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The Global Economy: What Is and Isn't Being Done to Keep it Afloat

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Introduction;

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JIM KESSLER: Good morning, everybody. Welcome to Third Way's capital market initiative speaker series. This is our third series, and glad it's really caught on. We've got great attendance on these things, and I'm really pleased that staffers are able to make it. I want to introduce a couple of people in the back, Lauren Oppenheimer and David Hollingsworth. Some of you know them, but they are the policy team of the Capital Markets Initiative and doing great work.

Our goal in this initiative is – both through our written products and the speakers series, is to promote a balanced, nonpartisan and above all an informed debate about the role capital markets have in the economy. Our only bias in this is that we believe that a healthy, well-functioning capital market is very beneficial to the economy. The rest we leave up to the – to debate.

And as part of this initiative, we want to bring really interesting and insightful speakers here to the Hill for staff – and, you know, people that are – that have a high degree of knowledge with the capital markets, but also with the economy as well. My recollection from my 12 years on Capitol Hill is, you get a smattering of these things, but you don't really get a chance to spend an hour with somebody who really – like, really in-depth on a particular topic, particularly with the economy.

A couple of things before I introduce this morning's guest: Obviously there's lunch. Grab it, eat it, get up again and eat more. There'll be a period for questions and answers, but if there's something that you want some clarification on during the presentation, you know, feel free to speak up. Our next event is going to be on March 23rd, and it will feature Paul Volcker. You'll get an invite in the coming weeks.

Future events that we have – not a date, but some of the speakers that are coming – is Dave Wessel, who's the economics editor for The Wall Street Journal; historian Niall Ferguson is a really interesting guy and a great author; and a special treat, we have the Georgetown Cupcake ladies coming – (laughter) – yes we do – about the role of venture capital in their rise. And yes, cupcakes will be served. So again, (last ?), thank you so much for coming. I know it's always a busy time on the Hill; it's hard to get away.

Our special guest today is Dr. Carl Weinberg. And I was up in New York giving a presentation, and I was – and Carl was one of the speakers, and I was on right after him. And while he was speaking, instead of thinking what I was going to say, I was just furiously writing notes. I just – there was just – I found his data and his insights just really fresh and provocative, frankly. And I thought, let's get him down here and talk to – talk to Hill staff.

He is one of the nation's most sought-after economists. He is the chief economist for High Frequency Economics, which is a firm that – if you read the business pages; and if you read the Journal, the Post, The New York Times; if you watch CNBC –

they're just a frequently mentioned source. Dr. Weinberg is one of the frequently quoted economists there. He writes a regular publication called "Notes on the Global Economy," widely read by people in finance and in the media. He writes weekly notes on China's economy, also a must-read.

Decades of practical international economic experience. He's taught economics at the European University in Florence; Wharton; and he currently teaches a course to graduate students on the international finance at NYU. His Ph.D. is from Wharton, and he is a graduate of Rutgers University, so he's an East Coast guy.

And he's going to talk about what we're doing and what we're not doing to keep the global economy afloat. And his subtitle is: "How I stopped worrying about the eurozone." And unfortunately we had technical difficulties, so his wonderful slide presentation, you're just going to have to imagine it in your head. So with that, Carl Weinberg. Thank you very much. (Applause.)

CARL WEINBERG: Thank you, Jim, for that great introduction. The problem with having heard my – me speak in New York is, you know all the jokes already. So I hope that you won't give away the punch line.

You know, I – this is a little embarrassing about the presentation, because when I was a kid economist, what they taught me at university – I mean, you think at university we learned about, you know, macroeconomics and microeconomics. What we really learned there are three things that you have to do when you give a presentation like this. You have to wear a suit, or no one will believe you; you have to have a presentation, or no one will pay attention to you; and you have to have a joke. And since my topic today is economic depression in euroland, I don't think a joke is really appropriate. (Laughter.)

And the presentation is here; it is what it is. I'll enjoy it – (laughter) – and we do have it up on our company website. And if – what's the best way? Should I just say it out loud now, or do you all get your BlackBerrys out and punch it in, or? It's www.hifreqecon – H-I-F-R-E-Q-E-C-O-N – hifreqecon.com/thirdway. And I'll repeat that again at the end. So you can pick up all the slides. I'll (wave ?) them for you. They're really interesting, and I'm going to enjoy them (alone ?). (Laughter.) But the problem I have, of course, is getting your attention without having a slide show or a handout or anything like that. And by the way, it's a PDF you'll be picking up, so you can pick it up and print it – pinch all my charts.

So let me say this. I'm here today to talk about economic depression in euroland. And my hypothesis is that we are facing – are in the midst of a chain of events that, technically speaking, are stoppable – but because of lapses of policy and the inability of European policymakers to get their act together, probably won't be addressed – certainly show no signs of being addressed yet.

So as a result, because of mismanagement of a sovereign debt crisis that started in Greece, moving into a banking crisis, moving down the chain of events – we are headed right now for – in Europe for an economic contraction that is so huge that it is – will be much more akin to the Great Depression than to any economic event that we have experienced in our lifetimes. We are looking at the potential for a double-digit contraction of GDP. We're looking at the possibility of deflation. We're looking at record-high unemployment, and we're looking at a euro that's likely to continue to descend. Do I have your attention now?

You know, the subtitle that I had appended to the presentation today was "How I Learned to Stop Worrying and Love the Euroland Debt Crisis." And in point of fact, I have some experience in this. Back when I was also a kid economist, but not as much as a kid economist before, I worked for Bank of Montreal on the restructuring of loans to Latin America in the 1980s. And we all remember that debt crisis.

And in those days, it was Mexico, Brazil, Argentina and the Philippines which – individually any one of which could have brought down the entire global financial system. And all the banks were atwitter about it. And we had a restructuring committee. We did a multi-year restructuring, and then we took the restructured loans and turned them into Brady bonds. And I thought I was kind of done with that. And then suddenly Greece popped up in March of 2010, and suddenly I was advising governments and people that the only way to resolve Greece is through a multi-year restructuring, which of course they couldn't do for all kinds of political reasons. And now we are where we are.

But I started reading, and one of my favorite books – I have a lot of really dismal books on my favorite reading list – is Reinhart and Rogoff, "This Time Is Different." Have you all read it? Anybody read it? So as you know, what they do is, they look at history going back to the 1300s. And they identify, just in the last two-and-a-half – well, three centuries, since the – well, two centuries – over 200 sovereign defaults, 200. And they tend to be clustered in bunches, what they call serial defaults: One goes and triggers another, and another goes and triggers another, another goes and triggers another.

And everybody we know has been in default. France defaulted eight times in the 19th century, once in the 20th century. Germany defaulted eight times. The only ones who haven't defaulted seem to be the Anglos. They list the United States as never having a sovereign default – although, as I remember, Herbert Hoover suspended the payment of the U.S. war debt at the beginning of the Great Depression. And I don't know why that doesn't get counted. So the U.S. is maybe technically off the list.

But Germany has defaulted. Spain defaulted innumerable times. Greece, since its independence in 1820-something, has been in default or restructuring of its debt or some kind of a fiscal crisis for more than 50 percent of the years in that period of time – more than half the time. And we're surprised that now they're popping up again.

