

**FINANCIAL CRISIS IN GREECE: IMPLICATIONS
AND LESSONS LEARNED**

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BEFORE THE
SUBCOMMITTEE ON EUROPE AND REGIONAL
SECURITY COOPERATION
OF THE
COMMITTEE ON FOREIGN RELATIONS
UNITED STATES SENATE
ONE HUNDRED FOURTEENTH CONGRESS
FIRST SESSION

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FINANCIAL CRISIS IN GREECE: IMPLICATIONS AND LESSONS LEARNED

WEDNESDAY, JULY 29, 2015

U.S. SENATE,
SUBCOMMITTEE ON EUROPE AND REGIONAL
SECURITY COOPERATION,
COMMITTEE ON FOREIGN RELATIONS,
Washington, DC.

The subcommittee met, pursuant to notice, at 2:19 p.m., in room SD-419, Dirksen Senate Office Building, Hon. Ron Johnson (chairman of the subcommittee) presiding.

Present: Senators Johnson and Shaheen.

OPENING STATEMENT OF HON. RON JOHNSON, U.S. SENATOR FROM WISCONSIN

Senator JOHNSON. This hearing will come to order. I want to first of all welcome our witnesses and thank them for taking the time to appear before us here today, as well as taking the time for your thoughtful testimony.

The title of this hearing, “Financial Crisis In Greece: Implications and Lessons Learned,” I think pretty well describes what I want to talk about. A couple of years ago when we saw the riots in the streets of Greece, that was pretty revealing in terms of economic models and governmental models that were not working too well. One of the first things I did is I asked my staff to do a little research in terms of describing the level of debt in America versus Greece. So we produced a chart, which we have updated as of the first quarter. I wanted to keep it all relative.

I was rather shocked at the result. I was expecting the debt per capita of Greece to be a whole lot worse than the debt per capita here in the United States, but I found the exact opposite.

At the end of the first quarter in 2015, every American’s share of our Federal debt was over \$56,000. If you were a citizen of Greece, your share of Greece’s national debt was about \$31,000.

One of the questions I have for our eminent witnesses is how can that be and what does that really portend for America’s future as well?

I am looking forward to this hearing. We need to be concerned about the events in Greece, what kind of contagion that might produce for the rest of the eurozone. And, of course, if it is having an effect on Europe’s economy, it will have an effect on the world economy. Those are the basic questions we need to ask in this hearing.

With that, I will turn it over to Senator Shaheen.

**OPENING STATEMENT OF HON. JEANNE SHAHEEN,
U.S. SENATOR FROM NEW HAMPSHIRE**

Senator SHAHEEN. Thank you, Mr. Chairman.

Thank you to both of our witnesses for being here today.

The bailout agreement reached earlier this month by Greece and its European partners I think we would all agree is far from perfect. But even Greece's Prime Minister, who was elected in January with a mandate to reject further austerity, agreed that it was preferable to the immediate alternative, which was Greece's probable exit from the euro and the undermining of its financial system and economy.

But I think that this latest bailout agreement gives rise to a number of important questions about the long-term viability of the Greek deal and the future of the eurozone as a political and monetary union with which the United States has particularly strong ties.

I would like to submit my opening statement for the record, Mr. Chairman, but I held a hearing in this subcommittee I think in 2010, where we discussed this very issue, what were the implications of the financial situation in the eurozone and the implications for Greece and the other countries that at the time were experiencing similar financial difficulties.

The prognosis was, from the people who testified that day, actually, that we would be here several years from now with no firm resolution to the crisis. Sadly, I think we are exactly where that panel predicted that we would be.

New Hampshire has the highest percentage of Greek-Americans in the country, of any State in the country. So for my constituents and for Greek-Americans across the country, they are asking what the future looks like and what are the implications for their relatives and friends, many of whom are still in Greece and experiencing tremendous difficulties.

So I very much look forward to your testimony relative to what is happening in Greece and to what we might do to support both the eurozone and Greece as they try and deal with their financial troubles.

So again, thank you both very much for being here, and I look forward to your testimony.

[The prepared statement of Senator Shaheen follows:]

PREPARED STATEMENT OF SENATOR JEANNE SHAHEEN

Thank you, Mr. Chairman, for calling this important hearing on the Greek financial crisis.

The bailout agreement reached earlier this month by Greece and its European partners is far from perfect. But even Greece's Prime Minister—elected in January with a mandate to reject further austerity—agreed that it was preferable to the immediate alternative: Greece's probable exit from the euro and the undermining of its financial system and economy.

However, this latest bailout agreement gives rise to a number of important questions about the long-term viability of this deal and the future of the eurozone as a political and monetary union with which the U.S. has particularly strong ties.

Does this deal chart a sustainable way forward? The agreement imposes additional reforms and austerity measures on a Greek economy that has already contracted by nearly 25 percent. Is it possible for the Greek economy to stabilize and subsequently grow under the terms of this agreement? What are the alternatives?

Central to any discussion of the Greek financial crisis is the issue of Greece's debt burden. The International Monetary Fund, which has played a key role in resolving

Greece's financial crisis at the request of eurozone members, requires borrowers to have a sustainable debt level. Yet questions remain about whether Greece's debt, even under this deal, can be considered sustainable without some concessions on restructuring—concessions some European leaders have resisted. How should debt relief or restructuring play into negotiations going forward, and what role should the U.S. play in that respect?

Finally, there are the big questions that hang over any discussion of the implications and lessons learned from the Greek financial crisis: mainly, what has this episode revealed about European economic governance and the European project more broadly? The answers to these questions have consequences not only for Greece, but also for Europe and the Atlantic alliance.

I look forward to our witnesses' insights and counsel on all of these important issues.

Senator JOHNSON. Thank you, Senator.

Our first witness will be Dr. Robert Kahn. Dr. Kahn is the Steven A. Tananbaum Senior Fellow for International Economics at the Council on Foreign Relations. Previously, Dr. Kahn has held positions at the World Bank, IMF, and the U.S. Treasury.

Dr. Kahn.

STATEMENT OF ROBERT KAHN, STEVEN A. TANANBAUM SENIOR FELLOW FOR INTERNATIONAL ECONOMICS, COUNCIL ON FOREIGN RELATIONS, WASHINGTON, DC

Dr. KAHN. Chairman Johnson, Ranking Member Shaheen, it is an honor to testify today on the Greek financial crisis.

Senator Shaheen said the agreement earlier this month between Greece and its official creditors has prevented, for now, a disruptive Greek exit from the European monetary union. With adequate financial support, this deal offers a very narrow path for Greece to return to sustainable growth with the euro, but difficult choices face the Greek Government and people in the days ahead, and Grexit remains a very real possibility, perhaps even the most likely outcome at this point.

So far, the effects of the crisis on the U.S. economy have been modest. Greece is quite small as a share of U.S. trade and finance. U.S. banks have minimal exposure.

Also, since 2009, Europe has established rescue facilities, strengthened buffers, eased monetary policy, and there has been significant financing and cash relief, and a private-sector haircut. All this allowed Greece to return to modest growth last year before this year's confrontation with creditors returned Greece to recession.

But my bottom line is that this is not 2008. This is not 2010.

Still, I would argue, we do need to be on the watch for contagion. Whether inside or outside the eurozone, Greece's debt is unsustainable. And the recognition of losses for creditors could reveal surprising new sources of financial instability.

Contagion through political channels is equally if not more worrisome. We will need to watch closely what the crisis means for antiausterity debates in the periphery and for the anti-EU movement in the United Kingdom.

I will go into more detail on these issues in my prepared remarks, but let me in my opening remarks highlight five critical points that I think will confront the committee in its work in coming months.

First, the plan that was agreed between Greece and its official creditors is a framework for a deal, not a deal itself. Many details are still to be negotiated. The sides are far apart. There are a lot of things that could go wrong.

Greece in the past 2 weeks has passed significant reforms for tax, judicial, banking system, but there is a long road ahead, and the political challenges are daunting.

If all goes well, the best-case scenario would involve agreement on reforms, European and IMF financing at record levels, restoration of ECB access, debt relief, bank restructuring, and the lifting of capital controls, all of this by the end of the year.

And as I said, this program could not only fail, there must be very strong domestic ownership of the reforms for there to be any hope of success. That is something that is still legitimately a concern.

Given these evident risks, we need to use our leverage to strengthen the plan, particularly as it regards debt, but policymakers also need to be thinking through a plan B for best how to support Greece in the case of Grexit. That would include humanitarian aid, recognizing that it would be extraordinarily disruptive in the near term and cannot by itself solve Greece's problems and structural challenges, including overregulation, distorted prices, and the rule of law.

Second, any program that keeps Greece in the eurozone is going to be hugely expensive. The agreement envisages a financing gap of €86 billion over the next 3 years, which a little more than half goes to meeting debt service. The rest would allow fiscal financing, the elimination of arrears, and a comprehensive fix of the banking system. But the amounts needed are likely to grow due to inevitable slippages and a rising bill for the banking system closure.

This morning, we learned that growth this year is now expected to be -3.3 percent, and the primary deficit in the range of -1 percent to -2 percent. This underscores the damage and the distance that has been done and the distance that still needs to be traveled.

So this is the price of trying to keep Greece in the eurozone. Even the strongest market-oriented reforms are going to cause some dislocation in short-run situations. So it is critically important that Europe pays its share of the financing.

Discussions now envisage a rescue package, a so-called ESM program, in the range of \$30 billion to \$40 billion, less than half the amount needed. I think that package probably has to be at least \$50 billion, so that the excessive amount does not fall to the IMF or is left unfulfilled.

Third, European debt does remain a critical hole in our international architecture. We have a policy for private debt, and there is a Paris Club for developing countries. But the debt overhang in Europe has become a destabilizing force.

Now it may be possible to address Greece's needs in the near term through pushing out debt maturity and lowering interest rates. The policy would be better if it came to terms more transparently with the need for debt reduction.

I have called for a Paris Club for Europe, and now is the time to put that idea on the table. I would like my proposal from October 2014 submitted for the record.

Fourth, it is important to recognize that any IMF program contains risks. It will need to provide exceptional access. And if we are honest, we have to acknowledge that even with debt relief, there will not be a high probability that the debt will be sustainable. Pragmatism will be needed under the rules, because strict interpretation of the rules would probably force Greece outside the eurozone.

Now the IMF has been the center of controversy recently, but I believe it has acted responsibly in pushing for both adequate financing and debt relief. I think the United States should show leadership as these decisions are made and, broadly speaking, be supportive of the Fund's position on this. In addition, the Fund's preferred creditor status, which has been challenged by events in Greece, does need to be reaffirmed.

Finally, let me step back. I think Greece highlights a trend that you can trace back really to the mid-1990s when there was a Mexico program or a program for Korea, and through to the rescue programs of Greece and Ukraine today. Across this period, we have seen a rapid growth in financial markets and greater integration from developing countries in global markets.

Now that offers important possibilities for development and growth, but it means that when crises do occur, the financing needs are large and growing relative to the resources the Fund has at hand. This is causing increasing conflict between official creditors about who is going to pick up the bill. And when gaps emerge, it forces restructurings, which may or may not come at the right time. These tensions are only going to grow in coming years.

From this perspective, it is critically important that we work to modernize the IMF, and we cannot achieve this objective unless IMF quota reform is passed. So I see these issues as linked.

In sum, we have a shared interest with our European partners in establishing a Greece, whether inside or outside the eurozone, that is competitive and growing. We also have a strong interest in a cohesive and economically prosperous Europe.

I believe that what happens in coming months with our support could go a long way to determining the future of Europe and of the eurozone more generally.

Thank you for your time. I would be glad to answer your questions.

[The prepared statement of Dr. Kahn follows:]

PREPARED STATEMENT OF ROBERT B. KAHN

Chairman Johnson, Ranking Member Shaheen, and other members of the Foreign Relations Subcommittee on Europe and Regional Security Cooperation, it is an honor to testify on the Greek financial crisis. The agreement earlier this month between Greece and its official creditors has prevented, for now, a disruptive Greece exit from European monetary union. With adequate support from major creditors, this deal offers a narrow path for Greece to return to sustainable growth with the euro. But difficult choices face the Greek Government and people in the days ahead, and Grexit remains a very real possibility, perhaps even the most likely outcome.

