

Congressional Testimony

European Union Economic Relations: Crisis and Opportunity

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Thank you, Mr. Chairman, ranking member, and members of this committee. It is an honor to once again appear before you this morning on the subject of US-European economic relations.

The European Union is a Marathon Political Project

While the purpose of today's hearing is not to rehash what led to the economic challenges currently facing the European Union, I would like to start my testimony with a reminder that the European Union is fundamentally a political project. Although the euro, as a common currency, is obviously an economic instrument, its introduction within the European Union remains principally an outgrowth of political motivations. Somewhat paradoxically, to understand European economic issues, one needs to always look primarily through a political prism.

The introduction of the euro was one step in an ongoing political project intended to ultimately lead to a deeper and wider integrated Europe, largely based on a set of basic values consistent with our own. While frustrating, inefficient, complicated, and often painful to watch, the evolution of the European Union is something we, as Americans, should encourage. Its future success serves our direct economic, financial, and strategic interests.

European leaders often note that their progress should be judged as one would in viewing a marathon and not a sprint. By that standard, it is still early in the race, and there are significant hurdles still ahead.

Current Economic Challenges Facing the European Union

More than a decade after monetary union, Europe currently suffers from:

- a broken monetary transmission mechanism, in which the traditional tools of monetary policy fail to reach the real economy;

- a dearth of available credit, which hinders real economic activity;
- lingering concerns about potential exits from the euro, thereby increasing sovereign borrowing costs and increasing overall investment risks;
- fragmentation, not only within the European Union, but within the euro area itself, with borrowing costs, political tensions, unemployment, and growth prospects increasingly diverging into distinct camps—the very opposite of what monetary union was intended to accomplish; and
- a negative feedback loop between banks and sovereigns, in which countries rely too heavily on banks to help finance their sovereign debt, risking a deterioration in the banks' own balance sheets if the quality of that debt is called into question, potentially leading to the need for the already weak and overly indebted sovereigns themselves to step in and provide capital to keep the banking system afloat.

While sovereign and bank borrowing costs have stabilized, in large part due to aggressive action by the European Central Bank (ECB), the short term economic outlook for Europe appears dim, with the International Monetary Fund (IMF) predicting an economic decline of 0.3 percent for the euro area this year¹ and the European Commission itself predicting a 0.4 percent decline in the euro area and a 0.1 percent decline across the European Union.²

In short, while the worst economic outcomes have so far been averted, Europe today suffers from economic stagnation, unreasonably high unemployment and a banking system that is in need of serious shoring up.

European Policy Responses So Far

In spite of this sober assessment, the European response over the past three years has actually been far more aggressive, effective, and positive than has generally been acknowledged. That does not mean that there are no further risks. But Europe midway through 2013 is significantly more stable and prepared for future events than virtually anyone could have predicted three years ago.

Over that relatively brief time span, Europe has:

- created a permanent rescue fund, the European Stability Mechanism (ESM) with 500 billion euros potentially available for program country bailouts;

¹ <http://www.imf.org/external/pubs/ft/weo/2013/01/>

² http://ec.europa.eu/economy_finance/eu/forecasts/2013_spring_forecast_en.htm

- created a “temporary” rescue fund, the European Financial Stability Facility (EFSF), with an additional 200 billion euros still available, having already been utilized in programs for three countries within the euro area;
- seen the European Central Bank expand its mandate to include, de facto, the preservation of the stability of the financial system, through various standard and non-standard measures, including the expansion of its balance sheet to over 2.5 trillion euros;
- undertaken significant fiscal, structural and financial sector reforms in Greece, Ireland, Portugal, Spain, Italy, Cyprus, and beyond; and
- reached agreement on the creation of a single banking supervisory mechanism under the auspices of the ECB.

This progress has been painful, has come at enormous political, economic, and social cost, and is far from sufficient. But we would be remiss in not recognizing that three years ago, each of these steps would have been seen as politically, legally, or economically unlikely or impossible.

The Role of the International Monetary Fund

The involvement of the IMF in the euro crisis was initially resisted by many leaders in European countries. In part this was because the IMF was seen as too technocratic and not politically malleable enough to play a constructive role. Perceived as an unyielding technocratic economic institution, the IMF could not be counted on to succumb to political pressures and avoid politically unpalatable outcomes. And yet, the IMF’s unparalleled expertise in program design, surveillance, monitoring, and implementation led to its inclusion in the “troika” along with the European Commission and the ECB, which together have led the crisis response.