Just as a footnote, because we all know the Greeks are struggling with restructuring their loans right now, the French had a very novel way to deal with restructuring loans. When they defaulted on their debt, what they did was, they sent the bond holders to the guillotine. So thus the – in French, the word – the word for bankruptcy or for sovereign debt restructuring is called the bloodletting. And this is something maybe – something to think about.

Let's think about what's wrong in Europe right now. I'm going to lay out for you a chain of events – because it's not really about Greece. Greece is, like, kind of the comma in the middle of the sentence that kind of makes the sentence happen. But there's a whole lot of words all around it. And I think of what's happening in Europe right now as a chain in the – of events that could be broken at any point along the way, but which has not been broken by policymakers at any point along the way. And thus it's festering into a crisis that will bring Europe down.

It starts with – let me just run through the steps, and then I'll elaborate – the mispricing of eurozone bonds. Back in – 10 years ago, when we had the start of EMU – the notion that all European bonds had the same risk and therefore ought to be priced accordingly – that pricing, that bubble in pricing, became – burst when Greek, in March of – when the Greeks stood up in March of 2010 and said: Ha ha, we were just kidding about all of our national accounts and government debt figures we've been sharing with you. We've been lying about them all along. The debt is really bigger, and we're in trouble.

And everyone thought that the rest of Europe would stand up and say: We'll help you, because we're all Europeans – instead of which, everybody stood up and said: Well, we won't really help you, although we'll lend you some money to help you get through the next few years. But we're not really going to back your bonds, in the way everybody thought they would.

So with this bursting of the bond bubble and the re-pricing of bonds, we are now suffering capital losses at banks, which are just becoming evident right now. As we get into the first quarter of 2012, we're seeing the results of banks' operating profits from 2011. And they're bound to be ugly. And banks are having capital problems.

So the fourth step in the chain is that banks, having no other way to restore their capital base, cut back on lending. And that gives us a credit crunch. And that credit crunch gives us a depression-like event. If any of you have studied the depression, what was wrong in the Great Depression was that we lost the banks. And whether we should have or shouldn't have lost the banks is one question. But the fact that we did lose the banks meant that we lost the economy.

And thus I have a primary mantra that I keep in mind every time I think about Europe, every time I think about what has to be done to save Europe. And that is: Save the banks, save the economy. Save the banks, save the world. Maybe you saw that TV show, "Save the Cheerleader, Save the World"? Same principle. One critical set of institutions has to be preserved, because if we lose them, we'll lose everything.

And this is the chain we started off with, with the mispricing; then the – then the correction; then the banking problems and the credit crunch and so forth. And it's all – we just see it happening in front of us. And we are on a course toward the end of this chain that has to be changed in order – something has to happen in order to prevent this chain from playing out the way it is. And I don't see anything coming from the policymakers in Europe that seems likely to be able to do this.

So let's talk about the problem, all right? Let's go back to the bonds, all right. Go back to the late 1990s. Some of you may remember the late 1990s, all right. Euro – how can I describe what was happening? Everybody was agog with the notion of the European Monetary Union. It was the next best thing to sliced bread. Chancellor Kohl of Germany, François Mitterrand of France formed a compact to pull the rest of Europe together into a common currency.

And of course, for Wall Street, a big change like this was an opportunity to make money. How do you make money? You get people to trade bonds, to exchange securities, because Wall Street picks up a little fee in the midst of all those transactions. So Wall Street investment bankers invented something that made absolutely no economic sense and sold it to everybody. I know, it's fun to be mad at Wall Street, right?

They invented the notion of the convergence trade. And here was the idea. We're going to have at the beginning 11 countries, eventually 17 countries, form together into a common monetary union. And there would be one central bank and one currency. And therefore all the bonds would have exactly the same risk. So therefore all the bonds should have exactly the same price, because if France got into trouble, Germany would certainly stand up and help it. If Greece got into trouble, Italy would certainly stand up and help it. It was just a no-brainer. It made so much intuitive sense that everybody went out and bought it.

The thing is, when you think about it, it didn't really make that much sense. I mean, we have bonds in the United States sold by the federal government, and they have one kind of risk. And we have bonds in the United States sold by the state of California, which have an entirely different kind of risk. Same idea: one central bank, one currency, all right. But we don't have a commonality of risks, and the bonds are priced to take that into account.

Well, in Europe, the theory of the investment banks was that the bonds should all have the same risk, and therefore they should all have the same price. And if you know how a bond works, as the price of a bond goes up, the yield on a bond goes down. So bonds that in Greece had been selling, three and four years earlier, for dirt, all right – with yields of 15 (percent), 17 (percent), 18 percent – as soon as it was announced that Greece was going to enter into the European Monetary Union, the difference between the yield on Greek bonds and the yield on German bonds, what we call the spread, just narrowed right in – down to a hundred basis points – not too different – that's one percentage point – not too much different than what Germany had to – and what France had to pay to raise money relative to Germany. Everybody was on the same idea that the risk was identical across all borrowers.

This lasted until March of 2010, when the Greeks stood up, said they were lying about their national accounts, said they needed more money and the bond market wouldn't give it to them at a reasonable rate, and they wanted everyone to help them. The response of the Germans wasn't to say: We will help you through this. The response of the French wasn't to say: We will back your bonds. The response of all the investment bankers in Europe wasn't to say: We have a borrower who's borrowed more money than they can possibly repay on the terms in which it was borrowed. Let's restructure it. Let's take all the bonds that are due over the next 10 years and turn them into 30-year bonds, so that then the payments – instead of having a big mountain of payments to make over the next 10 years – becomes a more gentle mountain of payments or hill of payments that go out 30 years.

That's what we did in Latin America in the 1980s. It's a perfectly good strategy. And everything could have been averted if people would just have believed that people really did stand behind and back everybody else's bonds; that there was some notion of fiscal unity behind the currency union that had been formed. But they didn't.

And as a result, Greek government bond yields blew out, relative to everybody else's. But not just the Greek government bonds, but suddenly investors thought: Aha. If Greek bonds aren't as safe as we thought they were, maybe our French bonds aren't as safe as we thought they were.

Maybe our Italian bonds aren't as safe. Maybe our Spanish bonds aren't as safe. So spreads in Europe – the difference between what countries had to pay to borrow, which had been very, very tightly clustered around the German borrowing costs – suddenly blew out. And the German costs didn't go up; Germany was seen as safe, so its yields stayed low. And the result was that, as the yields went up, the prices on all these bonds went down. And that meant that everybody who owned these bonds lost money.

And it's on a such a big scale – such an enormous scale, this markdown – that it has created a catastrophic destruction of wealth for the holders of these bonds. Who has these bonds? Primarily banks, insurance companies, pension funds – these are the big holders – but also, to some extent, individuals, foreigners. Some of them are owned in the United States, although not as many as before. But now we have a problem that is very similar to the problem that we had with mortgage-backed securities in the United States; remember that? Paper that, at one point, everybody thought was worth X suddenly became worth Y. And the people who owned those pieces of paper, mostly banks, took big losses and nearly failed.