Greece's direct trade and financial links to the U.S. economy are small, and there is less of a direct systemic threat to the United States than it was when the crisis began in 2009. But the risks are still material, and what happens in coming days and months can have dramatic consequences for Europe and for the global economy. While our leverage on intra-European negotiations is limited, there are a number of channels through which we can influence the path of the crisis, and it remains of vital importance to the United States that we remain involved—through the

International Monetary Fund (IMF), the Group of Seven (G7) and bilaterally with European governments.

In my testimony today, I want to examine the Greek crisis—how we got here, where we are going, and the critical decision points in coming months on which the United States can and should strive to influence outcomes.

ECONOMIC DECLINE, FISCAL CONSOLIDATION, AND DEBT REDUCTION

Since the start of the Greek debt crisis in October 2009, the country has experienced one of the most severe economic depressions for an economy not at war in the modern era (Figure 1). The size of the Greek GDP has shrunk by 25 percent since 2009, the unemployment rate has soared to over 25 percent, and youth unemployment is near 50 percent. After a return to modest growth in 2014, the economy fell back into recession as a result of the Syriza-led government's brinkmanship with its creditors, which resulted in a fiscal crisis, a bank run, and the subsequent closure of the banks.

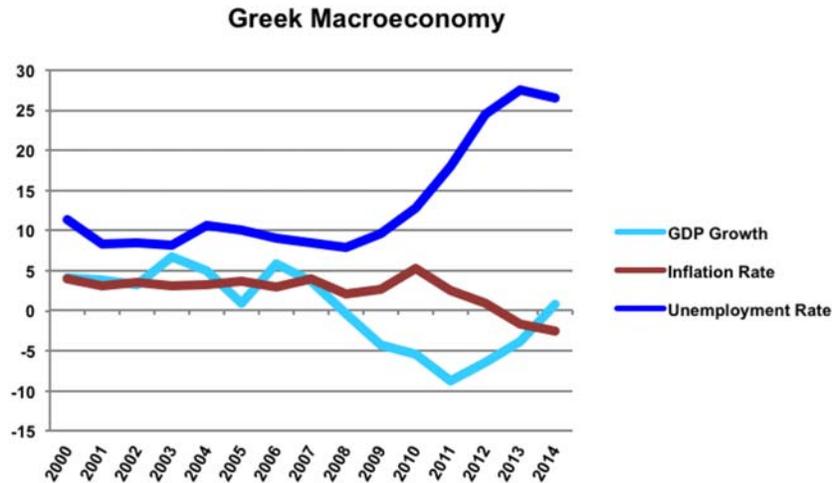


Figure 1
Source: IMF World Economic Outlook

There have been a number of excellent autopsies of the Greek experience, and I do not attempt to do service to the painful history of the period here. But a few observations are helpful to put the current debate in context. Certainly there is plenty of blame to go around for this disastrous economic performance: weak Greek policies, excessive deficits, and a distorted economy meant that Greece was always going to struggle to remain competitive within European monetary union. From this perspective, the economic problems of Greece date from well before 2009. Repeated adjustment programs prioritized fiscal adjustment over tough but necessary structural reforms to labor and product markets that would have allowed a return to growth, as we are now seeing elsewhere in the periphery. In addition, the incomplete nature of economic union in Europe—lagging well behind political union—also contributed to the current crisis. In particular the lack of fiscal union meant that Europe did not have the automatic fiscal transfers that we take for granted in the United States. Further, the inability to deal in a comprehensive fashion with the debt problems of the periphery further constrained Greece's room for maneuver and, in conjunction with weak overall growth in the euro area, limited demand for Greek goods.

Still, the proximate cause for the severe depth of the Greek recession was the drag from fiscal austerity. At the start of the crisis, the Greek primary fiscal deficit was on the order of 10 percent of GDP (with an overall deficit of nearly 16 percent). Even with significant financing, the shift from a deficit of that size to a small primary surplus last year represented a massive contraction in demand. From one perspective, it is unfair to blame creditors for austerity: after all, while a portion of the

financing went to meet maturing debt, external financing also allowed for a much more gradual path of fiscal adjustment than would have been the case otherwise, and deficits that remained for most of the period were among the largest in the eurozone. But the IMF has admitted that it underestimated the amount of drag (the fiscal multiplier) that would result from this level of fiscal consolidation at a time of low growth and significant economic slack across Europe. From this perspective, the surplus countries of Europe could have done much more to stimulate demand while the periphery countries adjusted.

Before the crisis, the debt looked sustainable on the basis of ready market access at low interest rates (figure 2). With the onset of the crisis, borrowing costs soared (figure 3), contributing to a “doom loop” in which high government debt undermined confidence and prospects for the banks, which in turn worsened perceptions of creditworthiness for the government to clearly unsustainable levels (figure 3).

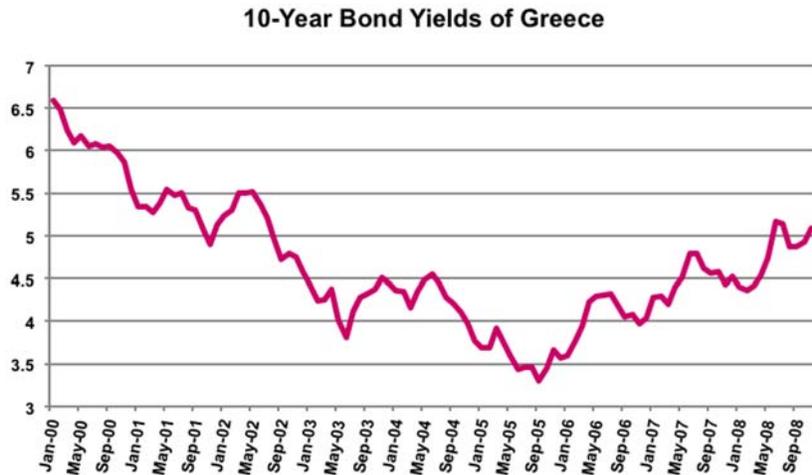


Figure 2

Source: European Central Bank (ECB)

10-Year Bond Yields and Spread

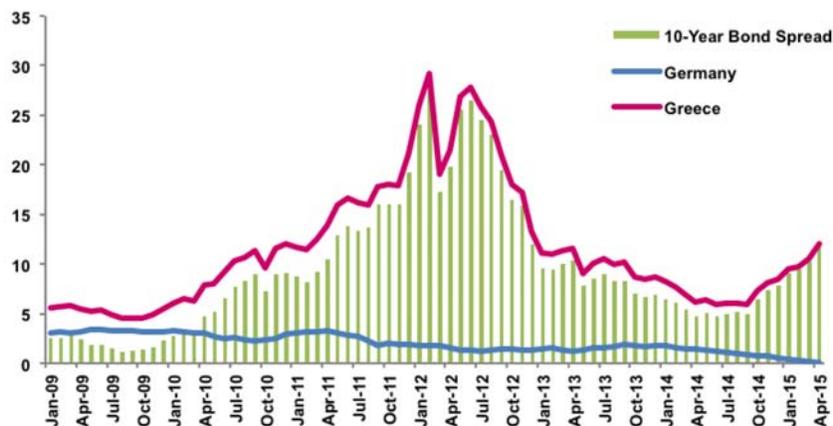


Figure 3

Source: European Central Bank (ECB)

By April 2010, the bond spreads rose to such a level that Greece essentially lost market access to finance its government. Greece subsequently requested financial assistance from the European Union (EU) and IMF, the first of a series of rescue packages that cumulatively have provided roughly \$250 billion in funding. IMF lending during this period was well in excess of the normal quota-based lending limits, which under the existing exceptional access rules would have required a finding that the debt was sustainable with “high probability.” In the absence of that finding, the Board decided to create a new “systemic exemption” that allowed this requirement to be suspended when there was “a high risk of international systemic spillovers.” This rule—which has also been used in programs for Portugal and Ireland—has become the center of a current debate over the appropriate flexibility in an uncertain world where political factors can come into play in deciding on IMF lending.

While there were important successes in the IMF programs, and a number of reviews completed, there were also some “notable failures,” as IMF admits in an ex post evaluation.¹ The program did not restore investor confidence or help Greece regain market access. The debt did not become sustainable and had to be restructured in 2012. Their report highlighted overly optimistic macroeconomic assumptions, as well as an overestimation of the Greek government’s ability to implement policy reform.

Following elections in January 2015, the new government abandoned its existing program, and sought to open new negotiations with a goal of ending austerity and achieving comprehensive debt reduction, all while remaining in the eurozone in good standing. These promises, coupled with their decision to roll back a number of reforms put in place by the prior governments, put Greece on an immediate collision course with its creditors. Despite improving regional headwinds (including improved growth and low interest rates), there was a significant worsening of economic conditions, with the economy returning to recession and the primary fiscal position turning negative. A deposit run from the banks was offset initially by extensive support from the ECB, but when the government decided to pull out of negotiations in late June, the ECB froze that support, leading to the closure of the banks.

THE JULY 2015 AGREEMENT

On July 22, the Greek legislature passed the second round of reforms, focused on: the court system backlog; protecting small depositors; and the introduction of rules to allow bank shareholders and creditors to cover the costs of failed banks.² These votes move Greece and its international creditors into the formal negotiating phase.

European leaders, meeting late into the night of July 12 in Brussels, reached an agreement that offers a path for Greece to remain within the eurozone. But it is an extraordinarily difficult path, requiring a commitment to market-oriented reform that this government—as well as previous ones—has not been able to sustain. The agreement traced out a series of steps which, if fully implemented, would lead to Greece receiving financing over the next 3 years totaling at least €86 billion. The first steps along this path have now been completed. In two rounds of legislation, the Greek Government passed measures including substantial value-added tax (VAT), other taxation, and pension reforms; a new code of civil procedure as part of judicial overhaul; full implementation of past EU laws, including procedures for automatic fiscal cuts when targets are not met; and, implementation of bank recovery and resolution directive as first step towards fixing the banks. In return, European creditors provided bridge financing totaling €7 billion on July 17 that allowed Greece to make debt payments and repay arrears to the IMF. The European Commission (EC) also unveiled plans to release €20 billion from the European Structural and Investment Funds, and €15 billion from the EU Agricultural Funds to support the Greek recovery over a number of years.³

Negotiations have begun this week on a broader agreement with the European Stability Mechanism (ESM) rumored to be in the range of €30–40 billion. These negotiations would address some of the most sensitive areas including early retirement and raising tax rates on farmers. Further reforms including: (i) Eliminating the pension deficit (that now stands at 10 percent of GDP); (ii) Adoption of ambitious product market reforms; (iii) Privatization of the electricity transmission network (ADMIE); (iv) A comprehensive labor market review including collective bargaining, industrial action and collective dismissals and a commitment to European best practices; (v) Large-scale privatization, including the possibility that €50 billion of assets would be turned over to an EU-controlled facility; and (vi) Broad-based administrative reform.

The best-case scenario involves comprehensive economic reform backed by agreement on a European package (ESM) by mid-August (ahead of a €3 billion payment due to the ECB on August 20) followed by an agreement on debt relief in the fall after a first review; tranches and conditional financing from the IMF and restored access to ECB programs; a comprehensive bank restructuring and a lifting of capital control—all by the end of the year. While the timing and modalities of IMF lending have not been determined, one scenario would have the IMF program moving forward after the first ESM review, which would allow time for negotiations to begin on longer term debt relief that the IMF insists is needed for it to agree on a program it can support.

This package could easily fail if domestic support for tough adjustment policies falters. Already, recent estimates suggest that the economy will shrink by 2–3 percent this year (versus a forecast of 0.5 percent growth previously), apparently necessitating additional adjustment measures. Given the evident risks, we need to use the leverage we have to strengthen the plan, particularly as regards debt (see below).

LESSONS FROM THE GREEK CRISIS

Given the exhaustive array of issues still to be negotiated, the plan that was agreed between Greece and its official creditors should be seen as a framework for a deal, not a deal itself. Yet the success or failure of the plan could be critical not only for Greece but for the future of European integration.

