospect of an alternative currency.

Mr. MORICI. Just because of—

Chairman WATT. I'm just trying to figure out what the alternative currency would be.

Mr. MORICI. Okay. You keep talking to me and you don't let me answer. If the chairman will give me some forbearance, we should not—

Chairman MEEKS. If you could, answer, and then we'll move on, because the gentleman's time has expired. You could answer the question, but as I said, he won't get a chance to answer because his time has expired.

Mr. MORICI. I'll try not to be unnecessarily provocative, Mr. Watt.

At the current moment, at current exchange rates, China's economy is worth \$5 trillion, ours is worth \$15 trillion. It is my position that if China's economy was properly valued over a period of 3 to 5 years, it would be worth \$10 trillion. Given how rapidly it's growing, it wouldn't be long before it was at least as denominated by currencies, as large as ours.

Just because the renminbi is not convertible today does not mean it wouldn't be convertible 5 years from now. And the fundamental value of a currency is a product of what the economy can produce, what you can get for it, and how well the fiscal affairs of a country

is run so that there is adequate confidence that too much of the currency won't be printed. Ergo, China will soon be as large as us if China's currency were fairly valued, and given the way we're printing money around here right now and the potential for inflation right now, it could be that people start to seek other currencies.

China could make its currency convertible 5, 6, or 7 years from now, and people might want to start holding it instead of ours.

Chairman MEEKS. The gentleman from California, Mr. Sherman, is recognized for 5 minutes.

Mr. SHERMAN. Thank you, Mr. Morici. I would think one possible reserve currency is U.S. Treasury inflation-protected securities. The idea that you have to hold a currency as opposed to a debt obligation of a sovereign, you—

Mr. MORICI. Well, the fact of the matter is governments really don't hold dollars, they hold debt securities.

Mr. SHERMAN. Right, they hold bonds. When you hold a straight U.S. bond, you're investing in the U.S. currency. When you hold a Treasury inflation-protected security, you're holding a not fully dollar-denominated security, a security that is payable by the United States but in a certain purchasing power.

Mr. MORICI. That is true, however—

Mr. SHERMAN. And that might be, if one were looking for a risk-free reserve currency available in today's market rather than the market you put forward for 5 or 10 years from now, why aren't more countries investing in TIPS?

Mr. MORICI. I can't answer why more countries aren't investing in TIPS.

Mr. SHERMAN. Okay. Now commenting on—the purpose of these hearings is—well, first I'm going to comment on China. The fact is, China is doing a spectacular job of running their economy. They're doing so because they cheat. And we're doing a terrible job, in part, evidenced by the fact that we let them cheat. And the rich and powerful in both countries benefit from them cheating and us letting them cheat. So you may be right that they will succeed.

But now, shifting to the focus, I think, of today's hearings, the bailout of Greece is not a bailout of Greece, it's a bailout of the banks that lent money to Greece. The total package for Greece and others put together by the Europeans is roughly \$1 trillion. Am I correct in believing that only \$39 billion of that is from the IMF, that our share of that \$39 billion is a little less than 25 percent, probably more than the stated 17 percent, and that accordingly our share of this bailout package is roughly one percent of the total trillion dollars?

Can anybody comment on that math? Mr. Truman?

Mr. TRUMAN. Actually, because of the way the Fund is financing itself today, our share is more like 10 percent, because the Fund is providing a little less than a third of the money. But half the third of the money is borrowing from countries other than the United States, so that we have—

Mr. SHERMAN. Now you're saying the IMF is putting up a third of the trillion dollars?

Mr. TRUMAN. The IMF is putting up 27 percent of the Greek program. The trillion dollars is the European support mechanism, which is not in existence yet.

Mr. SHERMAN. Right. Let me put forward the theory that the entire European support mechanism goes to absolute zero in value, it's lent entirely to countries that then immediately go bankrupt. How much does the United States lose?

Mr. TRUMAN. Well, it hasn't—it doesn't exist. I don't want to split hairs. The Greek program does exist.

Mr. SHERMAN. Right, the trillion dollar program is not a program. It's an announcement, a press release.

Mr. TRUMAN. It's a press announcement.

Mr. SHERMAN. Your colleague to your left has a good imagination, so I'm asking you to have a good imagination as well. Assuming the whole thing was not a press release, but put out there and actually done, and actually lost all, the whole trillion dollars, we would lose roughly one percent of that?

Mr. TRUMAN. If you want to use those numbers, which I think is probably exaggerated, but let's do that. So the Fund's part of it is $\frac{1}{3}$, right, and we are 20 percent of the third; we're, if I have my arithmetic right, $\frac{1}{15}$ of the total.

Mr. SHERMAN. So you would expect that the IMF will be putting up up to \$333 billion of this trillion dollar program?

Mr. TRUMAN. The way that it has been described by the Europeans in the press is that $\frac{2}{3}$ comes from them and $\frac{1}{3}$ comes from the IMF.

Mr. SHERMAN. And we have consented to that?

Mr. TRUMAN. No. No one has consented to anything.

Mr. SHERMAN. Okay. Shifting to another aspect of the IMF, due to the actions taken in 2009, which I voted against, in that package, Iran was given special drawing rights with a value of \$1.6 billion. How can Iran use this and put it to use should they have a need for funds?

Does anybody have a comment? What can you do with a special drawing right?

Mr. TRUMAN. Well, as a technical matter, any member of the Fund who receives SDRs can, if they have what's called a balance of payments need, transfer those SDRs to another country in return for currency.

Mr. SHERMAN. So while we say we're trying to put sanctions on Iran, the biggest thing we have done economically is to participate in an IMF program that has provided them with another \$1.6 billion, and in addition has made the IMF far more bailout-capable at a time when Iran is bailout-eligible. Whether the IMF would bail out Iran beyond the \$1.6 billion remains to be seen.

Mr. TRUMAN. I don't think the SDR allocation makes the Fund more bailout-capable.

Mr. SHERMAN. No, no, it's not the SDR. It's the \$250 billion that was put in makes the IMF far more bailout-capable.

Mr. TRUMAN. Perhaps.

Mr. SHERMAN. It was a package SDR, plus additional—

Mr. TRUMAN. \$500 billion if you want to talk about the NAB.

Mr. SHERMAN. Yes. I yield back. Perhaps we could allow Ms. Reinhart—

Chairman MEEKS. Go ahead. I'll allow her to answer the question.

Ms. REINHART. I would just like to point out that all this funding is fungible, and the IMF track record has been to channel the money where the difficulties are and that is what it's doing now.

Mr. SHERMAN. Greece money is a lot better than Iran, as far as trying to help countries with difficulty. And I yield back.

Mr. MORICI. And I would like to point out, if I might, Mr. Chairman, that the money you will lose if Greece fails is not—what matters is not what you lose through the IMF, what you will lose going back to Wall Street yet again and bailing out the big banks yet again.

Take a hard look at how much European paper is on their books and what that will mean relative to the tier one capital.

Mr. SHERMAN. We're not bailing them out again. I yield back.

Chairman MEEKS. Thank you. And we have a bill that says we can't bail them out again.

And let me just also just say that I want to thank all of the witnesses for being here. It has been my opinion that we're not really just trying to do anything with regards to Greece specifically, but it's the entire European situation, the debt crisis there, and hopefully so that we can prevent the problems coming back here to affect us here in the United States.

I think through the last colloquy that we had with the Governor of the Fed, he clearly indicated that the idea is if we were not with—if it wasn't for the swaps on the Fed side and if it wasn't for the IMF participating and we just allowed things to happen that again the lending to small- and medium-sized businesses, etc., and to John Q. Public could again freeze. And I would hope that, and part of the reason for this hearing is, to see what if anything that we need to do, because the last thing that we need to happen is direction to reverse itself from the positive direction of getting out of this financial crisis back to having what's taking place in Europe reverberate back to us here and cause our economy to again go into a tailspin.

So with that, let me say that the Chair notes that some members may have additional questions for this panel, which they may wish to submit in writing. Without objection, the hearing record will remain open for 30 days for the members to submit written questions to these witnesses and to place their responses in the record.

This hearing is now adjourned.

[Whereupon, at 5:15 p.m., the hearing was adjourned.]

A P P E N D I X

May 20, 2010

U.S. House of Representatives
Committee on Financial Services
Hearing: The Role of the International Monetary Fund and Federal Reserve in Stabilizing Europe
May 20, 2010

Statement for the Record
Congressman Ron Paul

Mr. Chairman, I am disappointed that yet again American taxpayers find themselves forced to pay billions of dollars in bailouts, only this time we are not bailing out profligate American companies, but foreign governments. Billions of dollars of IMF funding, much of it coming from US taxpayers, will be sent to Europe to bail out Greece and other European countries who might find themselves in financial straits.

Evidently the lesson of the US government's bailouts has not been learned. Bailouts do not, in fact cannot, make things better; they can only make things worse. Governments can pay for bailouts by increasing taxes, which takes money out of the pockets of hard-working poor and middle-class Americans and siphons it off into the bank accounts of failed bankers. Or government can pay for bailouts through inflation, increasing the money supply out of thin air and devaluing the value of the currency. In this case the bailed-out firms who have use of this new money reap all the benefits, while the poor and middle class see increased prices and the purchasing power of their savings reduced. Finally, governments can pay for bailouts through increased issuance of debt, increasing the tax burden of future generations, in the hope of finding investors who will purchase bonds which are increasingly unlikely ever to be paid off.

None of these options leads to long-term stability, they merely attempt to patch up a fragile financial system and put off financial reckoning until the next crisis. Bailouts provide a short-term illusion of continuing prosperity, while underneath the same rotten fundamentals ensure that bailout money is merely throwing good money after bad. Bailing out foreign governments is just as bad. Why should American taxpayers be on the hook because a foreign government cannot cover its debts?

What makes the situation even worse is that the bailout is being undertaken in a manner which is nearly impossible to stop. Bailout funds coming from the IMF, which receives nearly 20% of its funding from the United States, require the approval of IMF members, including the United States with its de facto veto power. Only the President can prevail upon the US representative at the IMF to vote against this bailout; the people and their Constitutionally-elected representatives in Congress are shut out. Compounding this is the re-emergence of dollar swap lines from the Federal Reserve to foreign central banks, which will likely result in the creation of tens or hundreds of billions of dollars of new money.