And this is the next link in the chain in Europe: that institutions that own these pieces of paper are now taking very, very big losses. And the problem is no longer reflating the bond market and getting it back to the way it was, because it ain't going there – in the same way that, when the Fed started buying U.S. mortgage-backed securities, everybody knew that the yields weren't going back to where they were, and the prices weren't going back to where they were. Once the bubble is burst – once Humpty Dumpty is off the wall, you can't put him back together again.

So the problem now is the one of dealing with the fact that wealth has been destroyed on an enormous scale. And that destruction of wealth poses problems for the banks. And it's interesting because everyone says, well, if Greece defaults, then it's a small problem, it's a small country. It can be fixed.

It's not a big deal. But what Greece did was it triggered what I call a little worm of doubt in everybody's confidence in these bonds. And by triggering that worm of doubt, other countries don't have to fail in order to bring down the banking system. They just have to see this worm of doubt lower the price of their bonds on the market and the financial system becomes undermined.

So what do you do about it? You know, well, if you have a bank – and there are some really nice graphics on here. I'm sorry you can't see them. I'm enjoying them right now. If you have a bank – and we have a balance sheet – I know, Jim said don't go into technical things, all right. And anybody here an accountant? Any accountants by training here?

Well, T diagrams are really boring stuff, all right. But it helps to look at them to understand how a bank works. So I'm going to try to talk you through a visualization – you may have to close your eyes to do this, and I won't be offended – of what a bank's balance sheet looks like, why it hurts, what's happening and how you could fix it.

So a bank has assets and it has liabilities. The assets are the good stuff. It's things like gold and cash. It's thinks like – well, bonds used to be good stuff. All right, now maybe not so good anymore for a European bank. It's things like loans, some of which are good, some of which are bad, so it goes.

And a bank deposits reserves. Every time you put money in the bank, it takes a little portion of that money and holds it on reserve. And the central bank, the European Central Bank in this case, insists on holding those reserves for the banks so that the money, they can be sure, is actually there on reserve. It's usually about 2 percent.

And on its liability side, a bank has deposits, which are what you have, right? You see it as an asset, but from their point of view, it's money you could take out at any point in time. It's a liability. They have loans that they've made from the public, bills and so on that they've put out to raise money. And they also have the money they owe the shareholders. The capital of a bank appears on the liability side.

So what happens in a double-entry accounting system is every time something happens, you have to put it on both sides of the ledger. Both an asset and a liability are affected. So if you have a big loss on bonds, then what happens if nothing else changes is that you have a big loss of shareholder equity. So this could go on to the point where shareholder equity actually becomes negative, in which case the bank becomes bankrupt and can’t function anymore.

Today we take a slightly more calculating view on what you have in the shareholder’s equity. We talk about something called capital adequacy. And that’s to say that the equity that remains in a bank – its real value, the value of the money the shareholders put into it – should be a certain ratio greater than, or a certain ratio of, a certain percentage of the total assets that that bank put at risk, where things at risk include loans, include sovereign bonds and so forth. And that’s called a capital adequacy ratio.

And in Europe, they’re aiming to get to 9 percent. Right now they’re probably around five (percent) or six (percent) overall. In comparison, in the United States, we’re currently at 12.8 (percent). And prior to Lehman’s we were around 7 (percent). So banks in Europe are woefully undercapitalized going into this. Now they’re losing value on their shareholders because of the losses on the bonds, and they run the risk of going bankrupt – some of which are broke already – and of having to raise more capital in order to become adequately capitalized.

In case you think I’m making this up, you may have been reading about UniCredit, an Italian bank – that’s broke. All right, Dexia, a Belgian-Luxembourgian creation, also broke. All right, you’ve heard about Commerce Bank and ING Bank going out there to sell assets to improve their capital adequacy.

This is actually happening in companies that we're observing, and we don't even have the fall closing numbers for 2011 publicly available yet to be able to ascertain how big the trouble is. But I don't believe these four banks are anything other than the tip of the iceberg, and we just don't know which banks are safe.

Now, just think about that for a second. We just don't know which banks are safe. How would you feel if you put your money in a bank and you didn't know if the bank was going to go bust, as many people felt in 2008-09? What if you have, again, that little worm of doubt that says, maybe my bank isn't going to be able to give me back my money?

Well, you don't give it your money, and then you have a run on the banks. And that's what's happened in Greece, where three-quarters of deposits in Greek banks have been extracted and moved into German banks, moved into British banks, moved into American banks. And these banks in Greece – this we know for a fact – are dead. They are insolvent, bankrupt, kaput. So this is really playing out in front of us. This isn't just an economist's story that we're making up. This is what we're observing in the world.

So what do you do? How can you fix a busted bank? Well, one thing you can do is you can sell more shares. You can say, I'm issuing 10 squinjillion (ph) more shares to sell to the public, and then all the money that you take in becomes new capital. Here's the problem, aha. Who wants to invest money in a bankrupt bank? No one. So UniCredit tried this, they tried selling shares to the public in order to increase their capital. That didn't work.

So what can a bank do? Now, if I had my chart up, we'd have this very elaborate depiction here of the other strategy that a bank has when it can't sell shares to the public. And this is a strategy of selling off its assets, which are primarily loans, which is to say, to retract credit. So when a bank calls in loans, it reduces its assets at risk – the loan – and it also, at the same time, though, reduces its deposits in the banking system.

Because the way you get a loan is you have a deposit, you write a check to pay the bank back, and your checking account deposit goes down and that goes down. And the graphics really make it easy to see how that works with reserve ratios. Forget about it, all right?

The thing that you need to know is this, that it takes a much bigger adjustment to achieve a capital adequacy ratio improvement if you do it by calling in loans than if you do it by selling shares. How so? Let's imagine a bank that has 9 billion euros worth of excess capital and it has 100 billion – I'm sorry, take that back. What's the number I used here? Let's not confuse me here. It's so much easier with the slides.

Let's say that you have a bank that has 6 billion (dollars) worth of capital and has 100 billion (dollars) worth of loans, so it has a 6 percent capital adequacy ratio. And let's say that the governments have decided, as they have, that in order to be safe you have to get to 9 percent capital adequacy by June. If you were to sell shares, you'd just have to sell 3 billion euros worth of shares – piece of cake.

But if you have to go the other way – if you have to call in loans to get the same 3 percentage point increase in your capital adequacy ratio – you have to pull in 33 percent – one-third of your entire loan book – in order to see the same improvement in your capital adequacy. And I state that as a statement. I'm happy to show you the math on it. I would have showed it to you on the slides.

But what this means is that the adjustment to even a small shock like Greece is ten times bigger if we have to do it by calling in loans than if we have to do it by selling capital. And my opinion is that the private sector people aren't going to buy shares. Now, who else might buy shares? Well, here in the United States, when the banks got into trouble in 2008-09, we had a partnership between the Federal Reserve Board and the government, the Treasury.

And that partnership was implemented through something called TARP. We all remember TARP. And TARP was a big box of money sitting on the table. And what TARP did was funded by the government, and what it did was, any bank that needed to raise capital to stay in business knew that it could, at any point in time, go to TARP and take as much money as it needed without any questions being asked – we'll sort it all out later – so that everybody knew that no bank would fail.

