FISCAL NOTES
A Review of the Texas Economy from the Office of Susan Combs, Texas Comptroller of Public Accounts

By Michael Castellon

JAMES K. GALBRAITH is one of the world's most prominent economists. Holder of the Lloyd M. Bentsen Jr. Chair in Government and Business Relations at the University of Texas' Lyndon B. Johnson School of Public Affairs in Austin, Galbraith is the author of six books on economics.

Those who follow the news know that European markets have entered a period of profound turmoil, a period of retrenchment and ballooning debt that ultimately may lead to the breakup of the "eurozone" — the 17 nations within the 27-member European Union that have agreed to share a single common currency, the euro.

In this issue, *Fiscal Notes* sits down with two noted economic experts to see how the European crisis developed and what effects it may have on the Texas economy.

Europe's troubles began — or at least became visible — with the onset of the worldwide recession in December 2007. In 2008, Iceland's entire banking system cratered, leading to even more instability and uncertainty in the eurozone's economies.

By late 2009, European states began to feel the crippling effect of excessive government debt. The bonds some eurozone nations had sold began to look shaky, and nations including Spain, Italy, Greece and Ireland felt the shocks particularly hard.

Beginning in 2010, proposed "austerity" measures to address Greek public debts fueled widespread, sometimes-violent street protests amid fear and uncertainty in European capitals.

At this writing, the European situation remains fluid, not to say chaotic. France and Germany, the primary players behind ongoing debt bailout deals, are widely regarded as "rescuers" of other eurozone states, despite the growing reluctance of French and German taxpayers to fund large-scale interventions.

> The goal of Germany and France is to prevent having to admit the failure of their banking system — and their banking system really has failed.
>
> — **James K. Galbraith, Lyndon B. Johnson School of Public Affairs**

FN: Can you take us through the process of how the European debt crisis came to be?

Galbraith: All credit economies have creditors and debtors. In 2008 in the U.S., too much debt was piled onto people who couldn't pay it — low-income homeowners and people who were exaggerating their incomes, and so forth.

In Europe, you have a series of countries that, for various reasons, fell into the same position. In Spain, it was a housing boom. In Ireland, it was a lot of shopping malls and out-of-control bank lending. And Portugal has never had a competitive industrial sector.

In early 2009, lenders got hit with big losses from the assets they'd been buying from the American banking system. So this time, they did what any sensible investor would do; they sold off their Greek, Portuguese and Spanish bonds to buy U.S. treasuries — stuff that was definitely going to get paid. That drove up the price of U.S. bonds and brought down the price of Greek bonds.

FN: Will current bailout plans offer the eurozone any hope of recovery?

Galbraith: I don't think so. It's not *intended* to offer recovery. It won't provide any relief to peripheral countries. What this is about is allocating the *losses* on debt.

I think the eurozone is in a death spiral due to the debt situation in the Mediterranean countries. I don't see that the European leaders are remotely close to doing what needs to be done to deal with it.

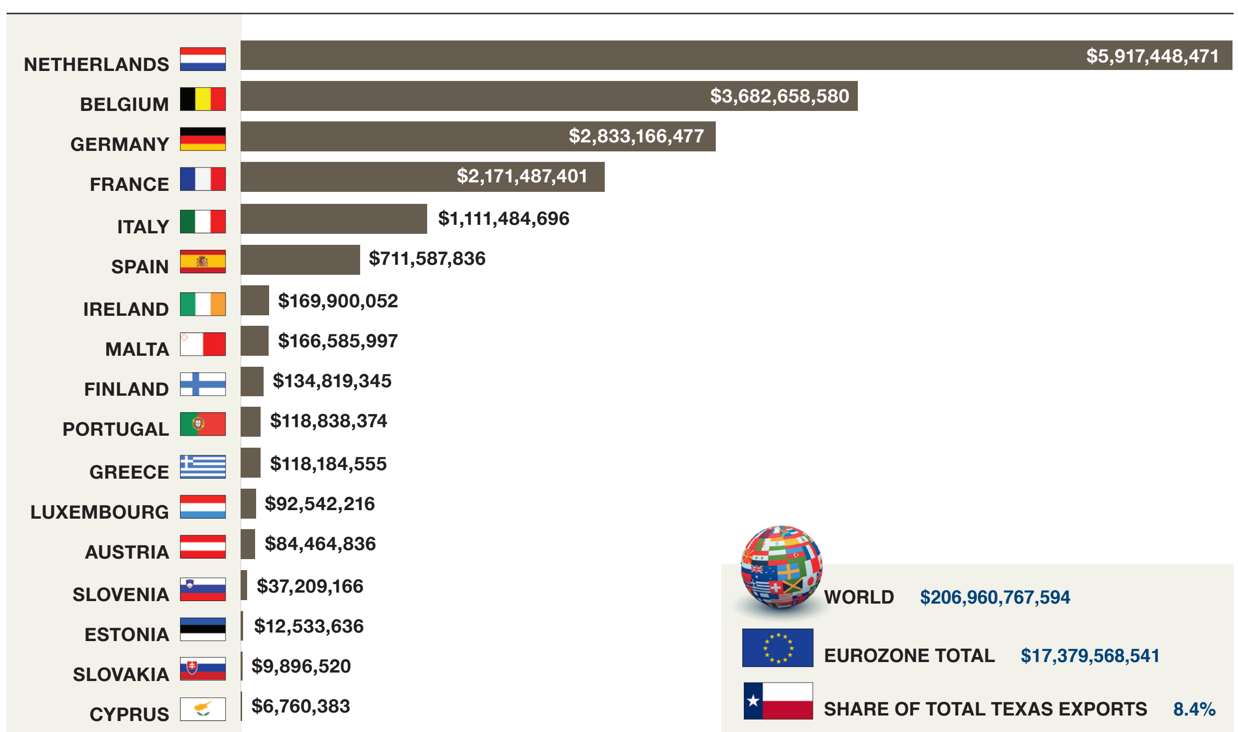
Restoring growth isn't a policy objective. The goal of Germany and France is to prevent having to admit the failure of their banking system — and their banking system really *has* failed, particularly in France.