Bailouts never work, they never have and they never will. The only thing they do is burden taxpayers and delay the inevitable collapse of the bailed-out entity. Fiscal and monetary responsibility is a tough pill to swallow, but is essential for the sound functioning of the economy. We need to end the cycle of bailouts and ensure that American taxpayers will not continue to subsidize foreign governments.

TESTIMONY

Peter Morici
Professor, Robert H. Smith School of Business
University of Maryland
College Park, Maryland

HOUSE OF REPRESENTATIVES
Subcommittee on International Monetary Policy and Trade
Subcommittee on Monetary Policy and Technology

Hearings
May 20, 2010

Lessons Americans Should Take from the Greece's Predicament

As the Flash Crash in U.S. equity markets May 6 illustrated, problems in Greece can have grave consequences for not merely other Mediterranean economies and Europe, but U.S. and the broader global economy.

The sell off on Wall Street May 20 and 21, in the face of strong U.S. economic data, reflected growing concerns that the Euro Zone bailout will not work—Greece may be beyond saving—and that European government finances don't work.

At its core, problems in Greece reflect broader problems in Europe that are spreading to the United States. The 750 billion euro assistance fund simply does not address those problems. It is perhaps a palliative, not a cure.

Outsized Expectations for Public Benefits

In Europe, voters expect a strong, broad and expensive social safety net—including universal health care, income security and early retirement—those benefits until now exceeded in many instances what is provided by governments in North America.

This safety net has so reduced risks to individual and rewards for initiative and entrepreneurship that the safety net has slowed population and economic growth to dangerous levels.

Slower population and economic growth has made the social safety net too expensive to sustain in rich countries and poor countries alike.

With the commercial integration that followed World War II through the European Common Market, composed initially of only six nations, and the broader European Free Trade Area, which encompassed most of the non-communist states, public expectations for benefits in poorer nations and regions,

like Portugal, Greece and southern Italy, grew to rival those in richer states. This despite the fact their economies lacked the resources to pay for those benefits, even more acutely than in Germany or France.

Politicians responded by expanding and enriching social safety nets but costs rose too, as doctors, teachers and the like expected salaries and benefits more comparable to their colleagues further north.

The price tag outran the ability of employers and governments to pay, and inflation and national budget headaches followed.

Until the euro was adopted in 1999, southern nations would let their national currencies gradually fall in value against the German mark and other currencies of richer nations.

That boosted exports and tax revenues. The pensions paid by Portugal, Greece and others became worth less if spent in Germany and other northern jurisdictions, while these Mediterranean states became great places for Americans and northern Europeans to vacation and retire.

After 1999, national governments in Spain, Portugal and Greece, and to a lesser extent more prosperous Italy, faced the difficult prospect of telling their citizens they could not retire as young, enjoy the same health benefits or employment security as the wealthier French, Germans and Dutch.

Instead, these governments borrowed heavily and now face severe retrenchment and perhaps eventual bankruptcy.

The Teutonic austerity Germany and others will compel to bail out these floundering governments will shatter the myth that the welfare state can be provided equally across Europe, or Mediterranean states will simply quit the euro and take with them the Franco-German dream of European Unity.

Before we chasten our Mediterranean friends too harshly for living beyond their means, remember northern reluctance to share wealth through a strong central government has much to do with their predicament.

In the United States, the states can't print money and some spend more aggressively than others but most social benefits are substantially assisted by Washington, which can tax New York to subsidize Mississippi. Brussels cannot tax Germany to help pay for Greek social benefits, at least as aggressively as needed.

Unless Germans and others are willing to let Brussels tax them as necessary to reasonably equalize social spending between richer and poorer states, the euro will remain an uncertain adventure and European unity a utopian dream.

The Threat of Contagion and the Future of the Euro

The 750 billion euro bailout is creating concerns in several dimensions.

Greece and perhaps the others may be beyond the tipping point. Even with moderate growth (that's the most we can hope for in this climate), no combination of austerity measures may be possible that would resolve Greece's financial problems. It simply will have to restructure its debt—sovereign speak for default.

That could have huge ripple effects, because the Portuguese, Spanish and several other governments would face much higher borrowing costs and much greater prospects of default. European banks, including those in Germany and other wealthy jurisdictions hold sizeable amounts of threatened countries' debt, and U.S. banks hold a lot of European debt.

Crisis could easily spread from Europe to the United States, much as the recent U.S. mortgage and broader financial crisis spread to Europe.

The European Central Bank is stepping up by buying sovereign debt, and with restructuring on the wings that could amount to simply replacing Greek and other sovereign debt with billions of euro and inflation.

At the end of the day—the combination of existing debt and public expectation for the minimum social safety net (health care spending, retirement benefits, baby bonuses, etc) may compel Germany and other richer countries to choose between Greece and other poorer countries quitting the euro—returning to their own currencies—*or* a combination of high inflation and greater fiscal union in the EU. Regarding the latter choice, either the North subsidizes the South through ECB printing euro and inflation, or the EU transfers tax revenues from richer to poorer countries.

The Germans rightly fear hyper-inflation, and a EU take over the social safety net by granting it taxing authority over the entire EU to finance it is unlikely. Instead, countries like Greece may be forced to leave the euro zone or the euro will disappear all together. This could take several years to play out.

Lessons for the United States

The U.S. federal government and many states face similar difficulties but for the fact that the United States prints dollars—the global currency—but that could change.

The budget published by the Administration contains optimistic assumptions about economic growth from 2011 through 2015—in the range of 4 percent—when most private economists think something less is likely.

It contains the politically less difficult fiscal levers—repeal of the Bush tax cuts for families earning over \$250,000, and the estimated revenues and costs of the new health care law were in line with CBO estimates for what ultimately emerged, including the interest and dividend tax.

More realistic assumptions about growth and the cost of health care put U.S. projected deficits on the path to unsustainability—more than \$1 trillion a year for many years. Hence a value added tax is now on the table.

In the current environment of indiscipline, a VAT would be a disaster.

The polemic is appealing. Other industrialized countries have one, now that U.S. social benefits are more like those with the passage of national health care, the United States should have one too?

Not so fast.

Europeans pay a VAT and have income and corporate taxes too but they pay little for health care and higher education—the government uses those taxes to pick up the tab.

With a VAT, U.S. individual and business taxpayers would have tax burdens comparable to Europeans but would still face hefty bills for private health insurance and college tuition that Europeans do not bear.

The reason is simple. Americans pay 50 percent higher prices for health care services than the Germans and other most other Europeans, and U.S. universities are hardly hubs of modern efficiency.

The recent health care law contains firm commitments about scope of coverage and benefits guaranteed each citizen, but it is soft about bringing down higher U.S. drug, medical professional fees, administrative costs, and malpractice costs into line with Europe.

U.S. governments, federal and state, pay for about half of U.S. health care expenses, and a VAT would take away the pressure to chisel down to size the price of drugs, physicians fees, etc to make health care affordable.

U.S. higher education is another big hole in household and state finances. We are paying too much for what we get, except perhaps from our most modest institutions—community colleges.

A VAT, without offsetting cuts in personal and corporate taxes, will only make Americans poorer and with fewer incentives to work and innovate than the

Europeans now have, cause businesses to offshore even more jobs and tax economic growth to anemic levels.

Without a VAT and absent real and substantial cost cutting for health care and provision of other public services, budget deficits will drive up U.S. borrowing costs to unmanageable levels.

With a VAT and no real cost cutting, the absence of growth will strangle American prosperity.

Greece is a warning to governments that promise too much and pay too much for what they promise.

The United States is hardly free of such folly.

Testimony before the Committee on Financial Services

of

Carmen M. Reinhart

Professor and Director of the Center for International Economics,
University of Maryland

May 20, 2010

Thank you, Chairmen Meeks and Watt and the other members of the Subcommittees, for the opportunity to comment on the International Monetary Fund's (IMF) role in helping Europe deal with its economic crisis. I was also asked to remark on whether the external support for Greece and other EU member nations exacerbates moral hazard and on the adequacy of the proposed fiscal austerity measures.

I am currently a professor in the Department of Economics at the University of Maryland. I suspect that I was invited today because, for more than a decade, my research has focused on various types of financial crises. Also, I was Deputy Director of the IMF's Research Department during 2001-2003.

IMF Mission. It is not surprising that questions have arisen about the legitimacy of IMF involvement in a program aimed at aborting sovereign default in Greece and, possibly, other high-income countries. The last of the peacetime sovereign defaults among high-income economies took place during the Great Depression of the 1930s, well before the founding of the IMF in 1944.

Item V of the purposes of the IMF in its Articles of Agreement reads: "*To give confidence to members by making the general resources of the Fund temporarily available to them under adequate safeguards, thus providing them with opportunity to correct maladjustments in their balance of payments without resorting to measures destructive of national or*

international prosperity.” Whatever the concerns about the solvency of Greece and other EU nations may be, these countries also face classic *maladjustments in their balance of payments* that arise from a substantial loss of international competitiveness. They are IMF member countries and, as such a part of the IMF’s original mandate.

As my recent work documents, the wealthy economies are no strangers to IMF programs. The US had two IMF programs in the 1960s while the UK holds the record with 11 IMF programs. Portugal had a program as late as 1986. These programs, however, did not attempt to deal with solvency issues and were of modest size, as was customary in the pre-1995-Mexican peso crisis bailout model.

Fiscal austerity. The need for Greece and other European economies to slash government spending is not some artificial imposition by the IMF or the European Union. Once investors decide that a country living beyond its means will have a hard time meeting its debt obligations, spending cuts become a reality of arithmetic.

But fiscal austerity usually does not pay off quickly. A large and sudden contraction in government spending is almost sure to shrink economic activity as well. This means tax collections fall and unemployment and welfare benefits rise, undermining efforts to reduce the deficit. Even if new borrowing is reduced or eliminated, it takes time to whittle down a large debt, and international investors are notoriously impatient.

In recent years, several countries facing market pressures opted for austerity measures and eventually recovered, such as Mexico in 1995, South Korea in 1998, Turkey in 2001 and Brazil in 2002. But they all started with debt burdens significantly lower than Greece’s.

