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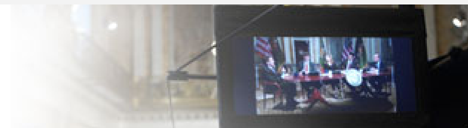

Written Testimony of Under Secretary Brainard before the Senate Banking Committee on Europe

2/16/2012

WRITTEN TESTIMONY OF UNDER SECRETARY FOR INTERNATIONAL AFFAIRS LAEL BRAINARD
BEFORE THE SENATE COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS
"EXAMINING THE EUROPEAN DEBT CRISIS AND ITS IMPLICATIONS"

As Prepared for Delivery

Chairman Johnson, Ranking Member Shelby, and distinguished members of the committee, thank you for the opportunity to discuss recent developments in Europe and how we are engaging with our partners to limit risks to the U.S. economy.

Europe is a Key Partner

The United States has an enormous stake in the continued strength and stability of Europe. The Transatlantic partnership is an enduring source of economic and political stability and is a cornerstone of our international engagement and alliances.

We are reminded daily of our unique partnership with Europe. The United States and EU are cooperating closely to increase pressure on Iran due to its noncompliance with international nuclear obligations. We welcomed Europe's decision to ban imports of Iranian oil and petroleum products, freeze the assets of the Iranian central bank, and take additional action against Iran's energy, financial, and transport sectors.

In Afghanistan, the United States, the EU, and other European donors provide the majority of funding for stabilization, promotion of democratic governance, and transition to a sustainable economy.

I am just back from leading a meeting in Abu Dhabi working closely with our European partners along with our partners in the Gulf and G8 to support the Arab countries in transition as they work to deliver inclusive growth and opportunities for their young people.

U.S. Economic Stake

Our economic stake in Europe is also immense. The United States has no bigger, no more important economic relationship than it does with Europe. A strong European economy—the second largest in the world-- is essential to a strong global economy and a robust U.S. recovery. Our recovery has strengthened recently but remains vulnerable to events in Europe.

The euro area is currently confronting difficult challenges of fiscal sustainability, of liquidity, and of structural imbalances. We believe Europe has the will and the capacity to manage these challenges effectively.

Nonetheless, if the euro area were to experience a deterioration of financial conditions, this could pose important risks to our recovery.

A further drop in growth within the euro area would reduce demand for US products and services at a time when external demand is an important engine of our recovery. The euro area accounts for nearly 15 percent of U.S. goods and services exports. It is the most significant foreign source of investment and jobs in America, accounting for fully 40 percent of all FDI in the United States. By way of illustration, fully one third of South Carolina's exports and over one quarter of Alabama's exports are destined for Europe, with a particular emphasis on autos and auto exports. Exports to Europe represent 18 to 24 percent of merchandise exports from New York, North Carolina, and Illinois, accounting for hundreds of thousands of jobs that could be put at risk by a decline in European demand.

As Chairman Bernanke noted in testimony, U.S. banks have made progress in protecting themselves against problems in European sovereign or bank debt. Our banks have built thicker capital cushions and better liquidity buffers since the crisis. In fact, the direct exposures of the U.S. financial system to the most vulnerable euro area program countries are quite modest.
However, our banking system still has material exposure to the core of Europe and to the broader banking system, which could be impacted if financial stress were to broaden in Europe.

Although we are in a better position to withstand financial stress and contagion, further deterioration in Europe could have a material adverse impact on our financial system. The globally connected nature of financial markets means that stress in European financial markets will be felt in the United States. Volatility in financial markets reduces risk appetite, undermines business and consumer confidence, and jeopardizes the availability of credit. That, in turn, can hurt American businesses and jobs, particularly in smaller firms that depend on credit from their banks to grow and innovate. It could also reduce the savings and wealth of American families.

The European Policy Response

The leaders of the euro area face complicated challenges that will require sustained political will to address over time. Market participants have demonstrated concerns about a combination of slow growth, low competitiveness, and large debts in some countries, as well as a large and highly interconnected banking system. These in turn are symptoms of underlying gaps in the European Monetary Union's institutional framework.

Over the course of the decade since the advent of the euro, substantial and persistent internal imbalances emerged within the euro area, with large balance of payments deficits in Spain, Portugal, Ireland, and Greece offsetting large surpluses in countries like Germany and the Netherlands. These reflected differences in competitiveness, as well as differences in fiscal policy. The internal imbalances were initially sustained by private capital flows, as private savers in the surplus countries financed deficits elsewhere in the euro area. However, in

the past 2 years, private financing has retreated. Resolving these internal imbalances is a difficult feat within the confines of a monetary union where currency adjustment is not an option and fiscal integration has lagged far behind.