Any program that keeps Greece in the eurozone is going to be expensive. The agreement envisages a financing gap of €86 billion over the next 3 years, of which a little more than half goes to meeting debt service. The rest would allow fiscal financing, elimination of arrears, and a comprehensive fix of the banking system. But the amount is likely to grow, due to inevitable slippages and a rising bill from the recent banking system closure.

This is the price of trying to keep Greece in the eurozone, recognizing that even the strongest market-oriented reforms can cause dislocations in the short run. It is important that Europe pays its share of the financing, with an ESM program that should be close to €50 billion—not the €30–40 billion now being discussed—so that an excessive amount does not fall to the IMF or be left unfilled, undermining the program.

Already, there are some suggestions that the amount needed could be higher due to the recent, sharp economic deterioration following the closure of the banks. Further, in any economic program, and especially in this one, the risk of slippage is high. It is assumed that there will be substantial privatization revenue, and haircuts to private creditors of insolvent banks may reduce the official bailout cost.

Creditors also sought to address these concerns by requiring additional budget cuts if targets are missed. But, with substantial headwinds already facing the economy, the feasibility and desirability of turning off the automatic stabilizers seem questionable.

Third, European debt remains a critical hole in our international architecture. We have a policy of private sector involvement (PSI), and the Paris Club for developing countries. But the debt overhang in Europe has become a destabilizing force.

There is a broad consensus that Greek debt is unsustainable, a point even conceded by the German Government. It may be possible to address Greece's needs in the near term through pushing out debt maturities and lowering interest rates, but a policy would be better if it came to terms more transparently with the need for debt reduction. Over the longer run a new architecture for dealing with debt is needed. I have called for a Paris Club for Europe, and now is the time to put that idea on the table. (I would like my proposal from October 2014, "A Paris Club for Europe," submitted for the record.)

THE ROLE OF THE IMF

The final piece of the Greek package, financial assistance from IMF, has drawn a lot of attention following release by Fund staff of a new debt sustainability assessment showing that the proposed policies, even if fully implemented and successful, would lead to debt levels close to 200 percent of GDP and gross financing needs of over 15 percent of GDP. The IMF suggests that, for a Greek program to make sense, it needs to include nominal haircuts or very long grace periods on payment (as much as 30 years). The IMF's document has been read as suggesting the Fund will not lend if these levels of relief are not delivered. Ultimately, though, the Fund will find it extremely hard to say no when its major shareholders are so committed to the program, even if the program does not meet the Fund's internal rules (including a high probability that the debt is sustainable).

Nonetheless, the IMF is right to be concerned about both financing and debt, and of being pulled into a financing arrangement that it does not believe in. On the financing side, as noted above the setting of the gap at €86 billion, and a sequencing where the IMF program is approved after the European facilities are in place, creates a risk for the IMF, and in the absence of adequate financing and debt relief, risks making the IMF a de facto lender of last resort.

It is important to recognize that any Fund program contains risks. It will need to provide exceptional access, and if honest we need to acknowledge that even with debt relief it will not meet the test of "high probability of debt sustainability" required under IMF rules. Pragmatism and flexibility will be needed. As in 2010, a strict rules-based approach could be equivalent to forcing Greece out of the eurozone.

Overall, the Fund has acted responsibly in this phase of the crisis, correctly pressing for strong policies adequately supported by financing and debt relief. It is not going to get easier—the Fund faces a number of difficult decisions in coming months on lending and debt, and it will be vital for the U.S. to show leadership as these decisions are made. In addition, the Fund's preferred creditor status, which has been challenged by recent events in Greece, needs to be reaffirmed.

THE CHANGING NATURE OF DEBT CRISES

Debt policy, and the IMF's role in resolving crises, has had to evolve in the face of changing markets and country conditions. Going back perhaps to the 1994 Mexico rescue package and the Korean IMF program of 1997–98, we have seen rapid growth of financial markets and greater integration in markets by large developing countries. That offers important possibilities for development and growth, but it means that when crises do occur, the financing needs are large and growing relative to resources the IMF has at hand. This is causing increasing conflict between official creditors, a conflict that is likely to intensify in coming years.

In recent years, a number of steps have been taken to address these tensions. First, there have been a number of changes to Fund rules to provide greater flexibility for it to lend beyond what its traditional quota-based rules would allow, including the exceptional access criteria in 2002 and the systemic exemption in 2010. These reforms are controversial, but I am not convinced that there are easy alternatives. The reality is that there will always be cases where events require a pragmatic policy response. No major policymaker at the time was prepared to force a debt restructuring in Greece in 2010 when the world was in the midst of a crisis (though a strong case could be made that the eventual private restructuring in 2012 came a year too late). Similarly, the 2014 Ukraine program arguably required a suspension of disbelief to argue a high probability of sustainability, but the argument

was made to facilitate a loan that was clearly in the interest of official creditors including the United States.

This is not an argument for unlimited discretion, but it is a recognition that we are increasingly in an environment where the Fund's rules are at odds with broader U.S. objectives. From this perspective, it is critically important that we work to modernize the IMF. And we cannot achieve this objective unless IMF quota reform is passed. Passage of this bill, by enhancing the resource base of the IMF and building stronger international support for its efforts, can reduce the number of cases where the systemic exemption would be needed.

WHAT IS AT STAKE FOR THE UNITED STATES

So far, the effects of this crisis on the U.S. economy have been limited. Greece is quite small as a share of U.S. trade and finance; U.S. banks have modest exposure. Also, since 2009, Europe has made important steps to address the crisis, establishing rescue facilities and strengthening buffers, and easing monetary policies in support of growth. There has been significant financing and cash flow relief provided to Greece, including through an aggressive reduction in private debt, coupled with substantial fiscal adjustment, allowing a modest return to growth before this year's confrontation returned Greece to recession. This is not 2008, and it is not 2010.

Financial contagion occurs when financial instability in one market is transmitted into other markets.⁴ The Greek debt crisis in its early stages gave rise to financial contagion, which contributed to the eurozone crisis as a whole. This can be seen in the co-movement of bond yields in different markets. Figure 4 shows that since the crisis started in late 2009, the bond yield of Greece seems to exhibit co-movement with those of other European countries particularly Portugal and Ireland. But that correlation appears to have broken down this year, suggesting less contagion from Greece to the rest of the eurozone.

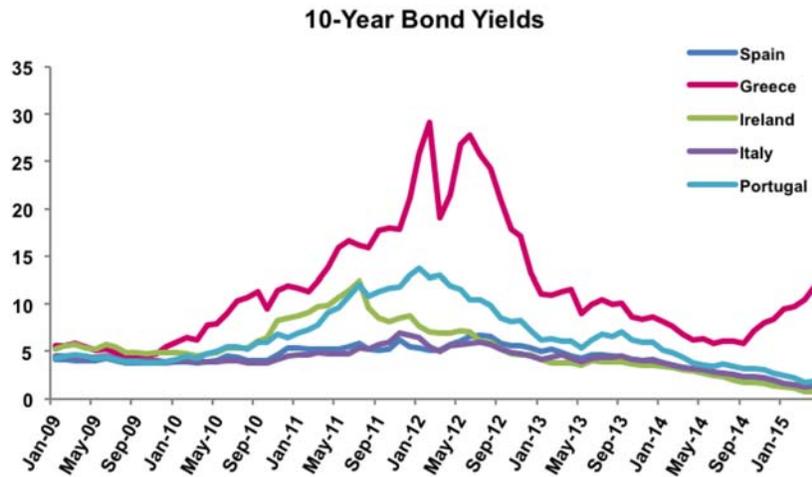


Figure 4

Source: European Central Bank (ECB)



Figure 5
Source: Bank for International Settlements

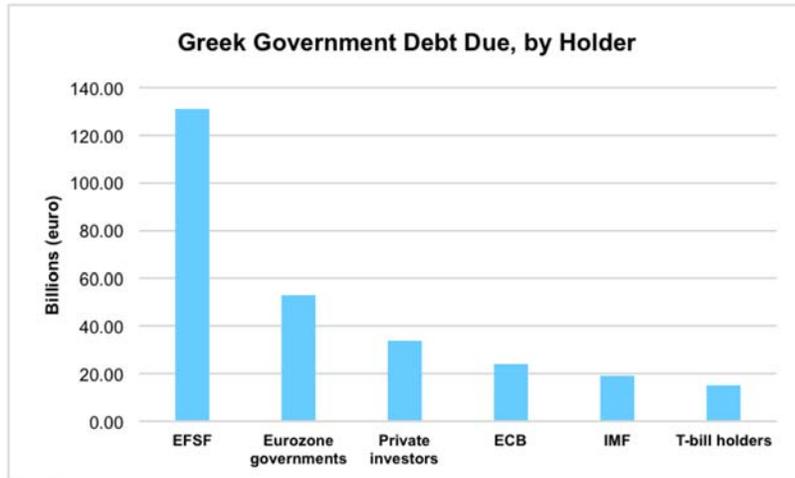


Figure 6
Source: Wall Street Journal

The United States, however, is not immune to a crisis in Europe. The EU is one of the largest trading partners of and shares close economic links with the United States.

Consequently, we need to be on watch for contagion—whether inside or outside the eurozone, Greece’s debt is unsustainable and the recognition of losses for creditors could reveal surprising new sources of financial instability. More broadly, the crisis has revealed flaws in the architecture of Europe and, whether Greece is in or out, makes a compelling case for further economic integration. More importantly, how the crisis is handled may speak volumes for the future of Europe and the eurozone, with important economic, political, and security implications.

AFTER GREXIT, WHAT FOLLOWS?

Should Greece decide to exit the eurozone, there is a great deal of uncertainty about what happens next. The process of introducing a proper currency could take time, though a rudimentary median of exchange could be put in place relatively quickly (perhaps through the introduction of IOUs). This would allow for an effective devaluation that would, over time, help to restore competitiveness. After Grexit, Greece would need humanitarian and technical support, an issue on which the

United States could take a lead role. None of this ensures success; ultimately it is policies that determine whether Greece could thrive outside of the eurozone.

There is a broad and strongly held view among European policy analysts that Grexit, if it occurs, will be negative for the European political project and for prospects for further integration. The argument appears to be that the brinkmanship of the past month, and the divisive nature of the negotiations, has created fissures within Europe that will be difficult to mend. There is particular concern about French-German relations, and what a break means for solving a range of global problems including sanctions toward Russia, support for Ukraine, and Iran. There are also concerns that Grexit will cause a domino effect of exits elsewhere. In the United Kingdom, in particular, there are concerns that a disruptive Grexit will boost support for those that would have the U.K. leave the EU.

One could make a more positive argument, if the difficulty Greece faces causes voters in other countries to decide that confrontational or nonorthodox policies are likely to be counterproductive. In that case, Greece's problems could lead to less, rather than more support for parties such as Podemos in Spain. Either way, the most significant source of contagion from Greece may be political rather than economic.

CONCLUSION

The intensification of the crisis in Greece has strained European solidarity and called into question some of the fundamental assumptions of economic and monetary union. The experience has led many to call for greater integration in the union, though the terms on how to best achieve it remain divisive. As Greece attempts to move forward and put in place policies that would justify continued financial support, Europe faces a series of difficult decisions—on debt, financing and policies—that could be decisive to the outcome. The U.S. Government can and should be a partner to those discussions.

In the end, we have a shared interest with our European partners in establishing a Greece—inside or outside the eurozone—that is competitive and growing. We also have a strong interest in a cohesive and economically prosperous Europe.

What happens in the coming months could go a long way to determining not only Greece's future, but also the future of European integration, and consequently Europe's relationship with the rest of the world.

End Notes

¹ IMF (2013) "Greece: Ex Post Evaluation of Exceptional Access under the 2010 Stand-By Arrangement."

² <http://www.bbc.com/news/world-europe-33616177>.

³ <http://europa.eu/rapid/press-release-IP-15-5373-en.htm>.

⁴ Vitor Constancio (2012) "Contagion and the European Debt Crisis."

Senator JOHNSON. Thank you, Dr. Kahn.

Our next witness is Prof. John Taylor. Dr. Taylor is a professor of economics and a senior fellow at the Hoover Institution at Stanford University. From 2001 to 2005, he served as Under Secretary of the Treasury for International Affairs, where he was responsible for IMF and World Bank oversight.

Dr. Taylor.