. A restructuring of Greek sovereign debt may not be inevitable but it certainly seems probable. A country such as Greece could seek to negotiate with its creditors to reduce its debt, but that path--essentially a partial default--is no panacea. Argentina's economy contracted about 15 percent after its default in 2001, as it was shut out of international markets for a time. When debt dynamics turn as adverse as those in Greece appear to be, authorities have no good options. Other EU countries facing debt difficulties may not require a restructuring of public debts. However, there is a pressing need to facilitate a restructuring of private debts, notably those of financial institutions.

Moral hazard. As in other situations, questions now arise about the tradeoff between exacerbating moral hazard and limiting contagion. I think it is safe to conclude that the combination of bailouts and forbearance are well entrenched in the expectations of financial market participants for the foreseeable future.

On contagion, it is relevant to recall that Thailand has an even smaller gross domestic product than Greece. But in 1997, Thai financial problems ignited the Asian crisis. Indonesia ultimately defaulted while Korea and Thailand only avoided the same fate through adjustments and international support. Asian economies posted output losses of 10 to 20 percent in that episode.

There are three main mechanisms for this contagion. First, many governments have common lenders, including international banks and hedge funds. If these institutions suffer large losses in one national market, they often pull back their lending to others. Second, trouble in one country acts as a wake-up call to investors, who scour their global holdings for similar risks elsewhere. When they look hard enough, they usually find something to worry about, triggering even more funding withdrawals. Greece, Ireland, Portugal and Spain may be miles apart, but to a worried portfolio manager, they look similar: They all have ongoing budget deficits and large private and public debts. Third, Greece casts a long shadow on the European continent because

fifteen other countries share a common currency with it. Greece's debt problems called into question whether the euro will survive.

The large EU/IMF package was intended to send a strong signal that the EU is committed to go to great lengths to avoid a breakdown of the euro. It is intended to provide broad-based coverage beyond Greece, as in the spirit of the TARP legislation in the fall of 2009. Like the US bailout package, an important feature of the plan of action is to have the ECB continue to treat Greek bonds as if the rating agency downgrades had never taken place. This is the kind of "forbearance" shown to toxic assets in the US over the past two years. The moral hazard issue of this approach cannot be understated.

At best, the EU/IMF initiative can buy some time for policymakers in other countries that have come under duress to implement difficult austerity measures and to move to restructure private debts. It does not change Greece's (nor anyone else's) levels of outstanding debts and their even more worrisome profile in the period ahead.

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May 20, 2010

Statement by

Daniel K. Tarullo

Member

Board of Governors of the Federal Reserve System

before the

Financial Services Subcommittee on International Monetary Policy and Trade
and Subcommittee on Domestic Monetary Policy and Technology

U.S. House of Representatives

Washington, D.C.

May 20, 2010

Chairman Meeks and Chairman Watt, Ranking Members Miller and Paul, and other members of the subcommittees, thank you for the invitation to participate in this hearing on the European sovereign debt problems and related international stabilization efforts.

Coming as it does on the heels of the financial crisis that began in 2007, and with economic recovery here in the United States proceeding at only a modest pace, the European sovereign debt problems are a potentially serious setback. It is thus important to understand the evolution of the financial turmoil in Europe, the European policy response, and the implications for the United States. After presenting some views on these subjects, I will describe the action taken by the Federal Reserve last week in support of efforts to contain the crisis.

Evolution of the Crisis in Europe and the European Policy Response

Although the sovereign debt crisis in Europe may have appeared to erupt virtually overnight, its origins were long in the making. For years many market participants had assumed that an implicit guarantee protected the debt of euro-area members. For a number of euro-area countries, including those most under pressure now, this presumption may have led to a systematic underpricing of risk, which made debt cheaper to issue than it probably should have been. Although strictures against excessive fiscal deficits and debts were built into the Maastricht Treaty, the European Union (EU) has had relatively weak mechanisms to enforce them, as EU officials themselves have recently acknowledged. Little provision was made for fiscal transfers across members of the euro area in the event that financial support for members became necessary. The global financial crisis created an environment in which the presumed EU guarantee was more likely to be tested, as stimulus measures and lost revenue led to sizable fiscal deficits and the rapid accumulation of debt across euro-area members.

Nowhere were these problems with the EU's fiscal framework more evident than in Greece. Greece's entry into the euro area in 2001 was associated with a sharp decline in Greek

government borrowing costs. Remarkably, the spread of Greek 10-year bond yields over those on German bonds fell below 30 basis points for a number of years. Despite these low borrowing costs, Greece was consistently unable to meet EU budget deficit targets or to reduce its sizable debt, putting the government's finances in a very precarious position at the onset of the global financial crisis.

Many date the start of the acute phase of the current problems to the revelation last fall that the Greek government's deficit for 2009 was likely to be several times larger than previously thought--it is now estimated at near 14 percent of gross domestic product (GDP)--and that its debt would significantly exceed 100 percent of GDP. In response, the Greek government announced substantial fiscal consolidation plans involving sizable increases in revenue and sharp wage cuts for government workers. However, concerns about the plan's feasibility, especially as growth prospects worsened, combined with what financial market participants took to be inconsistent signals from other European countries about the possibility of support, undermined the market's belief in an implicit guarantee. As a result, a sharp widening of spreads, rating downgrades of Greek debt, and stresses in the Greek banking system followed. By mid-April, it was clear that Greek financial institutions and the Greek government were rapidly losing access to market financing, just as sizable redemptions on the government's debt were looming.

After attempts at smaller and less well-defined support mechanisms for Greece failed to stabilize markets, EU and International Monetary Fund (IMF) leaders announced on May 2 a joint €110 billion support package. This international financing package is the largest ever extended to a single country and amounts to about 50 percent of Greece's GDP. In return, Greece was expected to implement an aggressive, front-loaded consolidation program to reduce its budget deficit from double-digit rates to less than 3 percent of GDP between now and 2014, with one-half of that reduction occurring this year alone.

The announcement of this package did not stave off market pressures, and by then the concerns of investors had already moved well beyond Greece. Doubts about the feasibility of the contemplated pace of Greek fiscal consolidation and concerns about the fiscal and financial situation in other vulnerable euro-area countries, especially Portugal and Spain, combined to move the situation closer to a crisis. Pressures were also beginning to be felt in dollar funding markets in Europe. Nascent signs of dollar shortages, a shortening of lending tenors on the interbank market, and increasing concerns about counterparty risk for many European financial institutions brought back memories of developments during the recent global financial crisis. More visible was the sharp decline in the euro in foreign exchange markets and plunging stock markets worldwide.

In response to these rapidly deteriorating financial conditions, in the early hours of Monday, May 10, European leaders announced a much broader package of stabilization measures than that previously announced for Greece alone.

One set of initiatives addresses sovereign risk. The European leaders announced the establishment of a European Financial Stabilization mechanism that would be based on up to €60 billion in European Commission funding and a special purpose vehicle that could raise up to €440 billion in additional funds in capital markets with guarantees provided by member state governments. Moreover, the IMF stated that it stood ready to cooperate with the EU, in accordance with established IMF lending programs and procedures, if requested by euro-area members. According to the EU, total available support through loans and credit lines, including potential bilateral IMF loans to member countries, could be as large as €750 billion (approximately \$900 billion). In addition, the EU and the IMF announced final approval and funding for the earlier announced Greek rescue package in an effort to assuage concerns about the country's financing needs.

Another set of initiatives addresses market liquidity. Specifically, the European Central Bank (ECB) announced that it was prepared to purchase government and private debt securities to ensure the depth and liquidity of euro area debt markets that were considered dysfunctional. In addition, the ECB expanded its liquidity provision facilities, including offering full-allotment operations for three- and six-month loans. Finally, as I will discuss in more detail later, to forestall an emerging shortage of dollar liquidity, the Federal Reserve reopened temporary U.S. dollar liquidity swap lines with the ECB and other major central banks.

The effect of the announcement on bond markets was immediate. Bond spreads for the peripheral European countries narrowed substantially, at least partly reflecting purchases of government securities by euro-area central banks. The ECB's enhanced liquidity provisions, including dollar credit from the liquidity swaps, have contained stresses in the European interbank market and provided an important backstop for these markets. Stock markets also initially rebounded strongly following the announcement of the European package; however, their declines over the past week serve as a reminder that investors are aware that this package cannot ultimately relieve the need for real, and likely painful, fiscal reforms in some euro-area countries.

Potential Ramifications for the U.S. Economy

Financial markets in the United States have been buffeted by the European problems. Over the four-week period leading up to May 6, just prior to news that EU members would be meeting to craft the most recent package, broad U.S. stock price indexes declined and implied volatility on equities rose sharply, reflecting some increased aversion to risk. The flight to quality also showed through to U.S. Treasury yields and the foreign exchange value of the dollar, with the 10-year Treasury yield declining 50 basis points over the four-week period and the dollar climbing more than six percent against the euro. Following the announcement of the May 10 package,

Treasury yields moved back up slightly and equity prices rebounded, but these moves were subsequently reversed and the dollar rose further against the euro.

These effects on U.S. markets underscore the high degree of integration of the U.S. and European economies and highlight the risks to the United States of renewed financial stresses in Europe. One avenue through which financial turmoil in Europe might affect the U.S. economy is by weakening the asset quality and capital positions of U.S. financial institutions. There are, to be sure, good reasons to believe that these institutions can withstand some fallout from European financial difficulties. In the past year, the Federal Reserve has pressed the largest financial institutions to raise substantial additional capital. Moreover, the direct effect on U.S. banks of losses on exposure to one or more sovereigns in peripheral Europe--which, in the current context of sovereign debt concerns, is generally understood to mean Greece, Portugal, Spain, Ireland, and Italy--would be small. According to the Federal Financial Institutions Examination Council, almost all U.S. exposure to peripheral European sovereigns is held by 10 large U.S. bank holding companies, whose balance sheet exposure of \$60 billion represents only 9 percent of their Tier 1 capital.¹ However, if sovereign problems in peripheral Europe were to spill over to cause difficulties more broadly throughout Europe, U.S. banks would face larger losses on their considerable overall credit exposures, as the value of traded assets declined and loan delinquencies mounted. U.S. money market mutual funds and other institutions, which hold a large amount of commercial paper and certificates of deposit issued by European banks, would likely also be affected.