While the IMF provided financial support for several European countries that accepted international programs, the main value added by the IMF in the euro crisis was as the principal driver of program design, monitoring, surveillance, and review. It was this unparalleled expertise, more than specific financial commitments, that has provided the IMF with disproportionately large influence relative to its financial outlays over the outcomes in Europe thus far. Nevertheless, it is worth noting that in those instances when the IMF did agree to provide financial support, it did so with strict conditionality and with virtually unanimous support from its executive board.

Beyond specific country programs, the IMF has played an influential role on specific and broad policy matters, including research and recommendations on issues relating to banking and financial sector reforms, tax policies, and a wide array of other macroeconomic and structural areas. In short,

throughout the euro crisis, the IMF has served admirably as an independent economic policy advisor.

This is not to say that the IMF performed flawlessly. It did not. The IMF undoubtedly could have done things better. At times, the Fund sent confusing or conflicting messages on the great economic debate of our time—colloquially known as “austerity versus spending.” The IMF accepted questionable assumptions in the initial Greek program—assumptions that were proven woefully incorrect. But even in these instances, I believe that the IMF played a crucial and positive role. With a country’s economic survival in question, even an international financial institution needs to balance its role as “honest truth teller” with the risk of triggering the very consequences everyone seeks to avoid.

Future Path for the European Union

Today’s Europe is both fragile and in the process of reinvention. Whether by design or crisis, today’s Europe is already greatly evolved from only a few years ago, with even more significant steps towards deeper integration still ahead. Next month, European leaders are expected to formally agree to the creation of a single banking supervisory mechanism under the auspices of the European Central Bank, slated to become operational next year. This is the first step towards full banking union across the euro area. Next steps along this path include Europe-wide bank asset quality reviews, bank stress tests, the creation of a single bank resolution mechanism and potentially a single resolution fund and a cross-border bank deposit guarantee scheme.

But, as with a marathon, the race does not get easier as it progresses, it gets harder. These looming issues involve both the potential for countries with strong balance sheets to find themselves taking on the risks of those with weaker ones and the potential quid pro quo of asking those seeking outside support to agree to rules and potentially treaty changes that could alter the shape of what it means to be a member of the European Union. The potential for a loss of some element of sovereignty in return for financial support remains a delicate and potentially destabilizing dynamic. It puts Germany and France, the two most important founding members of what is today the European Union, on the path towards increasingly uncomfortable conflict.

Why Does Europe Matter to the United States?

Quite simply, the European Union represents the most important strategic, financial, and economic partner this country has. While there may be times when we grow impatient watching Europe’s marathon, we need to recognize how deeply intertwined and invested we each are in each other’s success. The emergence of fast growing markets in Asia, Latin America, and Africa are of enormous

strategic and economic interest to the United States. Yet, the ties between Europe and the United States remain quantitatively and qualitatively in a league of their own.

Europe remains our strongest global ally. The European Union is based on concepts of rule of law, openness, respect for property rights, democracy, and, for the most part, market economics. We clearly have our differences. But, make no mistake. An economically strong Europe is in our national interest.

The transatlantic economy generates \$5.3 trillion in total commercial sales each year, employs up to 15 million workers on both sides of the Atlantic (Hamilton and Quinlan 2013, 1). The United States and Europe are each other's primary source and destination for foreign direct investment, with Europe representing 56 percent of total US global foreign direct investment (FDI) since 2000 (Hamilton and Quinlan 2013, 2). In 2012 alone, US FDI in Europe exceeded \$206 billion (Hamilton and Quinlan 2013, 2). Americans invested more in Germany alone than in all of Central America, including Mexico (Hamilton and Quinlan 2013, 4). European investment in the United States amounted to \$1.8 trillion in 2011, more than 70 percent of total FDI in the United States. In 2011, Europe's investment flows to the United States were seven times larger than to China (Hamilton and Quinlan 2013, 7). The transatlantic relationship also supports American workers, with European controlled companies in the United States employing roughly 3.5 million Americans in 2011 (Hamilton and Quinlan 2013, 12). The European Union represents 22 percent of the world's GDP and over 25 percent of global consumption (Hamilton and Quinlan 2013, v).

Conclusion

The euro crisis represents an opportunity to reform and restructure the European Union. While I don't wish to belabor the marathon analogy, those who complete the race often cite the encouragement they receive from those cheering them on along the way. It is in our national interest to remain invested and engaged in their success to ensure that Europe emerges stronger from this crisis.

References

Hamilton, Daniel S. and Joseph P. Quinlan. 2013. *The Transatlantic Economy 2013*. Washington: Center for Transatlantic Relations.