STATEMENT OF JOHN B. TAYLOR, HOOVER INSTITUTION AND PROFESSOR OF ECONOMICS, STANFORD UNIVERSITY, STANFORD, CA

Dr. TAYLOR. Thank you, Mr. Chairman, Ranking Member Shaheen, for inviting me to this hearing.

As requested, I would like to consider lessons for the United States from the Greek crisis, compare the United States and Greek debt situation, and draw some implications for United States policy as well as for Greece.

Obviously, the Greek economy has been performing terribly. Real GDP has actually declined to 5 percent per year for the last 5 years, and it is continuing to decline. But also for the past 30

years, growth has averaged less than 1 percent per year in Greece, and productivity growth is nearly zero for the past 30 years.

I think there are three key factors that have led to this situation. Most important, the Greek economic policies have been very poor, I will put it that way, the regulatory rule of law, budget, tax, et cetera. It has been documented by many observers.

Just some examples. The Heritage Foundation index ranks Greece 130 in the world, on par with many sub-Saharan African countries. The World Bank's Doing Business indicator ranks Greece 61, and in terms of enforcing contracts, 155th; registering property, 116th.

According to the Fraser Institute, on economic policy, Greece ranks 84.

According to the IMF, "To achieve [productivity] growth that is similar to what has been achieved in other euro area countries, implementation of structural [supply side] reforms is therefore critical."

Of course the United States by comparison scores higher on all of these indices.

One has to be careful about drawing analogies and lessons. Nevertheless, I see a problem in the United States, because it has been declining on these indicators as well.

So take the Fraser index, for example. The United States ranked two in the year 2000. It now ranks 14th. The Heritage index, we ranked five in 2008, now 12. The World Bank's index Doing Business, three in 2008, now seven.

I have noted these changes myself in my book, "First Principles." I actually found a connection, I think, between these measures of performance, which show some deterioration, and the slow economic growth that we have had recently, the slow recovery.

I think a second problem is there is really just one central bank for the whole eurozone. That meant going into the crisis that the interest rate set by the ECB was just too low for Greece. It caused risk-taking, clearly a housing boom and eventually a bust. While the United States, obviously, is not in a currency zone with other countries, I think there is a lesson here for the United States, too, because I think in that same period, 2003 to 2005, the Federal Reserve also set interest rates too low.

These events were not completely unrelated. That interest rate being too low in the United States was one of the causes of the excess risk taking, borrowing, and the housing boom, which led to a bust.

The third problem for the Greek economy is this unsustainable debt. Here I would point, in particular, to a decision in 2010 that the IMF made to start making more loans to Greece without first insisting that debt be sustainable. When the IMF did this, it broke its own lending rule, and, of course, the United States voted to go along.

This decision really bailed out the private sector, for the most part, and has left the public sector, the IMF, the Euro Group, and the ECB, holding the bag.

Now, if we compare the United States and Greece, you have to be careful. I see the chart with the flags. According to CBO's recent estimates for the alternative fiscal scenario, they have U.S. debt

going to 89 percent of GDP in 10 years, and 139 percent of GDP in 20 years. For some reason, the CBO no longer publishes debt-to-GDP ratios greater than 250 percent, so I did some of my own calculations and put a chart in, which is rather dramatic, I think, in my testimony. It really shows an explosion of the debt-to-GDP ratio. It looks much worse than the flag in your chart.

Now, the Greek situation by comparison is volatile. It is changing rapidly as we speak. Just at the end of last year, the IMF estimated the Greek debt-to-GDP ratio would be 105 percent in 2022. In June, they estimated it was up to 142 percent. The most recent estimate, a few weeks ago, is 170 percent. So their estimates are skyrocketing.

I think the reason is that, again, both the deteriorating situation economically in Greece and the failure to implement reforms.

Now, it seems to me the lessons here are very clear. I just have a few seconds left. For the United States and for Greece, they are similar.

The situation in Greece is not that growth is too low. It is that it is negative. The situation in Greece is not to avoid a crisis. It is to get out of a crisis.

But nonetheless, it seems to me that the policies are similar, and that is to get back to pro-growth policies in Greece, get those indices up however you measure. I think it will improve growth. Ultimately, that is what they have to do.

The situation on the debt, there is, obviously, more debt forgiveness that has to come, based on these IMF numbers. We are not in that situation yet, but, I would say, if we do not control the growth of spending in the United States, our debt is going to explode, as I have shown in that chart. And we will definitely be in a very difficult situation.

I think a way to start with that is with the fiscal year 2016 budget resolution. It lays out a path for spending. It has to be implemented, but that path seems to me to be sensible. It would increase economic growth I think not only in the long run, as CBO estimates, but also in the short run as well.

But that is only 10 years. Beyond that, more has to be done. Maybe we need some kind of agreement that spending cannot grow any faster than GDP. Certainly, we need that for health care expenditures. But something like that is needed.

But more generally, I think policies that reverse the situation where we have been recently on the fiscal side, on the regulatory side, on the tax side, would be the kind of things the United States needs to do to improve its well-being.

Thank you.

[The prepared statement of Dr. Taylor follows:]

PREPARED STATEMENT OF JOHN B. TAYLOR

Chairman Johnson and other members of the Foreign Relations Subcommittee on Europe and Regional Security Cooperation, thank you for inviting me to testify at this hearing on the "Financial Crisis in Greece—Implications and Lessons Learned." As requested I will consider lessons that the United States can learn from the Greek financial crisis, comparisons between U.S. and Greece debt, and implications of Greece's financial crisis in shaping future economic policy in the United States.

LESSONS THAT THE UNITED STATES CAN LEARN FROM THE GREEK FINANCIAL CRISIS

The Greek economy has been performing terribly by any measure. The economy has shrunk, with real GDP falling by an average of -5 percent per year for the past 5 years, and over the longer term economic growth has been very low. Since Greece joined the European Union in 1981 real GDP growth has averaged only 0.9 percent per year and productivity growth (on a total factor basis) has averaged only 0.1 percent per year.

Looking back in time, there are three key factors that have led to this situation, and all provide lessons for the United States:

First, Greece's economic policies—regulatory, rule of law, budget, tax—have been very poor, as has been documented by many observers. According to the Heritage Foundation's index of economic freedom, Greece ranks 130 among the countries of the world, the worst policy performance in Europe and on a par with many poor sub-Saharan African countries. According to the World Bank's Doing Business indicator, Greece ranks 61, which is well below Portugal, Italy, Spain, Ireland, Germany, and France; and on two important pro-growth measures in the World Bank's Doing Business indicator it ranks 155 on enforcing contracts and 116 on registering property. And, by yet another measure, the Fraser Institute's Index of Economic Freedom, Greece ranks 84 in the world.

These factors alone explain much of Greece's poor economic performance. For this reason in their latest report on Greece, the IMF (2015) concludes that "To achieve [productivity] growth that is similar to what has been achieved in other euro area countries, implementation of structural [supply side] reforms is therefore critical." No quantitative measure is perfect and there are exceptions, but there is a general association between these economic policy measures and economic performance.

Of course, U.S. economic policy scores higher according to these quantitative measures and one must be careful in drawing analogies and lessons. Nevertheless there is a problem: The United States has been declining in recent years on all of these measures of good economic policy. On the Fraser Index, the United States ranked 2 in the year 2000, and it ranks 14 today. On the Heritage Index it ranked 5 in 2008, and it ranks 12 today. On the World Bank's Doing Business Indicator it ranked 3 in 2008, and it ranks 7 today.

I have also noticed such a deviation from good economic policy in the United States in recent years and wrote about it in my book, "First Principles." I find a connection between our current economic problem of low economic growth and this deviation from sound policy principles. In the United States adherence to the principles of good economic policy has ebbed and flowed over the years, creating waves of bad economic times and good economic times.

A second problem for the Greek economy is that there is only one monetary policy—one policy interest rate—set for all countries in the eurozone, and that includes Greece since it adopted the euro. In particular the interest rate set by the European Central Bank (ECB) a decade ago was too low for Greece, and this encouraged excess borrowing and a housing boom, and eventually a bust and a huge debt overhang by 2010. The higher nominal wages and prices in Greece in the boom years also negatively affected Greece's competitiveness due to the single currency.

While the United States is not in a currency zone with other countries, there is a lesson for the United States here as well. During the period from 2003–2005 the Federal Reserve set interest rates too low and this was likely a cause of the excess risk-taking, borrowing, and the housing boom which ended in a bust and the financial crisis. In my view, this was also a deviation from good economic policy that led to poor economic performance.

A third problem for the Greek economy is a large unsustainable debt and the decision in 2010 the International Monetary Fund started making loans to Greece without first insisting on the Greek debt being sustainable. The IMF broke its own lending rule—that it should not loan to a country with an unsustainable debt—when it did so, with the United States voting to go along. This bailed out the private sector, and has left public institutions (the IMF and other European countries and their taxpayers) holding the bag.

The resulting acrimonious policy and debt negotiations have created political instability and confusion in Greece with deteriorating economic policy and continued low economic growth being the result. The debt problem has also caused difficulties for the Greek banks that hold some of the debt and thereby the Greek payment and credit system. The Greek Prime Minister's surprise pullout of the talks with the IMF, the Eurogroup and the ECB last month, his call for a referendum, and now the universal recognition that a third bailout is needed, are symptomatic of the political and economic instability. The lesson is clear for the United States as the

Congress considers increasing the U.S. quota contribution to the IMF: it is a mistake to break the rule about not lending to a country with an unsustainable debt.

COMPARISONS AND CAUSES OF THE INCREASE IN U.S. AND GREEK DEBT

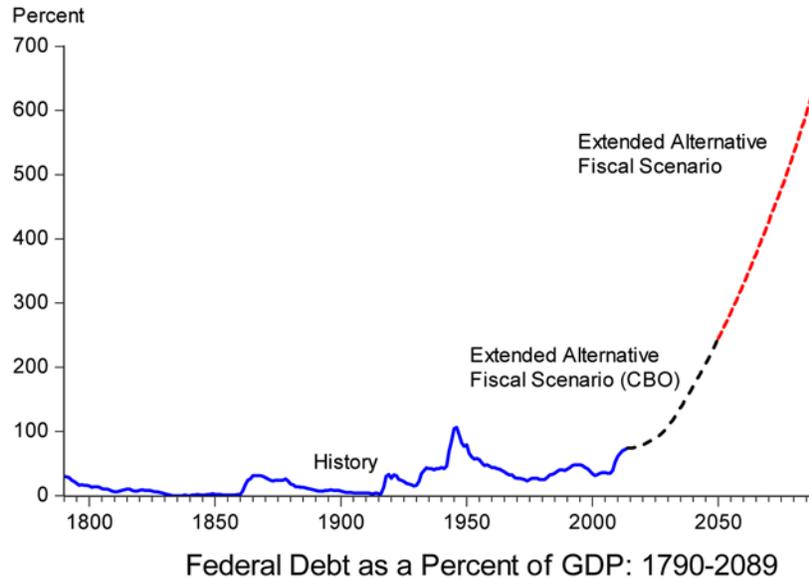
This summer the Congressional Budget Office (CBO) released its 2015 Long Term Budget Outlook for the United States through the year 2089. It shows that under its extended baseline assumption, the Federal debt will continue to rise as a share of GDP from 74 percent today to 80 percent in 10 years and to 100 percent in 20 years.

However, the alternative fiscal scenario is a more useful assumption than the baseline scenario. The alternative fiscal scenario, in contrast to the baseline scenario, assumes that certain likely policy changes will actually occur. For example, compared with the extended baseline it assumes that Medicare's payment rates for physicians stay at current levels rather than fall, that expiring tax provisions are extended, and that federal revenues after 2024 remain equal 18.1 percent of GDP rather than rising as a percentage of GDP.

Under the extended alternative baseline scenario, debt grows to 89 percent of GDP in 10 years and to 139 percent of GDP in 20 years. For some reason, the CBO no longer report debt levels higher than 250 percent of GDP, as it has in the past, though it does publish the primary deficit through 2089. Under the assumption that the interest rate remains at the levels reached for the last 10 years of the reported debt forecast, I estimated the debt to GDP ratio using the primary deficit for the entire length of the CBO outlook.