In addition to imposing direct losses on U.S. institutions, a heightening of financial stresses in Europe could be transmitted to financial markets globally. Increases in uncertainty and risk

¹ See Federal Financial Institutions Examination Council, "E.16 Country Exposure Lending Survey and Country Exposure Information Report," <http://www.ffiec.gov/E16.htm>.

aversion could lead to higher funding costs and liquidity shortages for some institutions, and forced asset sales and reductions in collateral values that could, in turn, engender further market turmoil. In these conditions, U.S. banks and other institutions might be forced to pull back on their lending, as they did during the period of severe financial market dysfunction that followed the bankruptcy of Lehman Brothers. The timing of such an event in the current instance would be unfortunate, as banks generally have only recently ceased tightening lending standards, and have yet to unwind from the considerable tightening that has occurred over the past two years. Moreover, aggregate bank lending, particularly to businesses, continues to contract. The result would be another source of risk to the U.S. recovery in an environment of still-fragile balance sheets and considerable slack. Although we view such a development as unlikely, the swoon in global financial markets earlier this month suggests that it is not out of the question.

Another means by which an intensification of financial turmoil in Europe could affect U.S. growth is by reducing trade. Collectively, Europe represents one of our most important trading partners and accounts for about one-quarter of U.S. merchandise exports. Accordingly, a moderate economic slowdown across Europe would cause U.S. export growth to fall, weighing on U.S. economic performance by a discernible, but modest extent. However, a deeper contraction in Europe associated with sharp financial dislocations would have the potential to stall the recovery of the entire global economy, and this scenario would have far more serious consequences for U.S. trade and economic growth. A resultant slowdown in the United States and abroad would likely also feed back into the health of U.S. financial institutions.

Federal Reserve Responses to the Crisis

Notwithstanding the fact that European sovereign debt problems could have negative consequences for U.S. and global economic growth, successful resolution of these problems ultimately rests predominantly on effective European policy actions. The Federal Reserve has

only a limited, though important, role to play by helping to prevent liquidity pressures from intensifying and leading to a more widespread freezing up of financial markets, including in the United States. To counter growing strains in dollar funding markets in Europe, last week the Federal Reserve re-established dollar liquidity swap lines with a number of foreign central banks following the receipt of information on the large support package developed by European leaders.²

The liquidity lines, which were authorized by a unanimous vote of the Federal Open Market Committee, are structured similarly to those that were put in place during the financial crisis. As you know, central bank swap transactions have a long and well-established history, and their use by the Federal Reserve and other central banks goes back to the Bretton Woods era of fixed exchange rates. In their current vintage, they are used by foreign central banks to relieve or forestall temporary liquidity pressures in their local dollar funding markets. Foreign central banks draw on these lines by selling foreign currency to the Federal Reserve in exchange for dollars. The foreign central banks then lend these dollars to financial institutions in their jurisdictions. At maturity, the foreign central bank returns the dollars back to the Federal Reserve in exchange for its own currency at the same exchange rate that prevailed at the time of the initial draw, and pays interest as well.

The loans provided by the foreign central banks to institutions abroad are offered at rates that would be above market rates in normal times. As such, when market conditions are not greatly strained, demand for dollar liquidity through the swap lines should not be high, as market alternatives would be more attractive. Likely for that reason, the dollar liquidity offerings by

² Swap facilities were reestablished with central banks in Europe (the ECB, the Bank of England, and the Swiss National Bank), Japan (the Bank of Japan), and Canada (the Bank of Canada). The agreements establishing these facilities can be seen at Federal Reserve Bank of New York, "Central Bank Liquidity Swaps," webpage, www.newyorkfed.org/markets/liquidity_swap.html.

foreign central banks to date have elicited only a modest demand.³ However, even in such instances, the existence of these facilities can reassure market participants that funds will be available in case of need, and thus help forestall hoarding of liquidity, a feature that exacerbated stresses during the global financial crisis.

Even if usage increases significantly, the risks to the Federal Reserve, and by implication the risks to the U.S. taxpayer, are minimal. U.S. interests are safeguarded by the foreign currency held by the Federal Reserve during the term of the swap. Moreover, our exposures are not to the institutions in the foreign countries ultimately receiving the dollar liquidity but to the foreign central banks. Over the life of the previous temporary swap program (from December 2007 to February 2010), all swaps were repaid in full, and the Federal Reserve earned \$5.8 billion in interest. Finally, the Federal Reserve bears no market pricing risk in these drawings, since the swaps are designed so that fluctuations in exchange rates or interest rates have no effect on the payments made at the end of the transaction.

Conclusion

The agreement of the Federal Reserve to reinstate foreign exchange swap arrangements was designed not to insulate banks and investors from losses they may incur, but as a prudent effort to help minimize the risk of financial turmoil in Europe, with the consequences that would ensue for the global financial system, including the United States. In the worst case, such turmoil could lead to a replay of the freezing up of financial markets that we witnessed in 2008. With unemployment remaining quite high, and with continued need for balance sheet repair by many businesses, financial institutions, and households, it is particularly important that the United States not sustain a significant external shock.

³ Amounts outstanding on the swap lines are posted weekly at Federal Reserve Bank of New York, "Federal Reserve Foreign Exchange Swap Agreements," webpage, www.newyorkfed.org/markets/fxswap.

The policy measures announced by European authorities a week and a half ago elicited a quick, strongly favorable market reaction, holding out hope that further financial disruptions can be averted. However, as reflected in the negative turn of equity markets later in the week, and continued tight funding in some European markets, uncertainties are still clouding financial markets. Market participants continue to seek clarification of the terms and scope of the measures broadly outlined by the relevant European countries and institutions.

In Europe, a key near-term priority is to continue work to prevent a drying up of liquidity by providing both euro-denominated and, through the dollar liquidity swaps, dollar-denominated credit to financial institutions. But, even if effectively implemented, this support, along with the support for sovereign debt markets provided by the other components of the EU package, will not solve the sovereign debt problems; it will only provide time to make necessary policy adjustments. Lasting beneficial effects will require credible action to bring fiscal deficits under control. For the EU as a whole, it seems clear that the mechanisms of the European Economic and Monetary Union need further development if it is to achieve its intended aims. Last week, the European Commission issued a communiqué outlining plans to enhance surveillance and develop a crisis management framework. I would anticipate a robust debate over these and related matters in the coming months.

The United States is in a very different position from that of the European countries whose debt instruments have been under such pressure. But their experience is another reminder, if one were needed, that every country with sustained budget deficits and rising debt—including the United States—needs to act in a timely manner to put in place a credible program for sustainable fiscal policies.

Thank you very much; I would be pleased to answer any questions.

The Role of the International Monetary Fund and Federal Reserve in the Stabilization of Europe

Testimony before
Subcommittee on International Monetary Policy and
Subcommittee on Domestic Monetary Policy and Technology
U.S. House Financial Services Committee

May 20, 2010

Edwin M. Truman
Senior Fellow, Peterson Institute for International Economics
Visiting Lecturer, Amherst College
Visiting Professor, Williams College

Chairmen Meeks and Watt, ranking members Miller and Paul, and the other honorable members of your subcommittees, I appreciate the opportunity to appear before you to discuss the role of the International Monetary Fund and the Federal Reserve in stabilizing Europe. I will focus primarily on the first aspect of this topic.

The Greek tragedy, which is now on center stage, was largely of the Greek authorities' own crafting. However, it also emerged as an aftershock of the global economic and financial crisis of 2007-09 and has set off a European crisis. The challenge is to manage the European crisis so as to minimize the negative fallout on the fragile global economy and financial system and to reduce the severity of other aftershocks, which inevitably will occur over the next several years. How successfully the Europeans, the United States, and other systemically important economies deal with that challenge will determine the strength of our own and the global economic recovery now underway.

The risk is that the European situation will spiral out of control, spread within Europe beyond Greece and push Europe back into recession, and further damage the US and global economy and financial system. Twenty percent of US exports of goods go to the European

Union. As of the end of 2009, US bank exposure to the European Union was \$1.5 trillion, half the total foreign exposure of US banks.¹

The world economy will not recover without a reasonably healthy European recovery. The US economy will not enjoy the sustained recovery without global recovery. That was the key lesson of the global crisis of 2007-09. Crises that initially affect large parts of the global economy and financial system have adverse impacts in all parts of the globe.

The major policy instrument available to the United States to contain the European crisis aftermath is the International Monetary Fund (IMF). The United States should continue to provide maximum, constructive support for the IMF in carrying out its responsibilities for the promotion of global growth and financial stability.

I will summarize my testimony this afternoon with eight points.

First, the program of Greek economic and financial stabilization and reform program approved by the IMF Executive Board on Sunday, May 10 is ambitious and demanding. It may fail, but it is in the collective interest of the United States and the international community to give the people and authorities of Greece time to implement at least the first phase of their program.

Second, the European Union (EU) authorities delayed too long in providing a framework to support economic reform and to provide the necessary financial support for Greece. Consequently, the financial contagion has spread to other countries in the euro area, and perhaps beyond. For possible future use, the EU authorities are now putting in place a European Stabilization Mechanism (ESM) and have taken other steps to contain the crisis, including

¹ US bank exposure to the Euro Area was almost \$1 trillion. These data are from the Federal Financial Institutions Examination Council's Country Exposure Lending Survey released on March 26, 2010.

unconventional actions by the European Central Bank (ECB). The IMF may be called upon to cooperate with the ESM, using the Greek program as a template. A positive response by the IMF to such a request, on appropriate terms, is fully consistent with the Fund's core mission. Meanwhile, the Federal Reserve System has reactivated some of the swap arrangements that were deployed to contain the recent financial crisis and its impacts on financial markets – in my view appropriately.

Third, the IMF is not, and should not be viewed as, an institution that lends only to emerging market and developing countries. Each IMF member may call upon its financial resources. Since the IMF's founding in 1944, the vast majority of members have done so, including the United States as recently as 1978. The role of the IMF is to provide prompt and persuasive policy advice and to help design and finance economic reform programs.

Fourth, beyond its traditional role with respect to macroeconomic policies, which is much needed to restore and maintain economic growth in Europe, a key area of needed IMF policy advice for Europe is on strengthening their banks that now face the high probability of another round of substantially impaired assets and the risk of sovereign defaults.

Fifth, all IMF-supported reform programs involve a balance between painful policy adjustments that adversely affect economic growth in the short run and necessary, temporary financial support. The correct balance between adjustment and financing is a matter of intense disagreement, but both are required. Striking the right balance is a matter of judgment. The correct judgment depends on the economic and financial circumstances of the country requesting support as well as in the global economy and financial system at the time.