This is really about preventing the breakup of the eurozone and the breakup of the ruling coalition in Germany. Those are the issues. [Eurozone leaders] are not what we picture [Federal Reserve chair] Ben Bernanke to be, a neutral technocrat trying to follow a mandate for growth, stability and employment. They're playing these very complicated games with other priorities.

FROM TEXAS TO TURBULENCE

VALUE OF TEXAS EXPORTS TO "EUROZONE" COUNTRIES, 2010

In 2010, Texas exported goods worth $17.4 billion to the 17 nations of the "eurozone," accounting for about 8.4 percent of the state's total exports for that year.



Source: U.S. International Trade Administration

FN: Considering how significant this situation is, will this have any immediate effects on the Texas economy?

Galbraith: Texas does have industries that sell to Europe, but losing a small fraction of sales to Europe is not a "make or break" situation to the Texas economy.

To take a closer look at Texas' financial industry, we also spoke with **John Heasley,** executive vice president of the Texas Bankers Association, who previously served as staff director and counsel for the Subcommittee on Financial Institutions of the U.S. House of Representatives Banking Committee.

FN: How are Texas banks faring relative to the national and global economy?

Heasley: We have 650 institutions, and we've had only a handful of failures over the past five years. The situation in Texas is due to a lot of things, like the ability of our tax and regulatory environment to draw business from elsewhere. We're also benefiting both from energy and the stability of our real estate and home prices.

When you compare us to the West Coast and the Southeast, we're doing relatively well.

FN: What effects do Texas and U.S. banks anticipate from the

> If there are problems in Europe, it may reflect on Wall Street and larger institutional lenders.
>
> **— John Heasley, Texas Bankers Association**

eurozone debt crisis?

Heasley: The collapse of the European market and the failure of the euro could have a lot of effects, but on a day-to-day basis, we still don't know the true impact.

If [European] leaders continue to flounder in their ability to deal with the debt of Greece, Italy and Portugal, that has a consequential effect on larger American institutions.

So if they get into trouble, American banks may have some exposure through money market funds and credit default swaps, which in this case are essentially insurance products against the failure of foreign debt.

Credit default swaps and mortgage-backed securities were part of our problem back in 2007 and 2008. We're really not sure how many credit default swaps are owned by institutions, but if there are problems in Europe it may reflect on Wall Street and it may reflect on larger, institutional lenders, which could limit credit [available] to institutions that suffered losses due to the situation in Europe.

FN: What industries are most likely to feel the effect?

Heasley: Any slowdown in [European] markets can affect exports in high tech and other industries that do a lot of business in Europe. Our largest trading partners are Mexico and Canada, but some of our products ship to Europe.

FN: Are American banks concerned?

Heasley: We have nowhere near the concern felt three years ago during the housing and mortgage fallout. In 2008, interbank lending froze to the point no one knew where the bottom would be. Even with the massive injection of capital into the American system through TARP [the Troubled Asset Relief Program], there was still some reluctance among institutions to do business with each other. That has a cascading effect.

[The current situation] hasn't escalated to that point. We've been insulated by the success of intervention at the federal level, and a lot of the TARP money has been paid back with interest.

We're fortunate that we have a more stable banking economy than we did four years ago. **FN**

For more information on trends and events affecting Texas, visit *TheTexasEconomy.org*