Even if your money was in Citibank, as mine was, you didn't want to diversify too much because you knew that this TARP money was available and that no bank was going to be able to fail. Where did the money for TARP come from? The Fed created money by buying assets, by buying bonds from people, and paying for it with new money that it created.

And as the Fed was creating this money, the Treasury was soaking it back in again, absorbing that excess liquidity, by taking it into TARP, by selling new bonds – new, good Treasury bonds. So a bank would sell a toxic asset to the Fed, the Fed would print money and give the good money back to the bank, and then the bank would then invest that money in a bond that was going to fund TARP.

So we had this partnership to create a big box of money on the table that could ensure that no bank would fail. That's what Europe needs to do right now because private sector people won't buy the bonds. Now, they have invented a construction for this. It's called EFSF, the European Financial Stability Fund, which is a great invention. It overcomes all the obstacles that the Europeans themselves have created to prevent them from doing something like TARP.

Because, you see, the U.S. is one government. To people in this room it may not seem that way at one time, but it's one government, all right? And we can transfer money around. The federal government can do this sort of thing. But in Europe, in the constitution, the government of Germany cannot lend money to the government of Greece. The European Central Bank can only do transactions with certain partners. The central bank can't come in and buy bonds directly at an auction. There are limitations to ensure that central banking and government actions are completely separated, and to ensure that transfers of money between governments, from one to another, aren't affected – that will enable one government's fiscal misbehavior, its fiscal deficits, to be financed by another government.

So to overcome all these obstacles, they invented EFSF, which is a corporation in Luxembourg. And this way it's not a government, so it can do things that the governments can't do. So EFSF is supposed to go out and raise money, but it hasn't. And the German government has objected to the pre-funding of EFSF because they don't believe that the EFSF should borrow money that it doesn't need.

That – the simple fact that EFSF exists, that it could borrow money, or it says it could borrow money, if it needed it, should be enough to guarantee that the money is never used. And this is one whole school of thought – it's part of what I call the German school of thought, the German approach to all of this, that you can use guarantees to fix banks – that is, in my view, bogus, and in my view is a major obstacle to reaching resolution of this problem within Europe.

Let me give you a for instance. Jim walks into the bank and he says: I want to borrow a billion euros. OK, nice. So the bank looks at him and says, well, you're a very important person. You've got a very important organization in Washington. You've got a very good job, you've got a nice suit, but frankly, we don't think you're worth a billion euros. Your balance sheet doesn't stand up to it. You know, in fact, you might even be broke for all I know. It doesn't matter, all right? You're not going to get the billion euros.

So then I walk in a minute later and I say, well, I know this Kessler guy and he's OK. I think you should lend him the billion euros and I'll guarantee it. Is he going to get the money? Well, the bank is going to turn to me and say, where's your money? What are you using to guarantee Mr. Kessler's loan? And I'm going to say, well, I'm sorry. I really don't have the money, but I'm pretty sure I could borrow it if I needed it.

Well, this is the problem with having this box of money on the table, but without having any money in it. The Germans want everyone to believe that they could raise whatever money is needed on demand, and the reality is that EFSF has faced deteriorating borrowing conditions, had to pay increasingly higher interest rates, and it's only borrowed 23 billion euros so far out of the 440 billion that it's authorized to borrow.

So the bank is going to go to EFSF and EFSF is going to say, sorry, we don't have any money. Go see your government. So Credit Agricole is going to show up at the doorstep of President Sarkozy and is going to say – Agricole is going to say, well, we need 20 billion euros to recapitalize ourselves. Could you please help us?

And Monsieur Sarkozy is going to say, well, you know, I'd really like to, but I just told the French people that they have to work longer until they get retired, that they have to get paid less from now until retirement, that they'll receive less in retirement benefits than they get there, that public-sector salaries are slashed, public-sector employment is slashed, public spending is slashed, and we're also raising taxes at the same time.

I don't think this is the right time for me to go to them and say, we're raising 20 billion euros extra in bonds to rescue a bank – especially since he wants to be reelected president in April or May, which he probably isn't anyhow. So the governments themselves have a political disincentive to go out and to rescue the banks. So this leaves the banks with no alternative but to start calling loans in and to start improving their capital adequacy by lowering their exposure to the market through loans.

And a great chart – oops, that you won't see – oops, it's gone now, or now I've lost it altogether. What did I do here? Oh, we're back. It is that we actually are observing this in the world. Credit to the nonbank private sector in euroland has fallen for the last four months in a row – fallen, actually declined. Even in 2008-09, it flattened out but it didn't actually go down.

And the money supply in Europe, because of the contraction in credit, is actually going down. And while many of you aren't professional economists, you probably know that historically, there is this debate between monetarists and Keynesians. All right, and I'm a Keynesian. I went to the University of Pennsylvania. We didn't let monetarists visit us, OK? I'm a particular point of view, all right?

But even I have to say that nothing good can come from this. There's no way in my little, addled economist's mind that I can observe that credit and money are contracting outright and take that observation and turn that into a story that has a happy ending. How much does credit have to contract? Well, I hate to be an economist, but it depends.

It depends on whose numbers you believe, not on the mechanism. The mechanism is clear. The European Banking Authority estimates that Europe is short, European banks are short 125 billion (dollars) in capital in order to make the capital adequacy requirements mandated for June. Now, they only looked at 71 banks out of about 900, so people like the IMF are guessing that the number is around 250-300 billion.

Mark Carney, the financial stability czar and the governor of the Bank of Canada – he's the financial stability director for the G-20 – he estimates that the number is somewhere around 400 billion. And if you use these 10-to-1 multiples, well, now you're talking real money. You're talking trillions of euros. And Carney's estimate is that if the banks that we're studied by the EBA, the 71 banks, have to raise their capital adequacy by calling in loans, they'll have to call in 2.5 trillion euros worth of loans in order to make the capital adequacy targets by June.

2.5 trillion euros is one-quarter of all the lending that there is in Europe. So if you reduce the amount of credit by one-quarter, what happens? Even if you don't have an economics degree, you know it's not good. So I think I'm rather modest when I stand in front of you and I say, well, we should be looking for a double-digit contraction of GDP for the euroland economy in 2012. The economy already contracted in the fourth quarter, just by a few tenths.

This is after noting that GDP never got all the way back from the dip it had in 2009, all right? We fell 5.5 percent and we've only clawed back about 3 percent of that. So we're going to go down again from not having gotten back where we were before, and the "D" word, depression, starts to come to mind.

And if you have a double-digit contraction of GDP, how could you not have record-high unemployment? We already have record-high unemployment in Europe, all right? It's not going to get any better as a result of this. And prices have nowhere to go but down in this kind of a credit crunch-induced economic downturn. And this is a depression in Europe.

Well, what are we going to do about that? How does that affect us here in the United States? Well, that's the big question, isn't it? You know, we saw in 2008-09 that our problems in the mortgage-backed securities market did indeed infect Europe. But now we're four years after that – well, three years after that, three and a half years after that – and we've learned and we've changed in many important ways.

In particular, American banks right now have this capital adequacy ratio of just short of 13 percent, almost double what they had going into Lehman. Seeing this problem develop over the last three years, especially since March 2010 when Greece went into the garbage can for the first time – it remains in the garbage can – we've seen banks in the U.S. cut off direct relationships with banks in Europe.