The results—both the CBO's extended alternative fiscal scenario up to a debt 250 percent of GDP and my calculations in later years—are shown in the following figure. The large spike in U.S. federal debt at the time of World War II looks quaint compared to the explosion of debt if policy is not changed. Clearly the future debt picture is not sustainable. A fiscal consolidation—a reduction in the primary deficit, the difference between revenues and noninterest spending—is needed if the debt explosion is to be avoided. That the debt is projected to grow relatively slowly as a share of GDP for the next 5 or 6 years has led to complacency, but the longer the fiscal consolidation is postponed the harder it will be to carry out without disruptions. Moreover, uncertainty about how the fiscal consolidation will take place—spending growth reductions, tax increases, additional debt ceiling debates, sequesters—is likely to be a drag on the economy.

The decrease in the debt to GDP ratio in the late 1990s, observable in the graph, was largely due to a decline in defense spending as a share of GDP coupled with strong economic growth. The increase in recent year is due to the weak economy—the recession of 2007–2009 and the slow recovery. The projected increase in future years is mainly due to the rapid growth of entitlement spending compared to GDP.



How does the Greek debt situation compare to that in the figure above? The political volatility over Greece in the eurozone and debates and delays over economic reform, create a volatile situation with estimates changing frequently.

At the end of 2014 the debt to GDP ratio in Greece was about 175 percent, and the IMF estimated that the debt to GDP ratio would decline to 105 percent of GDP by 2022. On June 26 of this year the IMF raised significantly its estimate of the debt to GDP to 142 percent for 2022 due to deteriorating growth and lack of reforms. Only a few weeks later on July 14 of this year, the IMF again raised the estimate by a large amount to 170 percent of GDP in 2022. And even with these increased estimates, the IMF says the projections remain subject to considerable risk of a worse outcome.

As the recent increased debt estimates illustrate, the source of the high debt to GDP ratio in Greece is largely due to the weak economy, which in turn is due to increased or expected increases in tax rates, unanticipated or sudden cutbacks in government spending, and the lack of pro-growth reforms. The IMF views the debt situation as unsustainable and is calling for substantial reduction in the Greek debt, which is now held mainly by governments.

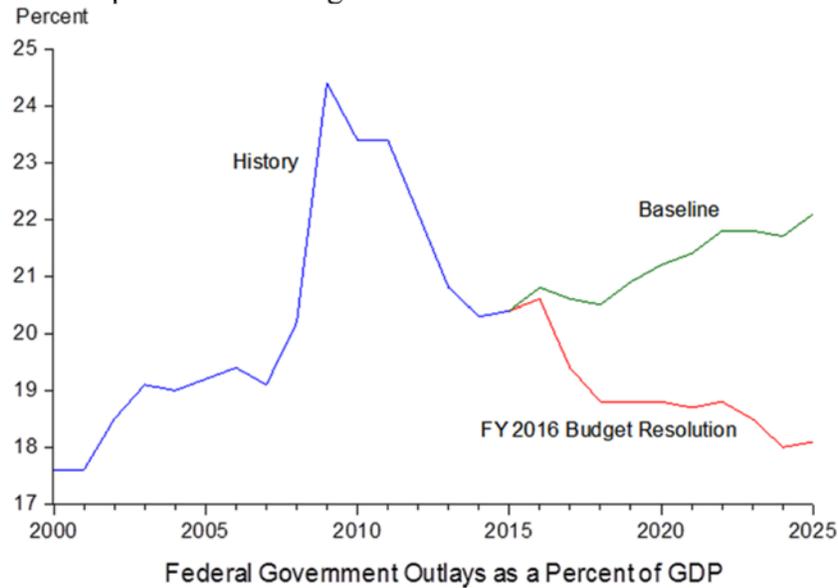
IMPLICATIONS OF GREECE'S FINANCIAL CRISIS FOR FUTURE U.S. ECONOMIC POLICY

The lessons summarized above have clear implication for economic policy.

Of course, there are implications for Greece: the best policy for Greece would be to change radically economic policy in a pro-growth direction, for example, by making it easier to start up businesses, ruling out tax rate increases, gradually reducing the size and number of government interventions in the economy. These would start to move Greece up in the economic policy indexes and, more importantly, increase economic growth and job creation, and reduce the debt to GDP ratio.

For the United States, the policy implications are similar, though their purpose is to accelerate the slow upward pace of the economy—say from a 2-percent growth rate to a 4-percent growth rate—and avoid an economic disaster, rather than to stop a precipitous downward drop in the economy and get out of an ongoing disaster, as in the case of Greece.

Economic reforms to control the growth of spending in a gradual and credible way would prevent a debt explosion in the United States. They would increase economic growth in the long run as well as in the short run as I testified at the House Budget Committee in June (see Taylor (2015)). Gradually reducing spending over the next 10 years as a share of GDP to the levels experienced around the year 2000—as indicated by the path in the FY 2016 Budget Resolution shown below—is one example of such a budget reform.



Beyond that, a credible legislative or even constitutional agreement to hold the growth of spending to the long-term potential growth of the economy would avoid the debt explosion and the damage that would cause.

In addition to a fiscal reform that would defuse the debt explosion, the policy implications point to:

- Monetary reform that leads to a more rules-based monetary strategy;
- Bankruptcy reform that ends bailouts of too-big-to-fail financial institutions;
- International finance reform to prevent loans to a country with unsustainable debt; and,
- Tax, regulatory, and trade reform that would substantially reverse the decline in various indexes of economic freedom and raise economic growth.

Thank you. I would be pleased to answer any questions that you may have.

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Senator JOHNSON. Thank you, Dr. Taylor.

Let me just clarify, so when you take a look at this, you are cautioning to be careful of this because it understates the problem? That is basically what you are saying, that even though we are almost doubled Greece's debt per capita, this is understating the problem because you are looking at the long-term fiscal projections?

Dr. TAYLOR. It is understating in that sense, absolutely. Also, currently, my debt-to-GDP numbers that I recited are different than this. That is because they are relative to GDP, not relative

to a person. And GDP per capita, of course, is much higher in the United States than in Greece.

Senator JOHNSON. So let me ask you, how are we getting away with this when we have almost doubled the debt per capita? Why are we not seeing riots in the streets?

Dr. TAYLOR. Partly, as I say, is because our GDP per capita is quite a bit higher. So I think in terms of measuring our ability to service and pay back the debt, measuring relative to GDP is more reasonable to do.

Senator JOHNSON. It is the more relevant figure.

Dr. TAYLOR. I think in addition, if you look at the details of the charts, there is kind of a relatively flat period that is projected for the next few years under the current assumptions. I think that leads to people feeling a little bit better about it. "Maybe we will address that problem later. Maybe if it is not you, it is your successors," people are thinking. I do not know.

But I think that is part of the problem why you are not seeing the harm. I would say, though, you do hear a lot of complaining about the economy. You do see problems in certain areas of our country. You do see income per capita stagnating, certainly, in certain places.

I do not think it is unrelated to the uncertainty about how this debt is going to be resolved.

Again, that explosion in my chart is as current law implies, so there has to be a change in the law. What is it going to be? People do not know. How are we going to get spending under control? Is there going to be a tax increase? Is there going to be a problem with respect to the debt limit? We do not know. I think that is an element of policy uncertainty that has to be a drag on the economy right now.

Senator JOHNSON. One of the things we did, we held a hearing in our Homeland Security Committee with CBO Director Hall, and we have converted to dollars their long-term fiscal scenarios and the alternate fiscal scenario. That shows over the next 30 years—which I think is really our problem, the demographic bubble, the baby boom generation, all of the promises made and we cannot pay for them—a deficit projected over about \$103 trillion. Talk about unsustainable.

Talk to me a little about what is being measured in those indicators, either one of you, the indicators that Dr. Taylor was talking about. I understand Greece is very high in the Heritage Foundation, but talk about what that actually measures.

Dr. TAYLOR. The various indices, they measure the rule of law, how independent the judiciary is. They measure how long it takes to start up a business. They measure the degree of regulation and its interference with the economy.

They do this in various ways. Sometimes it is judgmental.

They measure openness to trade. That is a common one that is less judgmental. But even there, how do you measure openness to trade?

The reason why I mentioned several is because they all tend to say the same thing. To be sure, you have to be very careful on using indices like that.

You mentioned my being at the Treasury. At that time, we tried to use indices like this to help decide what our foreign aid should look like to the very poor countries. There is, I think, a quite strong correlation between these indices and the growth of the economies. It does not mean it is causation, but I believe a lot of it is.

Senator JOHNSON. Would you say, in general, if you had to kind of typify a term, it measures economic freedom, the ability of a free-market system to operate effectively without being hampered by governmental interference?

Dr. TAYLOR. Yes, I like the word economic freedom. In fact, it is used in some of the indices. The World Bank uses "Doing Business." It is the same kind of concept, how free are people to start a business, how difficult is it, how difficult is it to operate in the marketplace?

But I think the concept of economic freedom is the way I have talked about it to my students and try to explain it, because it is a freedom there, which to me, if I might say a few words, to me economic freedom requires a strong rule of law, it requires a predictable government policy, it requires orientation to a market system, it requires a focus on incentives, and a limited role for government in the sense of government's role is based on what government should do, not what the private sector can do. It is basically a cost-benefit approach to government policy.

Senator JOHNSON. You could argue government should provide that stability of a legal framework for businesses to have some certainty in terms of making investment and understanding what is going to happen to them.

Dr. Kahn, based on those types of measurements, can you compare and contrast what went wrong in Greece and the differences between Greece and America right now?

Dr. KAHN. I think there are very dramatic differences in the fundamental freedoms, which I do not call freedoms. I call operating conditions. That speaks to corruption and rule of law. It also just simply speaks to government involvement that is pervasive in the economy.

It also helps to explain your chart, in the sense of saying why is it that some countries have such a lesser capacity to carry debt, because a country that has a rigid economy, that has extensive government-induced distortions in it, is not flexible to adapt to shocks and to produce a capacity to repay.

I think what we have seen in many countries that have had deep crises—Argentina, one that John worked on a number of years ago; Greece now—the actual levels of debt measured this way are not that high when you enter the crisis. What it really is is an economy that is not able to adjust, not able to operate anywhere near full employment where people cannot recognize their potential. So it is not able to generate the resources for the government, or at least that the government can capture, in a way that allows it to credibly service its debt.

I think we are very much seeing this at play in Greece. We can compare it very much to the United States. We can also compare it, by the way, to other countries in the periphery. I think what we have seen in Spain and Portugal, and particularly in Ireland, are countries that have, since the crisis hit, and by some measures

were in equally bad shape, have done a much better job of becoming more competitive, developing new industries, opening those up for private sector involvement in ways that have made them much more attractive to markets now and much more resilient.

So I do think it speaks to that issue.

Senator JOHNSON. We all hear the anecdotes of Greek citizens being able to retire at a pretty early age and the general level of the welfare state. Can you make some kind of comparison to America or those other countries that have snapped back from their financial crises?

Dr. KAHN. Among the industrial world, I think Greece does stand out for an extraordinarily large pension deficit. It was 16 percent of GDP last year, in terms of the deficit of the pension system. That required, I think, over 10 percent direct transfer from the government. These are large numbers, and after 4 years of adjustment.

I think to be fair, it is not so much the levels of pensions that are extraordinarily high. What it is, you touched on, it is early retirement and exemptions and special deals that have been cut over time as part of the political process in a way that has political and economic implications. One is that it creates a huge and unfinanceable deficit, but it also creates a political problem because if I am a Latvian middle-class worker and I am working very hard and working to 65 or now 67, and I am being asked to finance the pension of somebody who may be able to retire in their mid-40s, it seems inequitable and it, certainly, undermines the politics.

Certainly, getting at the early retirement system is going to be core for any sustainable solution in Greece.

Senator JOHNSON. Thank you.

Senator Shaheen.

Senator SHAHEEN. Well, as you point out, that speaks to the challenges in terms of trying to negotiate the recent bailout agreement. So what are the prospects that this latest round could be successful?

I have been impressed, so far, by the ability of the prime minister to actually get the reforms that he negotiated passed through Parliament when a lot of people thought that was not possible. But is that enough to set them on a course to growth again? Clearly, until they can figure out how they can begin to deal with economic growth, it is going to be hard to maintain a political situation that is viable and also to be willing to do some of the things that they need to do.