Sixth, the contribution of IMF lending to perpetuation of moral hazard is greatly exaggerated under current, and most, circumstances. For the potential borrowing country, the

greater problem is the stigma of borrowing from the IMF, which causes crisis-stricken countries to delay requests to borrow and creates incentives to self-insure by amassing huge stocks of foreign reserves, which is expensive for the country and distorts the global economy and financial system. On the creditor side, in most cases, investors take substantial hits to their reputations and to their balance sheets even though that does not deter others from repeating their mistakes.

Seventh, I am not greatly concerned that the IMF will be called upon to lend more to European countries, will run out of resources to lend, or will leave non-European members of the IMF in the financial lurch.

Eighth, citizens of the United States have a great deal to gain from successfully containing the European crisis. However, if the US and global economy are to recover decisively and enter a period sustained expansion, more needs to be done beyond simply containment. US policy should be oriented toward further substantive and financial support for the IMF in order to provide more confidence in the global economic outlook and in the restoration of financial stability.

In the remainder of my prepared testimony, I expand on these eight points, grouped together as three related topics: Greece and the European crisis, the role of the IMF in Europe and beyond, and the implications for the United States and US policy.

Greece and the European Crisis

The Greek economic and financial stabilization program requires a huge, but not unprecedented, amount of fiscal adjustment along with other needed policy measures to restore Greece's external competitiveness. On top of the country's general government debt estimated

at 115 percent of GDP at the end of 2009, its gross external debt was 168 percent of GDP, and it had a negative international investment position of 83 percent of GDP.

The IMF-EU-supported economic and financial reform program may not be successful, in particular because it will unfold against the backdrop of a very weak European economy and only a moderate recovery of the global economy. But Greece should be given the chance to implement its program.

Greece's government debt is estimated to have reached 115 percent of GDP in 2009, boosted by a public sector deficit estimated at 13.6 percent of GDP and accompanied by a 2 percent decline in real GDP and almost a percentage point decline in nominal GDP. The Greek program calls for a reduction of its budget deficit by 8.8 percent of GDP by 2013 in order to stabilize its government debt at 149 percent of GDP in that year before its debt ratio starts to decline. Before the projected pick-up in Greece's economy in 2012, it will have contracted 9.2 percent in real terms and 6.7 percent in nominal terms, which are probably optimistic projections.²

Some observers advocate an immediate adoption of an alternative approach that would involve a restructuring in which the stock of Greek government debt would be written down. A restructuring may ultimately be necessary, but it is not a cheap or easy way out. The broader negative ramifications for the world economy and financial system could be severe right now when the recovery is still fragile. Moreover, if there is to be a restructuring of Greek debt, it should be a one-time event, and its appropriate dimensions are obscure right now.

² The data and projections in this and the following paragraphs are from *Greece: Staff Report on Request for Stand-By Arrangement*, IMF Country Report No. 10/100, May 2010.

Under either approach, the citizens of Greece would still have to undergo a massive fiscal contraction to produce a primary budget surplus; that is the fiscal balance excluding all debt servicing costs. The deficit in Greece's primary balance was an estimated 8.6 percent of GDP in 2009 and is not expected to reach positive territory until 2012.

Greece and its political leaders are in hazardous territory, but the financial assistance from Greece's European partners and from the IMF is not creating additional moral hazard. The bad incentives were established long ago by the flawed architecture of the Economic and Monetary Union in Europe.

As long as one assumes that Greece will repay the extraordinary financial assistance it is receiving from official sources, foreign taxpayers will be subsidizing Greek taxpayers, but they will not be bailing them out. Nevertheless, it is doubtful that other countries will willingly elect to follow Greece down the road it has taken. Some creditors will benefit from the IMF-EU support of Greece's economic and financial reform program. That is the inevitable consequence of such efforts: some undeserving creditors escape from the consequences of their actions. However, even without a write-down of Greek government debt, many investors in that debt already have sustained substantial paper losses and creditors to the Greek private sector already have absorbed losses that will mount further. Greece's creditors may have thought they would be bailed out, but to a substantial degree they were mistaken. This will not stop other investors from making similar mistakes in the future, but it will also not encourage them to do so. Finally on this set of concerns, the risk to US taxpayers of non-repayment of funds advanced to Greece or other borrowers through the IMF is essentially zero. The IMF is a preferred creditor, and no country lending to or through the Fund has ever recorded a loss.

Cold-turkey fiscal adjustment by Greece that is accompanied by a debt moratorium, a suspension of payments, or a debt restructuring is also not a cheap or easy way out for the rest of Europe or the global economic and financial system. The adverse effects on other markets and economies would be substantial. The potential effects are already being felt as risk aversion returns to equity markets, credit markets again are freezing up, commodity markets discount the prospects of a strong global recovery, and the euro has fallen to its lowest level in real effective terms in eight years.³ The weaker euro may be good news to exporters and producers competing with imports from abroad, but that stimulus is unwelcome elsewhere, and it is likely to be swamped by the weakness in domestic demand within the Euro Area.

Because the European Union did not have mechanisms in place either to force responsible fiscal management or to support fiscal adjustment and because EU leaders delayed for months before cobbling together a mechanism to provide some measure of financial assistance, Europe is now undergoing a massive process of fiscal retrenchment.

Economic crises in Europe spread from Hungary, Latvia, and Romania, which represent a combined 2 percent of estimated European Union (EU) GDP and were already operating under IMF-supported economic adjustment programs, to Greece, another 2 percent of EU GDP. Now, crisis-related fiscal adjustment is underway in countries representing more than 40 percent of EU GDP.⁴ These adjustments have been forced on the citizens of the countries involved and, at this point, they cannot be avoided. However, it is difficult to imagine how Europe will avoid a double-dip recession.

³ My statement is based on the broad real effective exchange foreign exchange value of the euro calculated by the Bank for International Settlements (BIS) as of April 2010 adjusted by the euro's further decline against the US dollar since the end of April to 1.24 US dollars per euro.

⁴ In addition to the four countries mentioned in the text, this calculation includes Ireland, which embarked on its fiscal adjustment program earlier than other countries, Italy, Portugal, Spain, and the United Kingdom.

Against this background, it is appropriate that the leaders of the European Union, the ECB, the central banks of other countries, and the IMF have acted to try to mitigate the extent of the European economic and financial crisis and its inevitable negative effects on the rest of the world.

The Role of the IMF in Europe and Beyond

Is the role of the IMF in the Greek crisis and elsewhere in Europe consistent with the IMF's mission? My answer is yes for four reasons.

First, the IMF is a cooperative international organization with near-universal membership. Its mission is to promote sustainable global growth and financial stability.

Second, all members of the Fund should be eligible to borrow from the institution under appropriate conditions. The availability of IMF financial assistance along with advice on reform or adjustment programs is in the interests of all countries because all countries benefit from sustained, balanced growth and global financial stability.

Third, the Fund carries out its mission through its surveillance, policy advice, and lending programs. Those three mechanisms are, and should be, available to all members even if the wealthiest IMF members for a long time had not availed themselves of IMF lending facilities since the 1970s.

Fourth, IMF lending operations have not been limited to developing countries in recent years. In November 2008, Iceland embarked on an IMF-supported economic reform program. Its estimated per capita GDP on a purchasing-power-parity basis in 2010 is estimated still to be 25 percent more than Korea's, which borrowed from the IMF in 1997 and was the world's 11th

largest economy at that time.⁵ Moreover, the IMF, in cooperation with the European Union, already is supporting economic reform programs in Hungary, Latvia, and Romania. The wealthiest of those countries, Hungary, has an estimated GDP per capita that is less than half the GDP per capita of Korea. True, these countries are members of the European Union but are not part of the Euro Area. In retrospect, the Euro Area versus non-Euro Area distinction diverted the Europeans from acting promptly in Greece. The distinction primarily reflects the pride of the political elite in the countries using the euro as their currency. For reference, within the Euro Area, Greece's per capita GDP is approximately the same as Korea's as is Spain's, but Portugal's is 25 percent lower.

Since the late 1970s, the practice has been to use EU mechanisms to address the economic and financial problems of members of the European Union. The results were economic and financial programs that tilted the balance between adjustment and financing too far toward financing with insufficient adjustment. It was no surprise that, prior to the present crisis, the authorities in EU countries went to Brussels for help rather than to Washington. During those decades, policymakers in Washington were generally content that EU countries were not borrowing from the IMF because the IMF could then concentrate its limited resources elsewhere. However, in retrospect US policymakers should have promoted European adjustment assertively, including through the IMF. As a former Federal Reserve official, I hold myself partly to blame for this failure. The pattern of limited adjustment in Europe became part of the problem and contributed to the present crisis in Europe that now is threatening all of us. European official

⁵ These 2010 estimates of GDP per capita on a purchasing-power-parity basis are from the IMF's *World Economic Outlook* database.

now apparently grudgingly recognize that the credibility of IMF policy conditionality is greater than that of their own conditionality.

Is the IMF likely to exhaust its financial resources in lending to European countries and become unable to lend appropriate amounts to other members of the IMF? My answer is no.

The Economic and Financial Council (Ecofin) of the European Union on May 9 decided to establish a European Financial Stabilization Mechanism, often referred to without the word “financial” as the European Stabilization Mechanism (ESM), with potential financial resources of up to EUR 500 billion, or about \$650 billion at an exchange rate of \$1.30 per euro. In their decision the Ecofin stated, “The IMF will participate in financing arrangements and is expected to provide at least half as much as the EU contribution through its usual facilities in line with recent European programmes.” That expectation implies as much as \$325 billion in financing could come from the IMF. This may be the European expectation as part of their contingency planning, but it does not reflect an understanding of the way the IMF does its business. The IMF operates on a case-by-case basis.

References also have been made to using the “template” of the Greek program as a model. Templates are flexible. In fact, for the Greek program, potential IMF financing amounts to three-elevenths, or 27.3 percent, of the total of EUR 110 billion. Applying the inversion of this percentage to \$650 billion produces a figure of \$244 billion. However, the important point is that the IMF has not committed to lend to EU members beyond the current Greek program, even though it should stand ready to do so on appropriate terms.

