TESTIMONY

Testimony on the Economic and Fiscal Challenges Facing Europe

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Introduction

Chairman Paul, Ranking Member Clay, and members of the Subcommittee, my name is Bill Dudley, and I am President of the Federal Reserve Bank of New York. It is an honor to testify today about the economic and fiscal challenges facing Europe, and the Federal Reserve's efforts to support financial stability in the United States. Financial stability enables U.S. businesses and households to maintain their access to credit and ensures sustained economic growth. This is why promoting financial stability is an important objective of the Federal Reserve, and other central banks around the world.

Let me preface these remarks by stating that the views expressed in my written and oral testimony are solely my own and do not represent official views of the Federal Reserve Board, the Federal Open Market Committee (FOMC) or any other part of the Federal Reserve System. Additionally, because I am precluded by law from discussing confidential supervisory information, I will not be able to speak about the financial condition or regulatory treatment or rating of any individual financial institution.

The U.S. economy is currently expanding at a moderate pace, and strains in global financial markets, although having eased recently, continue to pose significant downside risks to the economic outlook. Because developments in Europe will have an important bearing on the prospects for growth and jobs here in the U.S., the Federal Reserve is monitoring the situation there closely. This is also why we have taken special steps in recent months, together with other central banks, to support the flow of credit to households and businesses.

Europe

The economic situation in Europe has been unsettled for the better part of two years, with pressure on sovereign debt markets and local banking systems. High debts, large deficits and slow growth in several European countries have called into question the sustainability of the entire euro area. The resulting strains in European markets have affected the U.S. economy.

The euro area has the capacity, including the fiscal capacity, to overcome its challenges. However, the politics are very difficult, both because the problem has many dimensions, and because many different countries and institutions in the euro area have to coordinate their actions in order to achieve a coherent and effective policy response.

Europe's leadership has affirmed its commitment to the European Union and its single currency union on numerous occasions. And the leadership is working harder than ever to achieve greater coordination in areas such as fiscal policy. A more robust and resilient European Union would be a welcome development for the United States. Three recent developments are especially encouraging in that regard.

First, liquidity concerns have eased significantly following the European Central Bank's (ECB) long-term refinancing operations in December and February. Through this program, the ECB provides three-year loans to European banks at low rates, accepting a wide array of collateral in return. Hundreds of banks accessed the program in each operation, and the ECB lent nearly €1 trillion in total. As a result, the cost of funding throughout Europe has declined since the program began, the euro has stabilized, and the sovereign bond market has improved. Changes in the ECB's collateral rules and reserve requirements have also had a positive impact.

Second, earlier this month, the Greek government worked with European leaders and its largest creditors to restructure the bulk of its €206 billion of outstanding privately-held bonds. This not only reduced Greece's total indebtedness, it helped calm persistent worries that a disorderly Greek default could become the trigger for a global economic crisis. Shortly after the debt restructuring, the EU approved a €130 billion aid package for Greece. Together, these measures will provide key support to Greek leaders as they pursue the difficult fiscal reforms that are essential over the long term.

Third, leaders in most euro area countries have approved a new treaty designed to increase fiscal coordination. The new rules already appear to be making a difference. Both Spain and Italy recently completed 2012 budgets that move their deficits closer to EU targets. Further, Spain and Italy took their fiscal actions in close consultation with finance ministers from other countries in the euro area, demonstrating a healthy ability to work together. While difficult work still lies ahead, countries in the euro area have made meaningful progress toward achieving long-term fiscal sustainability.

Looking to the future, the difficult work that remains also presents special risks—both for Europe and the United States. If Europe fails to chart an effective course forward, this could have a number of negative implications here. In particular, there are three areas of potential risk that I would like to highlight for the Subcommittee today.

First, if economic conditions in Europe were to weaken significantly, demand for U.S. exports would decrease. This would hurt domestic growth and have a negative impact on U.S. jobs. It is important to recognize that the euro area is the world's second largest economy after the U.S. and an important trading partner for us. Also, Europe is a significant investor in the U.S. economy, and vice versa. Thus, what happens in Europe has significant implications for our economy.