Dr. KAHN. I think we are in the first inning of a very difficult process. I agree with you that Prime Minister Tsipras, while I was deeply critical of the policies of the government in terms of the confrontation they created with creditors and the way they managed it up to the referendum, since that time, he has been extraordinarily capable in terms of getting through the initial stages of the agreement and the passage of two rounds of bills, some very tough measures that not only Greece has not done in the past, but he had been deeply resistant to. They enabled a bridge loan of over €7 billion so they could pay off some of their debt, but also, more importantly, started this process of negotiating with Europe.

There are huge differences, though, on this negotiation of this European program, or ESM program. Part of it is that the Europeans and the IMF believe there is going to have to be a lot more adjustment to come to deal with this decline in activity and the wider deficit. The Greeks are basically taking the view now that we have done what we are going to do, give us the money. That is a very difficult bridge to cross.

They have a large payment due in August. They need to get this ESM agreement done by then, so they can get another bridge loan to pay that. That will produce a first drawing from the Europeans. They will then have to do more measures and complete a review, maybe in October or November. That will then allow a discussion of debt relief.

And Prime Minister Tsipras has made it very clear that without debt relief, the political support for this collapses. So he is pressing to get that accelerated. But I do not think that happens until October or November.

And the IMF has then said we are not willing to go ahead unless there is adequate debt relief. We can decide whether that is a credible threat, but that creates a very difficult sequencing problem, which may be incompatible with the domestic politics, which I think are very much fraying even as we speak.

If there is an election called, a snap election called right in the middle of all this, it is very hard for me to predict.

But there is so much to get done and the sequencing has to get done just right. I think the odds, quite honestly, are quite long.

Senator SHAHEEN. Since we are talking about the IMF, you pointed out that you think we need to pass IMF quota reform, which I certainly agree with. But maybe you could talk a little bit about why you think that would be helpful in this situation. I think it would be helpful in Ukraine, as we are looking at how we can do more to help Ukraine,

But if you would, talk a little more about that.

And then, Dr. Taylor, you might want to weigh in as well.

Dr. KAHN. I will. I also will maybe come back and give a shoutout to a proposal John has on this score, which I think is very constructive.

As I noted, I think we are now in this environment where we are facing these very difficult, large programs, which inherently have a political element, inherently involve geopolitical interests. Nothing illustrates that more than the Ukraine program of 2014 and 2015, where the Fund clearly bent their rules to lend outside their normal limits.

As John said, they have these sort of archaic lending limits based on what they call quotas, how much you put into the Fund. They are out of date. They have expanded. They have adjusted. They have been very flexible in some ways, a number of ways, both creating the so-called exceptional access and then the systemic exemption, which was sort of putting the rules aside and saying we can put them aside to some extent, if there are these broad systemic consequences.

In 2010, I do not know any major policymaker in place then who wanted a very strict interpretation of the rules for Greece because it was very hard to say that debt was sustainable. It was not a zero

or one. It was not unsustainable or fully sustainable. But it was clearly a risky program. And the idea that you could say a high probability, it was not true.

So they came up with this idea, saying that when there are these broad systemic consequences, we are going to be able to be more flexible. I think Ukraine was another example where, if you looked at the numbers, the Fund should not have been lending. But they were at war and there was a broad imperative to help this country deal with that and to implement a program which on its face looked extremely promising and deserved a chance.

These are the kinds of choices we are increasingly going to face.

Now I do think that on the one hand we need to be able to build a fund that has the right-size quotas and has the flexibility to lend on sensible criteria. But on the other hand, it cannot be unconstrained discretion. There has to be some rules that constrain the use of that. It really has to be in these extraordinary cases and it has to be by a process that is disciplined.

But I still think that the IMF reform is critical here, not just in terms of getting the numbers right, but because it is a signal to China, to Brazil, to these other countries that we want them to be participants in the global infrastructure or architecture.

Do not go your own way with AIIB. Come here and negotiate with us. Let us build a framework that makes sense.

So I think it is very important from that perspective as well.

Senator SHAHEEN. Thank you.

Dr. Taylor, you have a reform proposal that has merit?

Dr. TAYLOR. I have an idea. It is related to the IMF's policies, though.

So around 2002, 2003, the IMF instituted something called exceptional access framework. It was basically a way to limit lending to cases where they should not have been lending. It actually came out of the financial crisis of the 1990s where they were all over the place. So it was reform. I think it was a sensible reform.

It basically said do not lend to a country with unsustainable debt. There are some nuances, but do not lend to a country with unsustainable debt.

It worked pretty well, until 2010. Then Greece came.

Greece, by any measure, as Rob indicated, did not have a sustainable debt. The IMF had the framework. What did they do? They changed the framework. They added an exception for this case. I think it is a real problem.

In fact, it is such an illustration of the problem, because once that decision was made for the public sector to be lending to Greece, it enabled the private sector to get out. So now all that debt, which was originally almost all private sector, is now almost all public sector.

It is a classic bailout of the private sector. It is visible for everybody to see.

And what has it done? It has led to these very acrimonious government-to-government discussions, where the debt of Greece is held by governments. That is what we are hearing. That is why it is so difficult politically, so unstable.

So I think it would be very good if the IMF went back to the policy it had before. I think if it became part of a quota voting bill,

it might make it more visible to people. That is an important thing for the United States. It would show some U.S. leadership, I believe, if we did that, because it is a problem.

You asked about Greece. Very briefly, I think it is unfortunately a kicking the can down the road situation. The IMF is now saying they need much more debt relief than seems to be in the cards. And I think they are right. They are looking at it as best they can.

So right now, it seems to me like it will be another discussion later, which will not be so comfortable, perhaps with a different government.

Just one last thing, the changes in Greece in this agreement I think are very small, in terms of really making a difference. They really have to do really pro-growth reforms. There is some of that, but not enough.

Senator SHAHEEN. Thank you. My time is up.

Senator JOHNSON. Thank you, Senator.

Let us talk about the Grexit. The transfer of this debt from the private to the public, even back then, was a haircut. The private sector did suffer pain, correct? Something like a 50-percent write-down?

Dr. KAHN. And a little bit more in present value terms, but yes, it was substantial, about 70 percent, by some measures.

Senator JOHNSON. I just want to understand, why did Europe do it? What would have been so terrible about letting Greece exit? And what would be so terrible about letting Greece exit now? Together with potential political contagion aspect, could you also discuss this from the standpoint of Spain or Portugal or another country in a similar situation, where they will just demand concessions and more debt, more loans from Europe?

I know it is kind of a broad range, but can both of you handle that?

Dr. Taylor.

Dr. TAYLOR. So if by exit, you mean exit the eurozone?

Senator JOHNSON. Yes.

Dr. TAYLOR. I think that would be very difficult. It is the euro. We can debate about whether they should have gone in or not, but getting out is a big deal. It is a new currency, how that is going to be implemented. Right now, a lot of the debt, the remaining private-sector debt, is held by the Greek banks.

So it is a big deal to get out. Maybe that is where it is going.

Senator JOHNSON. Can you describe what happens, why it is such a big deal?

Dr. TAYLOR. You have to introduce a new currency. You would have to decide what the exchange rate should be from the euro to the new currency. It would be a lot of debates, and that is hard to do.

In the reverse direction, Germany did that with East Germany.

I have some experience with this in putting a new currency into Iraq, actually. When I was at the Treasury, it was one of our jobs to replace the old Saddam dinar with a new dinar. It is a big deal.

So there are a lot of things that can go wrong.

I would say, if it could be avoided, it is probably best to avoid it. And to me, that is not the only problem, I would say. To me, and I mentioned that, the problems are really with these economic

policies that Greece has. I mean, they could be doing very well if they had better policies. That is where I would put my focus.

The JOHNSON. Dr. Kahn.

Dr. KAHN. I suppose I would come at it a little bit differently, in the following sense. Yes, there are a set of policies that if they were as strong as John would like would put Greece on a course back to growth within the eurozone, but they are very strong.

I have, as I have suggested, some doubts whether the political economy of Greece can sustain those.

If they cannot, for whatever reason, be put in place, then the only way you are going to deal with 25 percent unemployment, 50 percent youth unemployment—this is devastating socially within Greece, and should not be a long-term solution—would be to exit, because then you have your own monetary policy. You have your own fiscal policy. Any you have a currency that will adjust probably quite a bit to the point that new export industries expand. We have seen this in places like—

Senator JOHNSON. And tourists would start flocking to Greece.

Dr. KAHN. Tourists would come back in.

Senator JOHNSON. So is it really a good deal?

Dr. KAHN. It would take a big move and would take a degree of political stability, but they would come back in. New industries would spring up, intermediate goods production or transshipping, some agriculture probably. There would be new industries, as well as compression of the imports that go on now.

So I actually think that the case for Grexit is actually perhaps stronger from a geopolitical perspective than not.

Now, it is almost always painful to do it, and incredibly disruptive. In East Germany, West Germany, it was an artificial experiment. It was negotiated and planned. Most of the time this happens out of failure and out of the chaos of failure. So you see IOUs often get issued by a government as they are at the precipice and deciding what to do, a breakdown of the payment system.

So when that exit decision occurs, you can have a bank holiday, you can do an initial redenomination. But finding the right prices and deciding what stays in euros and what goes to drachmas is really only a first step of a comprehensive restructuring and work-out process.

Now, you asked the question to start, why is it so hard? I think this is part of the reason. It is very scary, even if in the long run it is good. Part of it clearly is political.

Europe has moved quite well ahead in terms of political integration. But the economic integration has lagged. In particular, the ability to do fiscal transfers of the sort we take for granted that allow that if there is a shock in Texas while California is booming, that money through the Federal system can move, and that is a huge buffer to economic activity.

They do not have that. They have been resistant to doing it. The Germans, in particular, have been resistant to what they would see as enabling moral hazard, of encouraging bad behavior. And the lack of trust between these countries is contributing to that feeling.

So I do think that in some sense this unwillingness to acknowledge either that a country can leave or that we have to deal with the debt and these kinds of issues in context in a sense is con-

straining smart thinking on this issue and limiting them to sort of what the rules allow.

There has been value to having those rules, but I think now we are in a place where they may be counterproductive.

Senator JOHNSON. But again, I think you would acknowledge that probability of this working out, of this being the last bailout and the getting their policies right, is quite small, correct? So the next step will be another bailout for the future. And they will never address the root cause of the problem, which is these awful economic indicators, lack of economic freedom, and, as a result, high unemployment, awful business creation, that type of thing. So game it out.

Dr. TAYLOR. I think the change in the currency, obviously, would have some of the effects you mentioned. It would not last forever, obviously. I gave you a statistic of 30 years of low growth in Greece. It would be a temporary thing, and welcome.

It may take pressure off the other actions. In Argentina's crisis in 2001, they devalued. They had effectively a peg and got off it. It was little bit of a boom but it was really quite destructive in terms of contracts that were supposed to be owed in one currency versus another. I think it probably made the situation worse for a while.

Senator JOHNSON. Senator Shaheen.

Senator SHAHEEN. So I totally agree that it would be very disruptive. I was with some Senators in 2012, meeting with Greece, then the Greek Prime Minister and other Ministers, talking about their efforts to address their challenges at that time. One of the things that really stood out to me was we met with a group of business people who were the Greek heads of American companies in Greece. We went around the table and asked all of them individually to say what they thought was the best outcome. Was it staying in the eurozone or was it leaving? To a person, they all said that they have to stay, that this was their future.

But looking at where we are now, and given the fact that all the countries in the EU are not in the eurozone, is there the potential to have a managed exit from the eurozone for Greece in a way that would help minimize some of that disruption? Because we are looking now at going into 7 years of a financial crisis that has really gotten harder and harder for the Greek people to manage. So is there the possibility for some other action to be taken that could help stabilize this situation and yet give them some relief in some way?

Dr. KAHN. Theoretically, I think a managed exit is certainly possible, but I see it as very difficult, given the way Europe is now operating. Interestingly, German Finance Minister Schauble in the late hours of that all-night meeting that produced the agreement, the run up to it, raised this idea of a plan B of a temporary timeout in the eurozone. And it had an element of what you are touching on, the sort of idea that you go into a holding area. You would receive humanitarian assistance. Potentially, it might be easier to negotiate debt relief. It would be less arduous, in terms of policies. It would be this kind of a standstill, in some sense, from a legal perspective.