How large are the IMF’s available resources to make commitments to lend?

My estimate is that the IMF now has at least \$250 billion in resources from usable quota subscriptions, the existing General Arrangements to Borrow (GAB) and New Arrangements to

Borrow (NAB), and ad hoc bilateral lending arrangements that have been put in place starting in late 2008. This estimate takes account of existing IMF lending commitments over the next several years, which were \$120 billion as of the end of January 2010, not all of which is likely to be needed. I estimate that another \$250 billion, on a net basis, should be available once the expanded NAB and 2008 adjustments in IMF quotas are in place. The IMF also follows a conservative policy in estimating its so-called “one-year forward commitment capacity,” and with the consent of the IMF Executive Board that policy could be temporarily relaxed, as has happened in the past. More importantly, if history is any guide, the general membership of the Fund will not allow the IMF to run out of financial resources. I return to this point at the end of my prepared testimony.

It is useful to review the procedure the IMF uses to draw upon members’ quota subscriptions to finance its lending operations. Every three months, the IMF draws up a “financial transactions plan,” which it releases after the end of the period. The quotas of IMF members included in the financial transactions plan are drawn upon proportionately to finance IMF lending operations.

As of the end of January 2010, the latest information that is available to the general public, the IMF had \$213 billion in available resources from the quota subscriptions of 52 members, about 80 percent of those members’ quotas, which in turn amounted to slightly more than 80 percent of total IMF quotas. The list included 21 members of the European Union, the United States and ten other members of the Group of 20 (G-20), and 20 other members of the Fund. My assumption is that Greece and, maybe, four other members of the European Union are not now included in the financial transactions plan right now. Excluding those countries, but assuming the plan is otherwise the same, about one third of all IMF lending comes from EU

members (23 percent from members of the Euro Area), 56 percent comes from other G-20 members (22 percent from the United States), and 11 percent comes from other members of the Fund. Thus, a large chunk of any IMF financing of programs of countries in the European Union comes from other EU members, and the remainder is spread around broadly. The IMF was designed a financial cooperative available to all members.

Finally, it is relevant in this context that IMF financial support of lowest-income, developing-country members does not draw upon the general financial resources of the IMF that would be used for lending to European members. The financial assistance to the lowest-income members for facilities such as the Extended Credit Facility and the Exogenous Shocks Facility relies upon mechanisms that fund the Poverty and Growth Trust in the form of repayments of previous loans or direct borrowing from other IMF members.

Returning to IMF responsibilities with respect to Europe, it is crucial in the period ahead that the IMF's policy advice is tailored to the maximum possible degree to the restoration and maintenance of domestic demand growth in Europe as a whole. This will require that in those countries with the fiscal scope to adopt policies that are calibrated to maintain support for their own, their partners', and the global economy. Many countries, including our own, must repair their fiscal positions and reduce the scale of government debt. However, in the global context, where some countries have no choice but to take drastic actions to repair fiscal weaknesses and restore debt sustainability in the face of market pressures, other countries should be more patient and deliberate if no less decisive.

Monetary policy will also be a challenge for the Europeans going forward, in particular, for the ECB and the Euro Area. Some countries using the euro will have to experience deflation – absolute declines in their price and wage levels – in order to restore their competitive positions

within Europe and globally. From February 2002 to April of this year, the real effective exchange rate for Greece had appreciated by 15 percent relative to that for Germany.⁶ For Spain, the figure is 10 percent. Thus, relative price levels must change substantially within Europe. To accomplish this adjustment, the ECB needs to achieve, if not exceed, its objective for inflation of less-than-but-close-to 2 percent for the Euro Area. This is necessary if countries such as Greece and Spain are not to experience absolutely crippling deflation. The IMF's April 2010 World Economic Outlook projection was that inflation in the Euro Area would be 1.1 percent this year, a number that now looks high, and will only reach 1.9 percent in 2015. This path for inflation will not do the trick.

Meanwhile, the ECB must keep an eye on the weakness in the euro. If the euro's decline continues substantially further, it would undermine the process of global rebalancing that should be underway. All members of the IMF have an interest in the ECB's success in meeting these challenges, and the IMF has the institutional responsibility to help to channel that interest constructively.

In the face of the inevitable further deterioration of balance sheets of financial institutions in Europe, resulting from the present phase of the crisis, the IMF also should encourage the Europeans to conduct another round of stress tests of their major financial institutions and, this time, to publish their methodology and the results of the tests. If the results reveal that most EU banks have adequate capital cushions, European and global financial stability would be boosted. If the results reveal the need for additional capital and the institutions are unable to raise it in the markets, governments should provide the capital support under appropriate terms and conditions.

⁶ I am using the BIS broad indexes for real effective exchange rates.

Meanwhile, the ECB should continue to be imaginative in its support of financial institutions and markets.

Implications for the United States and US Policy

I will not dwell on our own, well-known economic policy challenges for which the IMF can offer dispassionate advice that we would be well advised to absorb. Suffice it to say that in the future, US growth must be driven by a balanced expansion in domestic production of goods and services and in domestic demand for goods and services. If the growth of US demand outstrips the growth of US production, our trade and current account deficits will widen further, and the risk of a disruptive correction increases. Thus, we need a healthy and expanding global economy to keep the proper balance between our imports and exports. In the first quarter of this year, US exports of goods to the European Union increased a meager 2 percent while our total exports rose by 20 percent. We also need a foreign exchange value of the US dollar that is not artificially boosted because of economic and financial weaknesses elsewhere. The IMF has an important role to play in each of these areas, and the United States should strongly support an enhanced role for the Fund in economic and financial surveillance.

The IMF is in the process of completing its assessment of the US financial sector under the IMF's financial sector assessment program (FSAP), which in 2006 the US authorities finally agreed to undergo. The resulting financial system stability assessment (FSSA) will be released later this summer once it has been reviewed by the IMF Executive Board. The US authorities are to be commended for agreeing to release the FSSA and for agreeing to the release last week of seven detailed assessments and four technical notes. I doubt if an earlier review of the US financial sector would have revealed the depth of the problems exposed by the 2007-09 crisis, but it would not have hurt us. Nevertheless, the standing of the United States in the world was

adversely impacted by the perception that the US authorities thought they had nothing to gain from an FSAP.

The global economic and financial crisis and European crisis aftermath have important implications for other aspects of US policy toward the IMF and its membership. Given that the US Congress led the way in approving the expanded NAB and an increase in our IMF quota about one year ago, the United States is well positioned to press other countries to accelerate their own approval processes.

With respect to the need for additional financial resources for the IMF, one lesson of the European crisis is that the IMF's regular resources need to be further expanded. I have long advocated establishing a framework for the IMF to borrow limited amounts in the private markets. But that is not enough. Crises and the need for coordinated financial responses to them are not going away. As much as possible, the IMF should not rely on *ad hoc* borrowing arrangements.

Negotiations are now underway and should be completed by the end of the year to augment the IMF's regular quota resources. I favor a doubling of the IMF quotas, which would add about another \$250 billion to the Fund's lending capacity. This will require Congressional approval unless the United States opts out of an increase in its quota, which, I expect, will not be the case. Obtaining Congressional approval for increases in the US quota in the IMF is never easy. I bear some scars from previous efforts. However, in the end, I hope it will again be recognized that the citizens of the United States have a great deal to gain from a financially strong and effective IMF.

The current negotiations on the total size of IMF quotas also will result in a further realignment of IMF quota shares as well as, I hope, address other IMF governance matters. The

European crisis underlines the importance of shifting away from relying as much as in the past on IMF financial resources provided by European members of the Fund and toward greater reliance on other countries that may not have an immediate need to borrow from the Fund. That shift in relative financial contributions will foster a much needed shift in voting power and influence in the IMF from its European members as a group toward other members, which is long overdue.

Thank you.

**Testimony to the Joint Hearing of the Subcommittee on International
Monetary Policy and Trade and the Subcommittee on Domestic
Monetary Policy and Technology**

**“The Role of the International Monetary Fund and Federal Reserve in Stabilizing
Europe”**

**Amar Bhattacharya
G24 Secretariat**

There is broad based consensus that the roots of the Greek crisis lie in large accumulated internal and external imbalances and weak and deteriorating competitiveness. While the public and private sectors were both to blame, large fiscal deficits masked with the assistance of international banks was the primary culprit. The underlying vulnerabilities were exacerbated by the global financial crisis and the resulting economic downturn and increased risk aversion reinforced by sovereign risk vulnerabilities elsewhere in the region, ultimately leading to a full fledged crisis.

The buildup of these vulnerabilities reflects not only a failure of governance on the part of Greek authorities but inadequate surveillance on the part of European institutions and the IMF. The IMF’s Article IV consultations in 2007 had highlighted many of these vulnerabilities (although not to their full extent) but the lack of subsequent action is indicative of the asymmetry and lack of traction of IMF surveillance in advanced countries.

There can also be no doubt that the delay in coming to the IMF and in the announcement of a comprehensive program was costly. This delay has clearly contributed to the deterioration of market sentiment, led to global contagion and spillover effects and made the pace and design of adjustment measures more difficult.

Given the depth of the challenge, and the systemic implications not only for Europe but for the world economy, it is appropriate for the IMF to play a key role and to extend support to Greece. The scale of the standby that was recently approved by the IMF Board was unprecedented relative to quota (3200 percent) although comparable to some others relative to GDP. This “exceptional access” was based on the scale of financing needed even with the European support and the systemic risks involved. In principle this is fully consistent with the IMF’s role as a guardian of international financial stability and ability to meet the needs of all members.

But there are some specific constraints in the case of the Greek situation that make the program more difficult and risky. In particular, the restriction of being part of the Eurozone, which curtails the ability to use monetary policy or address competitiveness through the exchange rate, and the decision not to pursue voluntary or involuntary debt restructuring make the design of the program more difficult. Exit from the euro or debt restructuring entail their own risks with potential spillover effects, but the constraints imposed by the present approach require the program to be much more draconian.

In particular, the program calls for a very large and upfront fiscal adjustment based on expenditure and wage cuts, structural reforms to boost competitiveness and measures designed to protect the financial health of the banking sector. The program also includes specific measures to protect the vulnerable. But there is an inherent tension given the immediate impact of the fiscal measures on growth and employment and the longer-term payoff from structural reforms.