Second, deterioration in the European economy could put pressure on the U.S. banking system. As the recent round of stress tests revealed, U.S. banks are much more robust and resilient than they were a few years ago. They have bolstered their capital significantly, built up their loan loss reserves and have significantly larger liquidity buffers. The direct net exposures of U.S. banks to the so-called "peripheral" European countries are actually quite modest. The good news in the United States means that we are better able to handle bad news from Europe.

With that said, the exposures of U.S. banks climb sharply when one also considers their exposures to the core European countries and to the overall European banking system. U.S. money market mutual funds, in particular, have significant European holdings. This means that if the crisis were to broaden further and intensify, it would put pressure on the capital and liquidity buffers of U.S. banks and other financial institutions.

Third, severe stresses in European financial markets would disrupt financial markets here, which could harm the real economy. Stress in the financial markets causes banks to more carefully husband their balance sheets. When that phenomenon occurs, the availability of credit to U.S. households and businesses becomes constrained. Such conditions could also cause equity prices to fall, impairing the value of Americans' pension and 401(k) holdings. This would damage the U.S. recovery and result in slower output growth and less job creation. At a time when U.S. unemployment is very high, this is a particularly unacceptable outcome. In the extreme, U.S. financial markets could become so impaired that the flow of credit to households and businesses would dry up.

U.S. Dollar Swaps

In today's globally integrated economy, banks headquartered abroad play an important role in providing credit and other financial services in the United States. About $1 trillion in worldwide dollar financing comes from foreign banks, $700 billion in the form of loans within the U.S. For these banks to provide U.S. dollar loans, they have to maintain access to U.S. dollar funding. At a time when it is already hard enough for American families and firms to get the credit they need, we have a strong interest in making sure that these banks can continue to be active in the U.S. dollar markets.

Banks headquartered outside the U.S. make extensive use of dollars in their financing activities. In part, this results from the fact that the U.S. dollar is the world's number one currency—a status that brings with it many benefits for our country. It is in our national interest to make sure that non-U.S. banks remain able to access the U.S. dollar funding they need to continue financing their U.S. dollar assets. If access to dollar funding were to become severely impaired, this could necessitate the abrupt, forced sales of dollar assets by these banks, which could seriously disrupt U.S. markets and adversely affect American businesses, consumers and jobs.

One way we can help to support the availability of dollar funding, and ensure that credit continues to flow to American households and businesses, is by engaging in currency swaps with other central banks. Such swaps are a policy tool the Federal Reserve has used to support dollar liquidity for nearly fifty years. Most recently, the Federal Reserve established dollar swap lines with major central banks during the global financial crisis of 2008, and reactivated them in May 2010. Last November, the FOMC, cooperating with five other central banks, reduced the rate being charged on these swaps to increase usage.

The swaps are intended to create a credible backstop to support—but not supplant—private markets. Banks with surplus dollars are more likely to lend to banks in need of dollars if they know that the borrowing bank will be able to obtain the dollars it needs to repay the loan, if necessary, from its central bank.

Ultimately, these dollar swaps are designed to support financial stability, and avoid an unnecessary tightening in financial conditions, so that economic activity and job creation in the United States can continue to recover. Our principal aim is to protect U.S. banks, businesses and consumers from adverse economic trends abroad. I am pleased that the swaps seem to be working. In conjunction with the ECB's long-term refinancing operations, the swaps have helped European banks avoid the significant liquidity pressures we feared a few months ago and have reduced the risk that they would need to sell off their U.S. dollar assets abruptly.

Conclusion

In sum, I am hopeful that Europe can effectively address its current fiscal challenges. The Federal Reserve is actively and carefully assessing this situation and the potential impact on the U.S. economy. At this time, although I do not anticipate further efforts by the Federal Reserve to address the potential spillover effects of Europe on the United States, we will continue to monitor the situation closely.

Thank you for your invitation to testify today, and I look forward to answering your questions.