I actually think the idea speaks to what you are talking about. I actually thought there may be some merit to it.

Now, unfortunately, or fortunately, that proposal was put on the table in a way that was perceived by everybody inside and outside the room as rather a threat to Greece. We have a plan B. You can go into the penalty box, if you are not willing to accept our terms.

So it became very much part of the politics of that and in a sense has been ruled out. I think it would be very hard to get back to something like that, given, particularly in the Greek debate, it has become so very poisonous.

The one other footnote I would just add on your point, if you do a survey, as you said, I think to this day you would still find very strong support in Greece for staying in the eurozone. In that sense, I feel the Prime Minister Tsipras has done a disservice. When he came to power, he said I am going to get you debt relief. I am going to end austerity, get you lots more money, all within the eurozone. That was never a combination that was on offer.

So ending austerity, people have never faced that tension between doing the policy as John wants and the tough element of that with staying in the eurozone, that that is the price of staying in. I think that has never really been confronted.

So I worry that those polls are fragile.

One case I might note, and I think it was as late as December 2001 in Argentina, there were polls showing very strong support for the currency board, even though it had been very austere and there was a lot of criticism from it. What happened was the government was forced to put banking controls on and then support evaporated very quickly.

I think if it is the breach of promise that has been made that has happened and probably will continue to happen I think could destabilize that consensus or at least challenge it. Okay, you cannot have both, now you really have to decide. And that could change very quickly.

I agree with you, at this point, it is a force keeping things going in the right direction.

Senator SHAHEEN. The other question is, you both talked about the economic situation and consequences of where we are. But as you point out, there are also political consequences.

It seems to me that the eurozone, as you pointed out, has to make a decision about how they are going to deal with southern Europe and some of the economic challenges that they are facing in a way that provides more unanimity across the EU for how they are moving forward. And there are some other potential threats, I think, to failure to act, one of which is Russia.

There are frequent reports about Russia's efforts, not just in Eastern Europe, but also a suggestion that in Greece, it is a place where they have looked to try and destabilize the situation and move the Greeks away from the West and more toward Russia. Prime Minister Tsipras met with Putin, and I assume was offered some assistance.

So can either of you talk to some of those challenges and why this is critical to us here in the United States that they work out the challenges around Greece?

Dr. TAYLOR. So I think it is a longer term issue. It is hard to make the judgments but even creating the euro in the first place, the arguments were, we will avoid war, even to that extent. And what I think the problem was, yes, that is a good political argument, but economists at the same time, in the same meetings, would say yes but this is going to cause some economic problems. You are going to have only one interest rate for all these countries. You are not going to be able to let the exchange rate adjust, if wages move more quickly in one country than another.

One of the things that should have been said is that in this situation you have to really watch your debt. In fact, they did put the so-called Maastricht rules in place, but they broke them. That is where the debt started to rise.

But I think, in many respects, it reminds me of the debt backdrop to this meeting. If they had actually adhered to those Maastricht Treaty rules, we would have avoided an awful lot of this.

So sometimes the economic things that go along with these political sides get discarded. I think that is to some extent what you are seeing now. There is a disconnect between those who say they want to keep Greece and the euro with that exchange rate and the things that have to go along with that, the economic policies that go along with it, the fact that the Greek banks are holding Greek debt. All those things are just not part of the discussion. So it is a little wishful thinking.

In the Argentine polls wanted to keep their fixed exchange rate at the time, pegged or currency peg, and they did not vote against it. They just lost it. It was like an instantaneous thing because there was no choice. They had to get out of it.

Dr. KAHN. I think that there are two important elements to your question. One is a Europe that is not cohesive that is at odds with each other. We worry about a French-German alliance now. We worry about the ability to obey the rules, to make sensible rules. A Europe that is divided and frozen is going to be a difficult partner for us on a whole range of global and international issues.

I think Russia is perhaps one of the most important ones, as you pointed out. The effort with Greece was an effort to divide. When Cyprus had their crisis, we had a similar dynamic.

I am skeptical whether much money is ever going to come to these countries, but the point is that the United States does value very importantly a Europe that can also lead and can act responsibly on a range of issues. Trade, global trade and dealing with China, is another one where I think that partnership is very important.

So I think there is that broad issue that we want a united Europe that can grow and be prosperous and to be successful.

There are also country-specific elements that are pretty interesting. Now a lot of the tension has been elsewhere in the periphery. So, for example, Spain was actually quite tough on the Greeks in the negotiations, partly because they have an opposition party, not unlike SYRIZA, called Podemos, that until recently was rising very sharply in the polls. I think there was a great deal of concern by the Spanish leadership that if Greece got too easy of a deal that, indeed, it would empower those in their country to say we do not

have to do all this hard stuff. I think that was very much an important dynamic.

If Greece has a crisis, if they do exit, it will be very interesting and important to watch what that does. Does it feed the opposition or is there a sense, as we saw in Brazil I think in 2003, 2004, after the Argentina crisis, "I do not want that what they are having." I am hopeful that is the case.

The other one is Brexit, what happens in the United Kingdom where there is a very active debate, not on the eurozone entry. That is not on the table. But if in fact they want to stay in the EU.

Some commenters, I think it is interesting, have suggested that the Greek exit could be very difficult for the government. If you had an exit, you would have to have a treaty change to basically allow for exit, because right now the rules say you cannot. So the Germans and the French would want a very clean, quick treaty change to accommodate the reality.

But if I were an opponent of the British participation in the EU, this would be a Pandora's box I would want to open. So it will have a very uncertain debate on the internal British debate where people have been saying can we trust the EU? Is it a reliable partner? Do we want to be part of this coalition? Of course, that feeds into, as you mentioned, a whole other set of countries that are in the EU, value it importantly, particularly in Eastern Europe, but have no interest right now and being in the eurozone.

So I think it is a complex environment right now.

Senator SHAHEEN. Thank you. My time is up, but let me just be clear.

I agree with you. I think an EU that is unified, that is at peace, that is economically strong, is very important for the United States. They are our best ally and I want to do everything I can to support them. So I did not want to mischaracterize the issues that I was raising there. Thank you.

Senator JOHNSON. So you touched a little bit on the moral hazard aspects. I guess you are saying it could go either way. As you rightly said, I think the concern is it is going to go the one way where people have said that it worked pretty well for them, where there is no sense of moving toward economic freedom or cutting back on pensions. We will just demand a bailout. I think that is more likely.

Dr. Taylor, what is your assessment of that?

Dr. TAYLOR. Of the moral hazard for further debt reduction?

Senator JOHNSON. Yes, and how that will affect other governments.

Dr. TAYLOR. Yes, there is kind of a political contagion that, certainly, you have to worry about that is there. I mean, a lot of people did not expect a left-wing government to come into Greece, and it is there. And I think it has stabilized to some extent with the other countries, but it is still a risk.

I think that the difference here though with the usual kind of moral hazard with respect to debt is that debt is held by the public sector. We usually think if it is a bailout, then it is going to take away the incentives people have to be careful about who you are lending to or take away the incentives for a government to watch

its budget. It is now another government that is holding it. So it changes the dynamic completely.

It is worrisome to me politically because it creates an enormous amount of intergovernmental tension. And personalities can become a big part of it, as we have seen in this case. So it is not so much a moral hazard now. Maybe it is just a plain old government hazard that has been caused.

Senator JOHNSON. Let us to consider lessons learned first by going back to the history of Greece. They entered the eurozone on January 1, 2001. I think there are reports that they were not exactly forthright on precisely what their financial situation was. But they were not anywhere near in this deep of trouble in 2001, correct?

Dr. KHAN. Correct.

Senator JOHNSON. The first bailout was in 2010, so it took 10 years. Again, this is 15 years in the making here.

Is anybody willing to go through the history from 2001, and quickly walk us through exactly what happened? Again, the whole purpose of that is then to relate to what we are looking at. I mentioned a 30-year window, the definition of our problem with the baby boom demographic bubble.

Unfortunately, I have white hair. Thirty years goes by pretty fast.

So who is best to walk us through the history of the Greek crisis?

Dr. KAHN. I can start. I am sure John will correct me in a couple places.

So as you point out, with the start of the euro in 2001, Greek entry was initially fudged. There was flexibility that had to already be applied to basically say they met the criteria, but it was subsequently learned that they had misrepresented their fiscal data in order to get in.

Senator JOHNSON. But their debt was not at—

Dr. KAHN. Their debt was at quite more moderate levels. So it was seen as sustainable.

Now the interesting point to emphasize here is that, from 2001 to about 2007, there is a great deal of market enthusiasm about the eurozone, the sort of belief that everyone is in is never going to have any trouble. They are all going to change their policies and become Germany. There was going to this great pull to the higher level associated with being in.

I have some charts in my presentation. Markets provided a great deal of finance at very low rates. Also, I think, globally, there was a sort of reach for yield, if you will, that I think exacerbated it.

So in some sense, Greece could sustain weak policies, weaker than the rest of the eurozone, and there was little pressure, even though there were these rules, little pressure on them, because they had effective market access. Of course, that all changes in the runup to the global financial crisis.

So then you had this period of time where they basically were trying to delay an inevitable need for a program. That crisis really hits in 2009. But people had seen it coming, really, I think, for some time before that.

Senator JOHNSON. They are in such deep trouble. The deep recession of 2009, that was basically the catalyst for the ongoing crisis.

Dr. TAYLOR. I think they had in the interim some other problems. I mentioned the interest rates set by this time by the European Central Bank, which may not been too low for Germany but most indices are they were too low, at least for Greece, actually Greece, Ireland, and Portugal, when you look at the data. So the too low interest rate, too low for too long business, is a problem. It does cause search for yield. It does create excess borrowing. And it was quite a housing boom increase. So all that comes to an end with a thud.

So I think during this period, you saw some imbalances, which in terms of your questions about lessons for the United States, I think that is a lesson. That was not the greatest monetary policy, at least for Greece at the time. And it is part of the overall policy picture. It was one of the reasons why they have this debt problem today.

Senator JOHNSON. Talk a little bit more about what I would consider the possibility or almost certainty of the misallocation of capital when you have unrealistically low interest rates, how you do chase yield, how you end up putting money into high-risk assets, creating the types of bubbles that we saw burst in the housing crisis. Can you speak a little bit more to that, because we are still there, correct?

Dr. TAYLOR. Yes. There is definitely a risk. You never know where these imbalances will show up. A lot of people did not predict it was going to be such a problem with respect to housing. And now we look in retrospect and we see it not only in the United States but some other countries.

But what happens is if you are a manager of an investment portfolio and you are getting these very low yields, you are going to look for something else. Or if you are an elderly person trying to survive on a fixed income, these very low interest rates are going to lead you to take some risks with a higher interest rate. So it is very common.

I think in housing, it is particularly an issue. We have these adjustable-rate mortgages. So the very low interest rates that were set at that time made it very easy for people to borrow.

So that is the kind of thing that happens. It is also a sense the market is not allocating capital as much because the central bank is actually keeping the interest rate and a floor. Those cause additional distortions, some of which we do not know about. Some people blame the liquidity problems on that. I do not think it is so obvious.

But a lot of these distortions take place because of this very unusual type of policy that is taking place.

Senator JOHNSON. The mandatory spending programs, the pensions in Europe, we call them entitlements here, Dr. Kahn, you said that was 16 percent of Greece's GDP. I know in the CBO's alternate fiscal scenarios, the average over 30 years is going to be about 14 percent of Social Security and our health care entitlements.

So we are not there yet. I think currently we are around 8 percent. Do not quote me on that, but I think that is it, off of the top my head. So those burdens are going to be Greece-like in not too many years.

So again I just want to walk that forward. With Greece, have they always been at 16 percent, since 2001? Did that increase dramatically over that time period?

Dr. KAHN. I think it has increased a little bit recently. There were actually some cuts at an earlier moment. But I think it is a dynamic that is somewhat similar to the one we have struggled with, although on steroids, which is the fiscal consolidation of the last 5 years.