They stopped funding the dollars that European banks need to be able to do their lending in dollars. That market shut down, cold. They have cut off direct relationships and short-term credit lines with European banks, and most of their exposure is to companies. It's lending risk, direct lending risk.

It's pretty distant from the sovereign risk that we're looking at. And besides, American banks are very big and lending to Europe is a very, very small part of their business. So a very small bit is affected.

On trade, Europe is one of our biggest trading partners. But Europe is only 1.6 percent of total U.S. exports. So if we lost it all, that's how – I'm sorry, let me correct that, 1.6 percent of total U.S. GDP. Sorry. So if we lost it all, all right, we'd lose 1.6 percent of GDP. But it's unlikely that we're going to lose it all. GDP's not going to stop in Europe. It's just going to contract.

So as we saw in 2008-09, world trade fell by about one-third in that episode. And if we got a replay of that scenario, then we'd lose maybe four or five-tenths of a percent of U.S. GDP. We would feel the loss of exports, but it's not going to kill us. And this is the difference between '08-09 and now – that the firewalls are up and we're protected. That's what we know.

Here's what we don't know. We don't know what's happening off the balance sheet of banks. All right, we've all heard about contingent, off-balance sheet liabilities. Things like credit default swaps, which are insurance policies on bonds, all right. Every Greek bond at point was sold with an insurance policy. And that policy was written by who? Could've been Goldman Sachs. It could have been AIG, in which case they'd be the U.S. taxpayers' problem. It could be me or you. You could have written billions of dollars' worth of credit default swaps. Of course, they're all sold and traded over the counter in an unregulated market.

There are no – you know, if you do a futures contract in Chicago, you have to register with the exchange, you have to show financial strength, you have to show a collateral against the contract that you're writing. And the contracts are all traded publicly, so everybody knows who their counterparty is and knows that their counterparty is good. In this market, it could be Joe's hedge fund in Greenwich, Connecticut, that wrote a trillion euros worth of credit default swaps, which is to say if they go off – if bonds in Europe fail or default, we don't know what happens, where the – where the party ends, who ends up holding it. And obligations like this in the credit and derivatives market that are off the balance sheet of banks, they're off the balance sheet; we don't see them.

So we don't know what we don't know. And while we are optimistic that most American banks have moved – gotten rid of a lot of their stuff off their balance sheet, let contracts lapse or expire, reduce their risk profile on this kind of stuff, we won't know for sure, until something bad happens, what the possible linkages are there. And that's where the risk is, in my point of view. I think it's not a big risk. What we at High Frequency Economics are thinking: The U.S. is going to grow OK in the next year. We're a little bit more optimistic than the Fed. Looking at 2 to 3 percent GDP growth – not enough to bring the unemployment rate down very much, but certainly enough to keep it from rising and to make a little bit of progress. It's certainly better than what we're seeing in Europe.

So as for the world as a whole, well, this is something – when I told them this at the IMF, they nearly fell of their chairs. You ready for this? This is such a big aha. Europe's not the whole world, all right. So we can have a depression in Europe. They didn't realize this at the IMF. The – Europe can fall off a cliff and the rest of the world would be dinged, like the U.S. economy is likely to be, from the real linkages, but is unlikely to sink. Europe's less than 20 percent of world GDP. So is the United States. So many people are brought up with this idea that, you know, it's the 1960s again and America is 45 percent of the world's GDP. So if America sneezes, the world catches a cold, all right. That's not true anymore.

There is no dominant player in the world economy anymore – 20 percent for Europe, 20 percent for the U.S., 8 percent or so for China, all right. Emerging Asia, which includes China, about 21 or 22 percent of world GDP – bigger than Europe and the United States. Think about that, all right. Another presentation on that maybe sometime, all right. And the rest is scattered, you know, Japan, Britain, Latin America, all right. So it's a cylinder with a lot of – it's an engine with a lot cylinders. So one cylinder stops, the propeller's still going to keep turning, all right. We're going to continue to fly. We just might not go as fast as we otherwise might.

So that's our – that's the good news in all of this. We all don't have to, you know, move to some place that's safer, if you could think of where that is. We don't think the curtain's going to fall down around us, but we do think Europe is in for a really, really, really bad time. For investors, who in their right mind would invest money in this place? You know, I mean, if you're an investor and you could put a dollar to work in a – an offshore investment, do you want to invest in Europe where they're vastly contracting GDP with huge banking problems? I know I forget to mention declining demographics and a rising retiring population, all right. Or do you want to put your money to work in China, where you just drop a $20 bill on the ground and it grows at 10 percent a year. OK?

There – so what we're seeing is that – what we believe is happening is that money will be diverted from investment into Europe to other places. Some of it will come here and make investment in the United States more easily affordable, capital for investment in the U.S. more readily available, and help fund our government deficit, which is nice although not strictly needed because we've got some pretty punchy savings going in this country right now. But a lot more of it is going to go to developing Asia where double digit growth rates promise double and triple digit rates of return on capital. And that's a really attractive proposition.

You know how much the increase in population in China is going to over the next decade? Roughly – this is U.N. estimates so it's give or take 10 or 20 million people – 140 million new people, more people will be living in China 10 years from now than today are currently living in Japan, all together. So where do you want to sell Diet Coke, you know? So these are the kinds of propositions that investors are looking at.

So you know, where do I come down on all of this? Politicians can fix this at any point in time in Europe, they just have to get their act together. They have to create this big box of money and put it on the table so there's no worm of doubt about what – whether any bank is safe or not, all right. They need to enable their central bank to do more the kinds of things that the Fed has – did to help the U.S. economy back in 2008, 2009. We may not have liked what the Fed have done. We may be very critical and say, you know, it's a bad thing to print all that money, all right. But you got to think about where we would be if they didn't. And we're going to see where they would be if they didn't real soon, because they ain't putting the money in Europe. And we're going to see the consequences of that play out over the next few months.

So politicians can fix all of this. Politics may not allow that to happen. What I really think we need in Europe is a king – a king, a central banker king or an investment banker king, someone who can pull them all in the room and tell them this is what you have to do, because politicians – you all work for politicians, all right – politicians in Europe – politicians, all right, are do – propose solutions that are politically viable.

But what we have in Europe right now is not a political problem, it's a banking problem. And as we see with Mr. Corzine, all right, politicians don't always make the best bankers, all right. And we need someone to pull all the national political interests together and to stand up and say: I am the king, all right. I am going to tell you what we have to do in order to fix this, and you're going to do it. And you can lay it off on me that I told you to do it, so when it comes time to get reelected, you can say I didn't want to do it – (in French) – all right, but he made me do it, all right. And therefore, the best interest, the best economic interest of the region, can be served. But right now, we're getting policy solutions that are the ones that Sarkozy and Merkel can best sell to their own domestic constituencies rather than the things that have to be done – rather than the printing of the money, the prefunding of the bailout fund and saving the banks, or even just admitting that there's something wrong. It's as elemental as that.