The downside risks of the program are considerable. Social unrest could undermine the government's ability or resolve to implement the austerity measures. Growth could be much more adversely affected leading to a vicious rather than virtuous path to debt sustainability. Market confidence may not be restored keeping risk premia and financing costs high. The lessons from Latvia, where growth plummeted, or from Argentina, where the elusive quest for market confidence led to a downward spiral and crisis, are sobering.

It will be important therefore for the IMF to carefully monitor the situation, develop contingency plans, maintain its independence as a multilateral institution and protect its preferred creditor status. All of these are well recognized by IMF Management and its Executive Board. Nevertheless the challenges of implementing the program will be immense.

The Greek crisis has heightened concerns of contagion elsewhere in the region. The IMF may therefore be called upon to provide support to other countries in conjunction with the new European Stabilization Mechanism. Such contributions would need to be assessed on a country-by-country basis but would be consistent with the IMF's mandate. These interventions must also be carried out in a way that safeguards the IMF's resources and protects against future moral hazard through conditionality and private sector involvement.

As a result of the tripling of the IMF's resources agreed to by G20 Leaders and the Governors of the IMF, including through the enhanced New Arrangements to

Borrow, the IMF has sufficient resources to respond to these potential needs while preserving the capacity to support other regions in the developing world. But the IMF must remain a quota-based organization with adequate long-term resources to fulfill its mandate. There is a need therefore for a very substantial increase in IMF quotas in the next general review to be completed by January 2011, with appropriate balance between quota and NAB resources.

The enhanced oversight and financing role of the IMF in the wake of the crisis underlines the importance of governance and voice reform if it is to be an effective and legitimate multilateral institution. A key aspect of the change needed is to address the over-representation of Europe and the under-representation of emerging markets and developing countries. Europe occupies 8 to 9 of the 24 seats at the IMF Board and accounts for around 32 percent of voting power compared with Europe's share of 7.5 percent of the world population and 23 percent of the world economy.¹ An ambitious realignment of quota shares as called for G20 leaders and other reforms to increase the voice of emerging markets and developing countries will be crucial for the IMF to effectively assume this larger role.

¹ "Europe's Governance Stalemate Causes Gridlock for Global Governance Reform", Amar Bhattacharya, Colin I. Bradford and Johannes Linn, The Brookings Institution, April 23, 2010



Testimony of Martin A. Weiss, Specialist in International Trade and Finance, Congressional Research Service, before the House Committee on Financial Services Hearing on “The Role of the International Monetary Fund and Federal Reserve in Stabilizing Europe”

Chairmen Meeks and Watt, and Ranking Members Miller and Paul, thank you for the opportunity to provide written testimony for your hearing, “The Role of the International Monetary Fund and Federal Reserve in Stabilizing Europe.” The following provides a discussion of the International Monetary Fund’s (IMF) lending resources; recent lending to Greece; and possible IMF commitments to the new European Stabilization Mechanism.

Background

The international monetary system has changed significantly since the founding of the IMF in July 1944. Late in World War II, delegates from 44 nations gathered in Bretton Woods, New Hampshire, to discuss the postwar recovery of Europe and create a set of international institutions to resolve many of the economic issues—such as protectionist trade policies and unstable exchange rates—that had ravaged the international economy between the two world wars. As the global financial system has evolved over the decades, so has the IMF. From 1946 to 1971, the main purpose of the IMF was to manage the system of fixed exchange rates agreed to at Bretton Woods. The U.S. dollar was fixed to gold at \$35 per ounce and all other member countries’ currencies were fixed to the dollar at different rates. The IMF monitored the macroeconomic and exchange rate policies of member countries and helped countries overcome balance of payments crises with short-term loans that facilitated policy adjustments to take effect in reducing external imbalances.

This system came to an abrupt end in 1973 when the United States floated its currency and, after a period of instability, the modern system of floating exchange rates came into effect. The IMF adapted to the end of the fixed exchange rate system by shifting its focus to promoting a stable exchange rate system based on floating exchange rates, while continuing to provide temporary balance of payments financing to countries, including to those afflicted by capital account crises.

Current IMF operations and responsibilities can be grouped into three areas: surveillance; lending; and technical assistance. Surveillance involves monitoring economic and financial developments and providing policy advice to member countries. Lending entails the provision of financial resources under specified conditions to assist a country experiencing balance of payments difficulties. Technical assistance includes help on designing or improving the quality and effectiveness of domestic policy-making.

The United States is the largest single country contributor to the IMF, subscribing to around \$55 billion of IMF quota, 17.09% of the total IMF quota. It has a single seat on the IMF’s Board of Executive Directors and 16.74% of the total votes in IMF decision making.¹ The U.S. Executive Director (ED), Meg Lundsager, is the primary U.S. representative to the IMF. She sits on the Executive Board, which is comprised of 24 Directors representing all of the IMF’s 186 members and handles the day-to-day

¹ IMF Executive Directors and Voting Power, International Monetary Fund, March 12, 2010.

operations of the Fund. The majority of IMF decisions, including country loans, require a 50% majority vote. Special matters, such as gold sales or approval of new quota increases, require an 85% majority vote. Some decisions require a 70% majority, e.g., changes in charges on lending. Congressional authorization is required by law before the United States may agree to participate in any new IMF funding agreements. Changes in the Articles of Agreement (Articles) that define the operations the IMF may conduct, and the majorities required for various decisions, may be proposed by the Executive Board, but require acceptance by at least three-fifths of member countries with at least 85% of the voting power before they are effective. Only four amendments to the Articles have been made in the history of the IMF, while two amendments are currently in the process of being approved by members.

IMF Lending

In the years following the Asian financial crisis (1997-1998) and financial support for Latin American countries in early 2000s, the volume of IMF lending fell substantially. International trade boomed, many emerging market countries accrued large financial reserves, and global capital flows grew substantially. By the end of September 2008, outstanding IMF credit was \$11.5 billion, down from a peak of \$116 billion in September 2003. Weak demand for IMF loans, together with large early repayments of credit resulted in income shortfalls relative to the IMF's administrative budget in 2007-2008. As part of a 2008 reform package, a restructuring was implemented to lower expenses by US\$100 million, primarily through a roughly 20% reduction in IMF staff. Since the onset of the financial crisis in late 2008, however, the IMF has made record volumes of credit commitments as both developing and advanced economies have turned to the IMF for balance of payments assistance. Between October and December 2008, credit outstanding almost doubled, from \$17.1 billion to \$32.54 billion and has continued to rise steadily. Following the IMF loan to Greece, total IMF financial commitments, including precautionary facilities, now exceed \$180 billion.²

Current IMF Resources Available to Lend

As of May 13, 2010, the IMF has around \$239.26 billion dollars immediately available to lend.³ This figure is the IMF's one-year forward commitment capacity (FCC), which measures the IMF's ability to make new non-concessional loans available to members over the next 12 months. This includes, among other sources, quota resources, unused amounts available under currently active bilateral loans to the IMF from several advanced economies, and note purchase agreements with three large emerging market countries.⁴

Quota

Quotas are the primary national contributions to the IMF and are the foundation of a country's participation in the institution. Quotas are in effect lines of credit upon which the IMF can draw to finance its lending operations. Based on each country's size in the global economy, quotas determine: (1) the amount of financial resources each member is required to contribute to the Fund; (2) the amount of financing a member may receive from the Fund;⁵ and (3) the voting power each country has at the IMF.

² "IMF Financial Activities -- Update May 13, 2010," *International Monetary Fund*, May 13, 2010. Available at <http://www.imf.org/external/np/tre/activity/2010/051310.htm>.

³ 161.7 billion IMF Special Drawing Rights (SDR) at an exchange rate of \$1.47965 on May 13, 2010.

⁴ The FCC is defined as the Fund's stock of usable resources less undrawn balances under existing non-concessional credit arrangements, plus projected repurchases during the coming 12 months, less repayments of borrowing due one-year forward, less a prudential balance intended to "safeguard the liquidity of creditors' claims and to take account of any erosion of the Fund's resource base." "The Fund's Liquidity Position – Review and Outlook," *International Monetary Fund*, April 12, 2010. Available at <http://www.imf.org/external/np/pp/eng/2010/041210.pdf>.

⁵ Over time, this linkage has weakened and several countries have been granted special access, allowing them to borrow several times their IMF quota. Argentina, for example borrowed more than five times its quota in 2002. In addition, the poorest countries borrow from the IMF under the Fund's concessional facility, the Poverty Reduction and Growth Facility (PRGF). The resources

The total of all member countries' quota subscriptions is 217.43 billion IMF Special Drawing Rights (SDR), approximately \$318.75 billion.⁶ The current U.S. quota at the IMF is SDR 37.14 billion, approximately \$55 billion, 17.09% of total IMF quota.

Since the IMF's founding, it has been the stated intention of the IMF to base quotas on various formulas that technically deduce a country's ability to contribute to the IMF and its potential need to draw on IMF resources. Historically, quotas have been loosely guided by the calculated quotas and actual quotas are driven by political negotiations among the member countries. In April 2008, IMF members completed two years of negotiations and agreed to quota increases for 54 countries that were underrepresented at the IMF on the basis of a new formula. This quota reform can become effective following an amendment to the IMF's Articles. Proposed amendments would enter into force for all members once three-fifths of the members (112), having 85% of the total voting power, have accepted the proposed amendment.⁷ In some countries, including the United States, legislative approval is required before a country can accept a proposed amendment. When fully implemented, these reforms would increase the total IMF quota by 11.5%.⁸

In October 2009, IMF members endorsed a call by G-20 leaders for an additional shift in quota share to dynamic emerging and developing countries of at least 5% from over-represented countries to under-represented countries.⁹

Countries contribute to the IMF mainly in local currency. Since the external positions (balance of payments and international reserves) of many emerging market and developing countries are weak, the IMF selects a group of countries (currently 54), which is reviewed quarterly, whose quota can be drawn on to finance IMF loans. The total quota of member countries that can be used for IMF lending is SDR 179.7 billion or \$269.1 billion, and is around 83% of total quota.