And we should emphasize that there has been an extraordinary fiscal consolidation in Greece. They have not done all the structural things we think are so critical for growth, but they have been willing to cut the deficit. I think the primary deficit was 10 percent of GDP when the crisis hit and it was in primary surplus last year. So probably 13 percent, 14 percent of measures over that period.

But what that means is discretionary spending and investment, in particular, has been cut to the bone. And there is no discretion for what we think are some high-priority investment projects because you cannot touch, for the most part, the entitlements.

So in some sense, the desire of the IMF, in particular, to reform the entitlements is not just about putting overall fiscal policy on the right track, but also creating space for high-priority needs.

Senator JOHNSON. I always relate national debt loads to family debt, where if you are in debt over your head, how are you going to grow your personal economy? Any income above what is needed for just the basics is going to service the debt. Is that a reasonable analogy?

Dr. Taylor.

Dr. TAYLOR. I think it is reasonable. To service the debt, you have to have a certain amount of income. And in the United States, to service our debt, it has to be tax-generated or the debt is just going to grow and grow. It comes, ultimately, from taxes. So I think that is the problem with unsustainability.

If you look at the CBO's numbers, they have rising primary deficits, excluding interest payments. If that occurs, this debt is going to explode.

I think to me the numbers that are most striking are the entitlement spending numbers as a share of GDP. They just take off. That cannot be sustainable. That is really the problem.

Discretionary spending, if anything, is flat in their projections as a share of GDP, maybe even defense is coming down.

Senator JOHNSON. They actually decline.

Dr. TAYLOR. So the problem is clearly entitlements, and I think there is a reasonable chance to get a handle on that. To me, keep the growth of entitlements roughly equal to GDP. For certain things like Social Security, that is not as hard as it looks. For health, it is harder.

But I think if there could be a bipartisan agreement that we better keep the growth of entitlements roughly in line with GDP, and then we will not debate about how to do it, should it be premium support, should it be other kinds of methods, I think we could tackle the problem.

But it is a very serious problem, this entitlement growth, whatever the word you want to use in the United States.

Senator JOHNSON. Senator Shaheen.

Senator SHAHEEN. I want to go back to Greece and to whether there are lessons for the European Union in what has happened there.

To avoid another Greece, should the European Union embrace a different approach to its fiscal and monetary policy? I mean, is that ultimately what they should be thinking about?

Dr. KAHN. I believe they should. They should accelerate the economic integration in the eurozone. That would mean fiscal union, in particular, so that there is some greater automaticity at the federal level, in the case of shocks. And it can be done in a less politically disruptive way.

I think accelerating banking unification, some steps have been made but more could be done so that you really had a true backstop for the banks in a way that meant that you do not have a run on Greek banks, even if the Greek Government has some problems.

I have to be honest, the German Government would draw exactly the opposite conclusion. They would make the judgment that this shows bad behavior and cannot be rewarded, that the moral hazard concerns are significant, and greater integration is fine but that it would have to be on a very strict rules-based basis. And debt relief, which I also think it is critically important here, some sort of process for debt relief, would only come really at the end of the process and after all the other reforms are done. I just do not think that is politically very viable.

Senator SHAHEEN. Dr. Taylor.

Dr. TAYLOR. But in a way the European policy is itself a problem. I would use the word economic freedom. It is not as stressed as much. The unemployment problem is all over the place to me in Europe. We would never accept unemployment rates like they see for most of the area.

So to me, those are structural problems that have to be addressed. Some of it has to do with taxes. Some of it has to do with labor market reforms. I think if we could stress that more in our engagement with Europe, it would help a lot.

We talk about international discussions and talks, the G20, the G7, the G-whatever it is. I think if more of those were, "Here is what we are doing for our structure reforms. Here is what we are doing to raise our growth rate." The G20 tried to do that a couple years ago through the interventions of the Australians. I do not think we see enough of that. I do not hear enough about it. I know that the times I had an opportunity to do that, I tried to drive it in that direction.

But in a way, there is too much focus on these shorter term things, not that they are not important. But the real problem, if we want to be friendly to Europe, it seems to me we want to encourage them to be a good growth economy, not the mediocre growth economy they are.

Dr. KAHN. Just one point in maybe defense of the Treasury Department on this. I think if you look, for example, when the European crisis first breaks in 2009, 2010, we had really just started to come out of our crisis on the back of very aggressive policy action. We felt we knew something about how you should address these issues and we had an experience that was worth conveying. So I think if you look at the President's involvement in 2010 in the

first Greek program and the like, for better or worse, we had strong leverage in those discussions.

Honestly, it is natural that as time has gone on, our direct ability to leverage over these conversations is going to diminish. The G20 maybe is not as effective now as it was at the heat of the crisis. The Europeans have been through so many rounds, I think they feel they know what they are dealing with, and thank you very much for your lectures.

I was heartened to see the administration get involved in this last round, encouraging maybe a more constructive negotiation. But I think we also have to be honest. We have to think pretty carefully, how do we have leverage in this environment? It is trickier than it once was, and maybe it does relate back to the geopolitical issues you raised earlier.

Senator SHAHEEN. And we, certainly, took a different approach to the financial crisis than Europe did, because their approach was to go full speed ahead on austerity. Ours was to provide investment in a way to prime the pump of the economy. So, obviously, it produced very different results.

One of the things, Dr. Taylor, I would disagree with you on, when you said we would never accept such high unemployment rates, I would say we have inner cities and communities where we do have those high unemployment rates.

Dr. TAYLOR. We should not accept them either.

Senator SHAHEEN. We should not accept them there. Sadly, too often, we have accepted them. It is something that we should address.

Unfortunately, I have another hearing, but I want to thank you both very much for being here, and for shedding light on what is a very challenging problem, as we think about what is going to happen.

I, certainly, hope the EU and the eurozone and Greece will be successful in addressing this challenge. Thank you.

Senator JOHNSON. Thank you for attending. I appreciate it.

I just have a couple more questions. It really does relate to that high unemployment rate. But I want to look at a different statistic, the percentage of population in the work force, the labor participation rate. Both of these measurements right now in America, I do not have them right off of the top of my head, but they are at some pretty low levels compared to even 10 or 15 years ago.

Dr. Taylor, can you explain that?

Dr. TAYLOR. There has been a lot of research and debate amongst economists as usual on this.

I feel that a good fraction of the decline in the labor force participation rate is due to the weak recovery itself. It is basically jobs not growing much more rapidly than the population. In fact, the employment-to-population ratio has hardly budged since the bottom of the recession. It has just now increased slightly.

So yes, we are creating jobs but hardly enough to employ a growing population. So, I point to that. It is, certainly, more than demographic because the labor force participation rate of young people is down. I think it is an important issue to take up if you want to raise economic growth. If you want to raise economic growth, part of that is going to come by employing more of the labor force, to

get the labor force participation rate up close to where it was before this precipitous drop.

And I think that, to me, that should be a focus of policy. To me, if you want to have stronger growth, you need to have more jobs, you need to have more productivity, so each worker producing more, those two things. And both have to be addressed.

I think you are asking more about the jobs part, the drop in labor force participation, the employment-to-population ratio. I think in a way, that is an opportunity. We could get more jobs with a better performing economy.

But the other part is productivity.

Senator JOHNSON. Is the economy not a combination of labor and capital? So if you do not have as many people employed, you are going to have a smaller economy.

Talk a little bit about your valuation of a reduction of median household income and what is the explanation behind that? We are literally 5, 6 years into a recovery and median household income has actually declined.

Dr. TAYLOR. Well, I think it is the same story. The numbers are harder to measure, but if you are going to have a low growth, lower growth economy, say 2 percent, 2.2 percent, and that is going to measure the growth of your income in real terms, too. So that is going to mean growth of income is less. The population is growing, and the labor force is growing too, and the number of jobs is growing. It is just not growing fast enough.

In some sense, that is the productivity side of it, the income per worker, even per person, per capita. And productivity, maybe this is the best way to answer your question, productivity in the last 4 or 5 years is remarkably low for an expansion. It is like 0.5 percent, 0.6 percent per year.

So I think that is really the reason for these income numbers that we are concerned about. It is not clear when they started down or what, but I would not want to debate too much the beginning, the timing, the political part of it, because it is there and we need to address it.

Senator JOHNSON. I am not an economist. I am a business guy, so I have done a lot of strategic planning. I have done things like SWOT analysis, Strengths, Weaknesses, Opportunities, and Threats.

A very simple SWOT analysis, I just want your comments on this, I think America's primary strength, number one, is that we are the world's largest market, which means we are the world's biggest customer. Coming from a manufacturing background, I can tell you, manufacturers want to be close to customers. From my standpoint, that is an enormous competitive advantage on the global scene. So we are the world's biggest market.

We do have, because of innovation, fracking, hydraulic fracturing, horizontal drilling. We have an energy boom, so we have relatively cheap, abundant energy.

So if you are going to manufacture things, you need power. Cheap power is better than expensive power. From my standpoint, that is an advantage. And it directs your policy as well. Let us keep the energy prices low.

On the weakness side of the ledger, our regulatory environment is onerous. There are numerous studies pegging that at about \$2 trillion per year. I know it is disputed, but it gives you some sort of sense. I would add, there are only 90 economies in the world that are larger than \$2 trillion.

Our tax system is uncompetitive. We are going to be holding a hearing tomorrow in the Permanent Subcommittee on Investigations, laying out how uncompetitive our corporate tax rate is versus the rest of the world. You have to benchmark these things.

Our legal environment does not provide certainty. All of the rules, all of the precedents, as a business person, leaves you very uncertain.

To me, those are, in a nutshell, the strengths and weaknesses, which pretty well should direct government policy in terms of, not driving up the cost of power, trying to reduce the regulatory burden, making our tax system more competitive, and letting us bring some certainty to our legal and regulatory framework.

Do you have other strengths, other weaknesses? Can you just basically comment on that?

I will start with you.

Dr. TAYLOR. I agree. I could probably list a few more, like trade and openness.

But the question is getting it done. How do we move this agenda forward? I think that is what I worry about at this point. There is no question that that is the kind of thing that needs to be done.

Senator JOHNSON. We have to understand it. One of the reasons I throw it out there is you have to simplify what it is that we need to do, so people understand. Otherwise, you get drawn down into the very detailed policy debates.

With trade, you have to keep open markets.

Dr. KAHN. I very much believe that is critical. We need to be able to be the rule setter for a large, open global marketplace that is attractive to other countries to come and participate in. I think that is a core element of our prosperity, and entrepreneurship.

Obviously, we talked about these Doing Business indicators. I still think in terms of many of these characteristics that the United States is an extraordinarily dynamic and vital economy.

I spend most of my time looking at countries that are in crisis. So it may be a low bar, but I think there are still a lot of great strengths in the U.S. economy.

Senator JOHNSON. Again, we like those indicators improving for America.

I will give both of you a chance, if you have any kind of closing comment, if there is something on your mind or if there is something you want to get off of your chest, I am happy to do that before I close out the hearing.

Dr. Taylor, anything?

Dr. TAYLOR. So tell me what specifically—

Senator JOHNSON. I am just asking if you have any closing comments before I close out the hearing, something we did not address.

Dr. TAYLOR. I am sorry. Just more generally, it seems to me that the underlying set of ideas here, that there are lessons to learn from other countries and Greece, is very important. And we can

look at our history, what has worked and what has not worked. You can look at different countries.

It is a way to convey the important issues to people, to voters, to people in America.

So I would say keep it up.

Senator JOHNSON. Dr. Kahn?

Dr. KAHN. Just to go back to my opening remarks, just to emphasize, there are a kind of series of almost subtle decisions that are going to be made by the international community in the coming weeks. It will deal with debt for Greece, but as we have been talking about, but with precedent for others. It will deal with financing and most of all, who pays, who picks up that bill.

The IMF is in many ways caught in the middle of it. I think for the most part, we should be supporting them.

But I think the important emphasis for you, given the committee's jurisdiction and our general interest in this strong, vibrant, global economy, is the United States should be involved in those decisions because ultimately, cumulatively, they can have a pretty material impact on how the global economy operates.

Senator JOHNSON. Thank you.

Again, I want to thank both of you for coming here and giving your time, thoughtful testimony, and answers to our questions.

This hearing is adjourned.

[Whereupon, at 3:26 p.m., the hearing was adjourned.]