I'll finish with two observations. In December, I think after I saw you in New York, I went to a meeting in Rome that on the 19th of December was pulled together by my friend, Ignazio Visco, the governor of the Bank of Italy. And it was supposed to be a memorial session for Tommaso Padoa-Schioppa, who I'm sure you all know. Well, he was a very prominent Italian central banker, very prominent in the ECB and the IMF. He died, unfortunately, a year ago. So he invited all the people who worked with him to come to this conference. Who was on this list? Well, Mario Monti, the president of Italy; Mario Draghi, the president of the ECB; Mervyn King, the governor of the Bank of England, all right; Klaus Regling, the head of the European Financial Stability Fund; John Lipsky, the deputy managing director of the IMF; Michel Camdessus, the former managing director of the IMF, who was about as close to a king as you have at the IMF in terms of its (whole thing ?).

Altogether, there were over 50 central bankers and government leaders and European bureaucrats – central bank governors, deputy governors, finance ministers, deputy finance ministers. And there were 22 speakers on the program. And if there were 22 presentations, there were 27 different ideas expressed, all right. Nobody's on the same page about anything. If they can't even agree on what's wrong, it was Greece, it was the banks, it's the Germans, it's the Americans – we get blamed for everything in Europe, all right. What's wrong today? Greece is the problem. The banks are the problem. The euro is the problem. Everybody has a different idea. How do we fix it? Print money. Don't print money. Fund EFSF. Don't fund EFSF. I won't fund EFSF – that's Klaus Regling. The second most unpleasant conversation I've ever had in my life was with him at that conference about prefunding the – if they can't get their heads around the idea, the same idea, how can they be expected to solve the problem in a finite period of time?

Second observation. Why am I so concerned about the banks? April 2009, pretty close to the bottom of our experience here, I went down to the University of Pennsylvania, and I visited my professor and mentor, Lawrence Klein, all right – at that time, 89 years old; grew up in Omaha, Nebraska, during the Great Depression, right in the middle of the Dust Bowl; Nobel laureate. I said to him: You know, Larry, it kinds of feels like we're getting into a depression here today, but how would I know? You know, what did you see when you were a kid growing up in Nebraska, you know, that told you there was a depression? You know, what did you see? How did you know it was happening? And are we seeing anything like that today?

Oh no, he says, today it's nothing like that. He says, today, you want to buy a new house, you go to the bank, you fill out the application for the mortgage. The bank says, sorry, no mortgage. Your credit score is not high enough or your income is not high enough or we're just not lending in that neighborhood anymore, not lending in Miami anymore, whatever. So you go home and you feel bad. When you to go buy a car, and you fill out the application and the bank says, sorry, we're not going to give you a new loan for the car because your credit score is not high enough, blah, blah, blah, blat, not enough down payment. So you go home and you drive your old car, you feel bad.

He says, in the depression, you went to the bank to take out money to buy food because, you know, they didn't have credit cards or debit cards or things like that. And the bank was closed, and you couldn't eat. That, he said, that was bad. He said, when you have – owned a company, and you went to the bank to take out your payroll, because people didn't have direct deposit, you know, into their various – it was a little packet with cash in it, and you went to the bank to take out your payroll and the bank was closed and you couldn't pay their – your employees, and then they couldn't eat. So because they couldn't eat, they had stopped working for you and your business would fail. That was bad.

Now, I'm not saying Europe is going to get quite to that point, but we do have a catastrophic destruction of wealth that's epicentered on the banking sector. And I don't see, unless something happens to stop it, how we can get out of it without really, really severe consequences. And that's my message to you today. I'm very sorry about the presentation, but I do hope you will pick it up from our website. Thank you. (Applause.)

MR. KESSLER: Thank you very much.

MR. WEINBERG: Is this my speaker's gift?

MR. KESSLER: Yeah, that's your speaker – we have time for questions. Thank you so much for doing that presentation without a (net ?), which was – which I know can be really difficult. And I thought it was really interesting.

Let's start over here.

Q: Some of the reporting I've seen suggests that Germany, (in general ?), doesn't see this as big an issue. They're just not as worried about it. And they're actively using the crisis to get sort of the other things that they want other governments in Europe to do that are, you know – (inaudible) – about that. And I'm also curious what you'll think will happen to the euro – (inaudible).

MR. WEINBERG: So I think very much the Germans are trying to use it for their own political advantage. I agree that they don't share the same sense of urgency that everyone else in the world shares about this. Their perception is that German banks are sound, that Germany has the wherewithal to protect its own interests, so other places can come and go and we really couldn't care less because we're Germans, all right? I think that's very bad reasoning. It's certainly very anti-European reasoning.

And I think it misses the point that the European financial system is so closely interconnected. You know, it would be like people in – pick a good state in the United States in 2008 (or there ?) wasn't one – people in the strong state saying, you know, well, we don't care, we're covered, so we're not going to let any of our money go to help out recapitalize banks in New York. So I think it's very narrow-minded. But I agree with you, that is, you know, I think part of the politics of what's going on there.

The euro as a currency, you know, that question always comes up. And there are a lot of people who say, well, EMU should end. Now, it's a big argument in my house, because my wife's an historian and I'm an economist, all right. And I have this view of history that says that nothing happens unless somebody gets paid to do it, all right. It's very simplistic, all right. She says it's narrow-minded, but it's my point of view, all right. And to me, EMU, preceded by European Union, preceded by European Community, preceded by the Common Market, preceded by the European Free Trade Association, preceded by the European Coal and Steel Agreement – all right, these various iterations that have now spanned half a century have been enormously profitable for every single one of the countries that's in there, and that it pays nobody to leave it.

If you think Germany is just going to say: I'm out of here. Leave these deadbeats behind, all right. Try this some time. Watch TV – it's a little scary – watch the coverage on one of the news networks of the latest riot in Athens, all right. Don't look at the very attractive reporter in the front, don't look at the riots in the background – ignore all of that. Look at the parking lot. The parking lot is filled up with Volkswagens, Audis, Mercedes, BMWs, all right. The Germans love selling their stuff to the Greeks who make nothing. And in fact, there's a balance of payments version interpretation of this story of what's wrong in Europe that suggests that the whole thing is a balance of payments promise because the Greeks do make nothing.

If the Germans were to pick up and go and form a new Deutsche mark, well, the first thing that would happen is they'd lose all these exports, because the new Deutsche mark would take off. And the second thing that would happen is that all of the assets of the German banking system, which are a euro-denominated loans and euro-denominated bonds, would drop like a stone in new Deutsche marks and the German banking system would be bust. Other than that, it's a good idea. It's a very strong incentive for them to stay in.

On the Greek side, it's just the opposite. If the Greeks got up and left, a new drachma would drop like a stone. Everything they import will go up in price, and you would see an inflation that would knock your socks off, all right. I saw that happen. I've experienced 5,000 percent inflation in Argentina when something very similar happened in the 1980s. I can tell you it's not very fun, all right. Then, all of the money that they owe denominated in euros, in new drachma terms, would explode. And debt service would become a crippling burden on national income and so forth.

So nobody's going anywhere, I think. There'll be a lot of talk and rhetoric and popular demonstration and so forth. But when push comes to shove, everybody's better off staying in this thing that they created. Now, mind you, they didn't have a good reason to create it. But now that they have it, the cost of leaving are, to my opinion, are enough to keep everybody in.