Extending an IMF loan using quota resources involves a transfer of foreign exchange from creditor members to the IMF and then a transfer from the IMF to its borrowing members. These transfers reduce the available quota resources from creditors and increase their reserve positions with the IMF by the same amount. Creditor members receive a market-related return on their reserve positions with the IMF. The amounts transferred and received by these members are managed to ensure that their reserve positions in the IMF remain broadly even in relation to their quota, which are reported by the IMF on a quarterly basis. As of January 31, 2010, SDR 7.33 billion (approximately \$10.85 billion, 19.7% of total usable quota) of U.S. quota is being used to finance transactions.¹⁰

Existing New Arrangements to Borrow and General Agreements to Borrow

In addition to its regular quota resources, the IMF maintains two standing multilateral borrowing arrangements—the New Arrangements to Borrow (NAB) and the General Arrangements to Borrow (GAB)—currently with a total borrowing capacity of about \$52 billion.¹¹ These are backstop resources

for the PRGF do not come from quotas and are not restricted by any limits.

⁶ Special Drawing Rights (SDR) are the IMF's unit of account. Initially defined as equivalent to 0.888671 grams of fine gold, the value of the SDR was switched to a basket of international currencies following the collapse of the Bretton Woods system of fixed parity exchange rates in 1973. The current basket includes the euro, Japanese yen, the British pound sterling, and the U.S. dollar.

⁷ Only four amendments to the Articles of Agreement have been made in the history of the IMF.

⁸ Currently 70 IMF member nations have accepted the proposed Voice and Participation amendment (which would triple the basic votes of members and provide an additional alternate Executive Director to the two constituencies, currently African, with the most members). In order to maintain its 17.09% share of total quota, the United States will subscribe to an additional \$8 billion in IMF quota. Necessary authorization and appropriation are included in the Supplemental Appropriations Act (P.L. 111-32).

⁹ CRS Report R40977, *The G-20 and International Economic Cooperation: Background and Implications for Congress*, by Rebecca M. Nelson.

¹⁰ Financing IMF Transactions Quarterly Report (November 1, 2009 – January 31, 2010), *International Monetary Fund*, <http://www.imf.org/external/np/tre/ftp/2010/050110.htm>.

¹¹ The NAB is the first line of recourse and it totals \$52 billion—the GAB does not provide additional resources.

intended to temporarily supplement available quota resources and borrowing. If activated, participating creditor countries make loans to the IMF, and the IMF uses those funds to provide loans to eligible countries. Repayments flow from the country to the IMF and then from the IMF to the GAB/NAB creditors.

Under current rules, before the IMF can draw against these resources, countries representing 80% share of total credit volume and also a majority of the IMF Executive Board must agree to their use. The NAB has been activated once—to finance a loan to Brazil in December 1998 as a short-term bridge to an increase in quotas. The GAB has been activated 10 times. The last time was in July 1998 for Russia. Current U.S. commitments to, and voting share at, the GAB are \$6.33 billion (25%) and to the NAB are \$9.89 billion (19.5%). Hence, given the requirement for support from an 80% majority of credit arrangements, the United States can in practice prevent the current GAB/NAB resources from being activated.

Increasing IMF Lending Resources

In April 2009, the G-20 Leaders and the International Monetary and Financial Committee agreed to increase the resources available to the IMF through immediate bilateral financing from members and to subsequently expand the NAB and make it more flexible. Although resources from most pledged bilateral financing are available and being drawn on for current IMF programs, the expanded NAB is not yet operational.

Bilateral Contributions

To date, around \$259 billion in bilateral arrangements are in effect, and are being used with IMF quota resources to fund IMF loans. These arrangements include loan agreements with 16 countries and note purchasing agreements with three countries. Additional bilateral pledges are under discussion. The IMF has decided in its current Financial Transactions Plan (FTP) that disbursements under Fund-supported programs will draw equally between quota and borrowed resources (bilateral loans to the IMF and note-purchases).

Expanded New Arrangements to Borrow

Following a year of negotiations on the design and operations of the expanded NAB, the IMF Executive Board adopted a proposal on April 12, 2010, by which the NAB would be expanded from about \$550 billion, with the addition of 13 new participating countries.¹² The U.S. commitment to the expanded NAB is \$100 billion and the necessary authorizations and appropriations were enacted in FY2009.¹³ In order to become operational, the expanded NAB requires both consent from current participants representing 96% of total (current) credit arrangements and adherence of new participants representing 70% of the total credit arrangements of new participants. Once the expanded NAB becomes operational, the bilateral loan and note purchase agreements would expire. The U.S. share in the expanded NAB, assuming that all participants agree to the amounts stated in the April 12, 2010 press release, would be 18.80% of the total expanded NAB.¹⁴ Approval from an 85% majority of credit arrangements is required to activate the expanded NAB, so it cannot be activated without U.S. approval.

IMF Loan to Greece

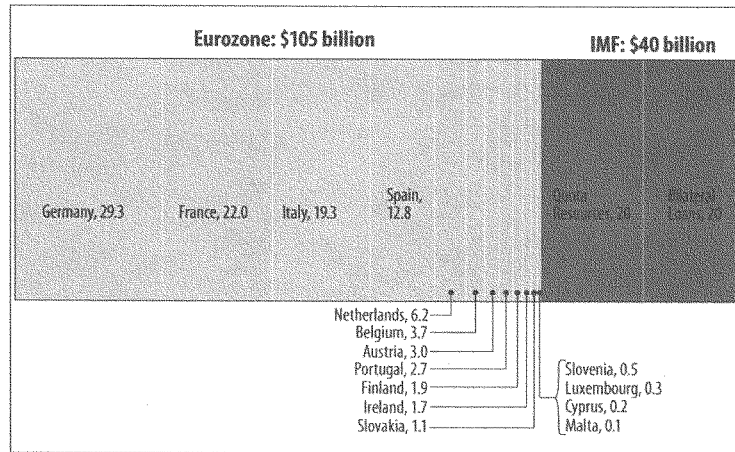
¹² IMF Executive Board Approves Major Expansion of Fund's Borrowing Arrangements to Boost Resources for Crisis Resolution, *International Monetary Fund*, April 12, 2010.

¹³ To meet the U.S. \$100 billion commitment to the expanded NAB, as well as an \$8 billion increase in the U.S. quota at the IMF, Congress appropriated \$5 billion in the FY2009 Spring Supplemental Appropriations for Overseas Contingency Operations (P.L. 111-32).

¹⁴ IMF Executive Board Approves Major Expansion of Fund's Borrowing Arrangements to Boost Resources for Crisis Resolution, *International Monetary Fund*, April 12, 2010.

On May 9, 2010, the IMF Executive Board approved a €30 billion (around \$40 billion) loan for Greece as part of a total package with the European Union (EU) amounting to \$145 billion over three years (**Figure 1**).¹⁵ European countries will provide €80 billion (around \$105 billion) and assistance will be disbursed to Greece on a fixed 3:8 ratio between the IMF and the EU.

Figure 1. Eurozone/IMF Financial Assistance Package to Greece
Eurozone member state and IMF source of resources, Billion US\$



Source: Reuters and International Monetary Fund. Prepared by CRS.

Notes: Eurozone member state commitments are bilateral loans, and some commitments are subject to parliamentary approval. IMF quota resources and bilateral loans fund a Stand-By Arrangement (SBA) loan for Greece.

IMF disbursements to Greece will be financed in the same manner as other disbursements on recent IMF loans, using a mix of quota and borrowed resources, which as noted above, is currently set at a ratio of 1:1. Thus, for every \$11 provided to Greece under the newly approved loan package, \$8 will come from EU countries and the IMF will draw \$1.5 from quota resources and \$1.5 from resources borrowed by the IMF through bilateral loans and note purchases by member countries. Since the United States has no bilateral borrowing arrangements with the IMF, U.S. resources will not be used for the 50% of the IMF loan to Greece drawn on non-quota resources.

For the half of the IMF loan to Greece that is drawn from quota resources, U.S. quota can, and will likely be drawn on, to finance a portion of the loan. As discussed earlier in this testimony, the United States receives a market-related return on its creditor positions with the IMF. It is important to note that countries whose quota is drawn on to finance an IMF loan do not take any additional financial risk compared to other IMF members. The Fund's membership as a whole bears any risk from lending to Greece. Furthermore, member countries whose quota resources are chosen for a specific IMF loan have a claim on the Fund's balance sheet as a whole.

Since the IMF was established, no member of the Fund has experienced a loss from providing resources to the Fund, either by lending to the Fund or through the payment of quota subscriptions. This reflects the multi-layered safeguards on Fund lending, including policy conditionality and regular reviews of performance by the Board, together with the Fund's preferred creditor status, which means countries continue to service Fund credit even if they default on other debt.

¹⁵ For more information on Greece, please see CRS Report R41167, *Greece's Debt Crisis: Overview, Policy Responses, and Implications*, by Rebecca M. Nelson, Paul Belkin, and Derek E. Mix.

IMF Resources Used for the European Stabilization Mechanism

Despite press reports of IMF contributions of €220 to €250 billion (about \$279.38 to \$317.47 billion) to Europe's newly announced European Stabilization Mechanism (ESM), the IMF has made no formal commitments.¹⁶ According to IMF Managing Director Strauss-Kahn, any IMF contributions "will be on a country-by-country basis," and "through the whole range of instruments available to the IMF."¹⁷ Any such commitments would also be subject to the approval of the Executive Board in the same manner as all IMF lending arrangements. If the IMF decides that loan programs for other European countries will be necessary, the IMF contribution will likely be on par with recent joint EU-IMF financing packages, where the IMF has provided roughly one-third of the total financing for the adjustment program, and the EU the remainder.

The European Stabilization Mechanism consists of two components:

- A new European Commission Facility that can provide up to €60 billion (about \$76.20 billion) to eurozone members; and
- A €440 billion euro (about \$558.76 billion) Special Purpose Vehicle that will be guaranteed on a pro rata basis by participating EU member states and will expire after three years.

¹⁶ Ian Talley, "UPDATE: EUR250 Billion IMF Contribution To Europe Hypothetical-IMF's Lipsky," *Dow Jones Newswire*, May 11, 2010. See also "Transcript of a Press Briefing by International Monetary Fund First Deputy Managing Director John Lipsky on the Euro Countries Stabilization Measures," *International Monetary Fund*, May 10, 2010. Available at <http://www.imf.org/external/np/tr/2010/tr051010.htm>.

¹⁷ IMF Welcomes European Actions to Stabilize Euro Area, *International Monetary Fund*, May 9, 2010.