MR. KESSLER: Way in the back.

Q: You said something earlier when you talked, suggesting the U.S. deficit isn't really that much of a concern. Can you elaborate a little bit on that? I mean, you have the report from CBO that the deficit – (off mic) – Bush tax cuts let expire, then we'll sort of get a bit of reduction of deficit over the next – (off mic). Do you think that's important? Or is it not something you think is terribly important?

MR. WEINBERG: Well, I don't really know what to do with that one, because while I can answer it, I'm not sure that I should, given where I am. (Laughter).

MR. KESSLER: Give it a whirl.

MR. WEINBERG: Huh?

MR. KESSLER: Give it a try.

MR. WEINBERG: Is it – is it safe? Will you get me out of here safe –

MR. KESSLER: Sure.

MR. WEINBERG: – because – (laughter) – you know, I'm bound to tick off half the people in the room, no matter what I say. So – (laughter) – there's no way – no way to win on that one. I think the U.S. has a fiscal deficit problem, all right. I think that the deficit and debt problems, unchecked, will lead to catastrophic results very similar to what Greece has.

However, I do not believe that the deficit problem has to be addressed right now, just as I don't believe that the debt problem in Europe – which is greater than ours – has to be addressed right now. While over the next decade there has to be a clear path back toward debt – deficit reduction – and more importantly, toward debt reduction as a share of GDP, which is a very different thing, all right – I don't believe that they have to, or we have to, at this point, drop everything and sacrifice growth.

If we look at the U.S. economy, after the First World War we had a debt ratio of 140 percent; Britain had 170 percent. That's pretty high. That's higher than anybody except for Japan right now. It's as high as Greece; it's higher even than Italy. And the way that we grew out of it was by growth, by decades – two, three decades of noninflationary, sustained, rapid economic growth. And that's the way to – in my opinion, to bring the debt ratio down, all right. While fiscal restraint is a big part of that, while structural problems in the deficit do have to be addressed, we don't have to drop everything right now to do it. That's just my view. Do I have to leave now?

MR. KESSLER: I think that's OK. I think that's good effort. Let's go right over here, then – (inaudible) – there.

MR. : WEINBERG: You guys make me nervous.

Q: Hello, my name is Ari Amano (sp) from the – (inaudible) – economic foundation. I have a question on – actually two questions. One concerning the so-called (government ?) approach of putting a box on the table but only backing it with promises and not any money in it: Don't you think that, in this case, the European Central Bank would actually come to help? Because they're not only responsible for keeping inflation down, but they're also responsible for stabilizing the economy as a whole?

And the other question is concerning the so-called European (king ?) you were alluding to. I mean, who has the power to do that, where – (inaudible) –

MR. WEINBERG: I'm available. (Laughter.)

Q: I didn't get that.

MR. WEINBERG: I said I'm available.

Q: Yeah.

MR. WEINBERG: Let – so first question is ECB, all right. And that's a really good question, and a lot of people don't have a full understanding of how central banks work relative to governments, all right. But the ECB cannot do what you suggest. What the ECB does is, the ECB creates money by taking assets from the banks and giving them cash in exchange, right. The Fed did it by buying securities outright; the ECB is doing it by buying securities for a fixed term of three years. But the effect, at least for those three years, is the same. Technical differences, but we – that's not the key point.

The key point is that for a bank that takes in an asset, cash, and gives out a liability to pay it back – the balance sheet is unaffected. So the ECB creates liquidity so institutions can remain in business. But it cannot affect solvency, all right. Solvency is when the two sides of the balance sheet get out of whack, when you lose money on a bond and the shareholders' equity goes down. And there's nothing the ECB can do – in its power – impossible, can't happen, all right –

as with the Fed, to affect the solvency of a bank. And if a bank is insolvent, people will stop doing business with it, and eventually it will atrophy, no matter how much access to liquidity it has.

So the ECB is doing a very good thing by printing the money. And it's put the money in the economy. But now the partnership with the government has to be there, to soak that money up and to put it in a box where it can then be injected into the balance sheet on the shareholder equity side, all right. So it's a very good question, and you got to really dig into the – drill into the way central banks work, but it's impossible.

And that's why the Fed couldn't do what TARP did in the U.S., all right. The Fed can't buy shares in banks; neither can the ECB, all right. Would you want to own a currency? Would you like to own – have money that was backed by stocks? Doesn't seem like a good idea. The Japanese tried that, and then in 1990 when their stock market crashed, they wiped out their whole banking system; they haven't come back yet. Credit's been contracting there for 15 years – another presentation. (Laughter.)

Now the other question was the king, all right. I say "king" somewhat facetiously; maybe that wasn't clear. But, you know, you need someone who everyone can respect to stand up and say, this is the way it's got to be, all right. So I don't propose, you know, a new court at Versailles. I mean, the king would have to be in France, right? So I don't propose – (laughter) – a new court of Versailles, you know, with gold robes and everything like that.

But we need someone like the role that Bill Rhodes played in resolving the Latin American debt crisis of the 1980s, all right – someone who comes at a banking problem from a banking point of view, and has the gravitas to be able to influence the policymakers and to tell governments what has to be done in order to make it work. Christine Lagarde would ideally do that, but she's not doing it, all right. She's playing European; she's holding up a little red bag and saying, I'm here to collect money, all right? And she's not going out and telling world leaders, all right, you are doing the wrong thing; this is the right thing.

And so we – my personal choice would be – what's a – triumvirate is three rulers; what's with two? Du-umvirate (sp)? Duovirate (sp)? Two. I would – I would like to see Bill Rhodes from – former Citibank chairman, who's not European – (notice ?) it's very careful, all right – and Angel Gurría, the secretary general of the OECD, who is also not European – he's Mexican, all right – together address this problem and come up with a series of solutions, a binding arbitration that all governments would agree to do that.

Why do I pick Angel? Because in 1984 – when I sat on the Mexican – Mexico Advisory Committee to restructure Mexico's loans – Bill Rhodes was the chairman, and Angel Gurría was my (counterparty ?), the minister of debt for Mexico, all right. And together at that table, we restructured $57 billion worth of loans into a 27-year loan package that eventually became the basis for Brady bonds. So here are two guys who know how to do this. Here are two guys who can fix Greece in a heartbeat, and here are two guys who, (come in ?) the outside, can come in and inject ideas. I think we need focus, and we don't have focus. So that's just my opinion.

Q: Thank you for your presentation.

MR. KESSLER: Can you – can you just – (inaudible) – so folks can hear him. If you –

Q: OK. OK. Thank you for your presentation, even though we didn't get to see the slides yet. You said at the – (laughter) – at the beginning of your presentation that you were concerned about the contagion spreading from Greece to other countries. And because of that, you've seen the spreads on their bonds increasing. And then at the end of the presentation, you said that the European Monetary Union has to stay together.

But what I don't understand is: Why not let Greece fail, either orderly or disorderly, and then let the banks that are – that are, you know, close to being insolvent – let them fail the way Lehman failed, but guarantee the depositors the way we do with the FDIC, so the risk is on the bondholders and stockholders – and then just shore up the strong banks so that, you know, you're – you know, you've got – you've got the – you know, the strong-bank/weak-bank model that, you know, was talked about over here for a while? So I guess the question is, you know, why not let Greece fail and inoculate the rest of Europe?

MR. WEINBERG: Well, the – to point, Greece has failed. Greece has failed; it's bankrupt; it's burst; it's in – it's in debtor – it's in debtor – what they called debtor-in-possession mode right now, OK? The negotiating committee is working on a restructuring that's going to hit private sector bondholders by 70 percent.

And if they don't accept that deal, and if they can't wrap their heads around it – and I don't think they can, because there's a subcreditor group of hedge funds who have a blocking position in the debt – this is so beautifully complicated; it'll make a great movie someday – that they may not allow it to happen, in which case there'll be a hard default to Greece. But one way or another, Greece is down; Greece is dead. Every bank in Greece is dead. All right? So, you know, it's – that's – Greece isn't a problem anymore; Greece is a fact.

So as you point out, another problem is the impact on the banking sectors. And so, if we're on the same page – and what you're suggesting is one of the very possible solutions that could happen, (in ?) parallel with the question that we just had from the back. You know, why don't governments just dig into their pockets and support the banks that are salvageable, and merge the banks that aren't salvageable into them? All right?

And the answer is that the governments don't want to have to raise the money. They're committed to fiscal austerity above all, "über alles," all right? And the governments don't want to have to go to the taxpayers and say, we're going to raise taxes to bail out the banks, or we're going to borrow more money to bail out the banks – especially with national elections coming up in France, and major elections coming up in Germany, and other elections all around euroland going on, they don't feel that they can take that move.

So the problem is taking the political pain of raising the money. And that's why EFSF is so cool, because it's not a government. They could borrow the money tomorrow, and no political leader gets nailed for it because no government did it. Sarkosy – "moi"? I didn't do it, all right. So – but the problem is that the national leaders don't want to go the route of breaking austerity in order to bail out the banks. And that's the stumbling block. Fix that, you fix Europe.

MR. KESSLER: We're going to do two more questions – one in the back, and then right up here in the second row. Well, I thought there was one in the back, Mike (sp).

MR. : There was, but it was asked.

MR. KESSLER: OK. So let's go right here, and then we'll go over there.

Q: Do you want to address at all the problem of moral hazard that this might create for any of those banks? And is that much of a concern? And if it is, what could be done as part of (it ?) to offset that concern?

MR. WEINBERG: Yeah. I mean, I think moral hazard's a big problem. I think that you open the door to moral hazard by bailing out institutions that are in trouble. You know, and the question is – it's one of, you know, the public good. You know, is the public good best served by being right about, you know, not opening Pandora's box on moral hazard, but letting the banks fail; or by taking the risk of moral hazard, all right, and saving the banking system and sorting the rest out later?

And now with a hard deadline in June coming up, and with numerous banks in Europe already failed, and more ready to go, my interpretation – and this is just an opinion, and it can be – you know, intelligent minds can disagree on this, all right – but I don't think moral hazard is the immediate problem. You know, I think the immediate problem is, save the banks at any cost.

You know, and I apply that kind of thinking to everything. You know, I mean, you look at what happened here in the United States in 2008, 2009. Was it good to run up the fiscal deficit? Was it good to borrow all that money for TARP? Was it good to recapitalize the banks and introduce moral hazard? Was it good for the Fed to print all that money and maybe, maybe – I'm not saying it is – but maybe open up the door to inflation, at least in people's thinking?

None of that was good, all right. But it wasn't as bad as letting the banking sector fall off the table, all right, and drag the whole economy along with it – because my interpretation of invents (ph) – yours may differ – but my interpretation of events is that Lehman's was a tragic mistake. And it's not because I worked there in the '80s either, all right – but that it was a tragic mistake that caused a fissure in the banking system, all right, that didn't have to be there. So if Lehman's had gotten what other banks had gotten, the institution wouldn't – probably would have faltered, but not in that catastrophic way.

So that's just my take on it. You know, and I'm a pilot, all right. And what I do when I fly the plane, I got a million things going on, all right. And my instructor always yells at me, he says, Carl, you're thinking about too many different things, all right. Worry about the next three things that you have to worry about, all right. And you get one done, move the other things up the list; take another one. Just focus on the next three things, and you'll get to where you're going. Otherwise you'll dissipate yourself. So to me, moral hazard's on my list of things to worry about, but it's substantially further down the list than, save the banks, save the economy. That, to my mind, is the – is the most important thing.

MR. KESSLER: And our last question right here.

Q: Hey, I just wanted to ask, in regards to some of the transmissions to the U.S., you seemed fairly optimistic in terms of our exposure. And I just wanted to ask kind of your opinion on how serious you think the exposure through the commercial paper market is, and kind of the – if something did happen with, you know, a number of European banks going under – whether that could, you know, break the buck on something here in the U.S. – (inaudible) – of money market funds. And if that isn't a big risk, what is the biggest one to look for in terms of – what is the U.S.' biggest exposure from something like you're describing (and ?) happening in Europe?

MR. WEINBERG: Yeah. So those are all good questions. And, I mean, we don't know what we don't know. I hate to sound like Rumsfeld, but there are a lot of unknown unknowns in something like this, because we don't know what's off the balance sheet. That's my biggest concern. I think the – American banks have seen coming for a long time the problems in Europe with much greater clarity than the Europeans themselves have; and, having been through what we went through here, with better understanding of what it means for the banking center.

So I think all the visible exposures have been largely firewalled by now. And any bank that didn't certainly deserves to lose their shirt, whether it's in the commercial paper market or the bond market or wherever. But we don't know what we don't know about the off-balance sheet stuff. And that, to my mind, is where the biggest risks are.

MR. KESSLER: Thank you very much again, Carl. (Applause.)

MR. WEINBERG: Thank you, Jim.

MR. KESSLER: Thank –

MR. WEINBERG (?): Sorry about the – (inaudible).

MR. KESSLER: That was – that was great presentation. Thanks, folks, for coming, taking time out of your busy day. We will send around the PowerPoint presentation. Paul

Volcker on the 23rd of next month – right, next month; and eventually cupcakes, OK? (Laughter.) Thanks again.

That was great.

MR. WEINBERG: That was good?

MR. KESSLER: It was really, really good. This is so valuable, for them to hear this, you know?

MR. WEINBERG: (I hope ?) I didn't scare them too (much ?).

MR. KESSLER: You might have. (Chuckles.) But it's OK.

MR. WEINBERG: Very good.

MR. KESSLER: You know.

MR. WEINBERG: Thank you for having me. This was nice.

MR. KESSLER: I was – I was really glad you could – (inaudible). You have time to grab lunch – (inaudible)?

MR. WEINBERG: I think I'm just going to head back –

MR. KESSLER: OK.

MR. WEINBERG: – (inaudible) – sorry; just because I've got a plane to catch, and I got some work I have to –

MR. KESSLER: Sure.

MR. WEINBERG: – do before. So as much as I'd like to, another time.

MR. KESSLER: Terrific. Thank you again so much.

MR. WEINBERG: (Inaudible). I'm going to send you a – (inaudible).

MR. KESSLER: OK, yeah.

(END)