The leaders of the euro area have pledged to do whatever it takes to stand behind the euro. And we have confidence the euro area has the capacity and the resources to stand behind that commitment. It is a common feature of financial crises that the pace of markets far outstrips that of political process. The challenge of delivering on European leaders' commitment has been magnified by the considerable time that is required to secure agreement among 17 heads of state and permit deliberation and approval by 17 national parliaments. Despite these challenges, Europe has made enormous strides.

For our part, in addition to the actions we have taken domestically to strengthen the US economy, we have been working strenuously to protect against elevated financial stress in Europe. Since the risks associated with Greece first became apparent in early 2010, the President and Secretary Geithner have worked tirelessly with their European partners, the IMF, and their G20 partners to underscore the gravity of the situation and the critical need to act quickly and with decisive force to restore confidence and combat contagion.

The United States and our international partners stand with European leaders as they work to restore confidence in the foundation of the eurozone. We have consistently supported a comprehensive plan to decisively address the crisis with 4 key elements: reforms to address the root causes of the crisis; ensuring European banks have the liquidity and the capital cushions they need to maintain the full confidence of depositors and creditors; a powerful firewall to stem contagion and ensure sovereigns have access to affordable financing as they reform; and charting a sustainable path forward for Greece. Our European partners are making progress on these key elements.

The first priority is reform: structural reform to restore competitiveness and growth, fiscal reform to restore sustainability of public finances, and repair and reform of the banking system. Italy and Spain have new leadership committed to restoring market confidence. In Italy, a country that ran primary surpluses for seventeen consecutive years preceding the financial crisis, the key challenge is to strengthen competitiveness and growth. After just a few months in office, Prime Minister Monti has is laying the groundwork for a more dynamic economy, with a first round of measures to liberalize the retail sector and create incentives for companies to increase investment and hire more women and youth. A second round, that includes liberalization of professions, transport, energy, and other sectors, has been submitted to parliament. Negotiations on labor reforms are ongoing.

Likewise, Spanish President Mariano Rajoy is moving aggressively to address Spain's vulnerabilities, including by undertaking a historic restructuring of its financial sector, which has reduced the number of savings banks to 15 from 45 and improved their institutional governance and framework. Spain's Cabinet recently approved a draft bill that obliges all levels of government to approve expenditure ceilings and debt targets, with fines for non-compliance, and introduces tougher monitoring of regions' fiscal situations.

Each of these countries face an extremely challenging agenda and completion will require determined efforts over a sustained period of time.

These efforts by individual countries are being reinforced across the euro area by broader economic governance reform. On December 9 of last year, Europe elaborated plans to strengthen the foundations of the euro area through a fiscal compact and stronger coordination of economic policies. Late last month, leaders from 25 of the 27 EU member states endorsed the agreement.

Second, European monetary and banking authorities have taken steps to provide strong assurances that European banks will have access to liquidity and build strong capital buffers. In recent months, the European Central Bank (ECB) has taken critical actions, including lowering interest rates, providing liquidity to banks and buying sovereign bonds in the secondary market.
Last December, in the face of deterioration in bank liquidity conditions and with frontloaded bank debt amortizations on the horizon, the ECB introduced the three-year Long-Term Refinancing Operation (LTRO) and announced broader eligibility for collateral, which seems to have significantly eased bank funding pressures and tensions in sovereign debt markets. Meanwhile, the European Banking Authority has undertaken an effort designed to significantly strengthen bank capital buffers.

Discussions on a successor program to support Greek reform efforts are ongoing, as are discussions with private bondholders on a voluntary exchange. Since 2009, Greece has undertaken fiscal consolidation of approximately 5 percentage points of GDP. Greece has also implemented a reform of its pension system and a labor reform aimed at liberalizing wage negotiations and promoting more flexibility in employment schemes. But with a heavy debt burden and significant lack of competitiveness, Greece will need to sustain a challenging path of reforms for many years in order to restore growth and sustainability.

Finally, it is critical that the euro area continue its efforts to build a strong firewall to stem contagion and to ensure that sovereigns undertaking difficult fiscal and structural reforms have access to financing at sustainable rates. In December, European leaders agreed to establish a permanent crisis resolution fund, the European Stabilization Mechanism (ESM), by June –a year ahead of schedule. And they committed to assess the adequacy of resources in their firewall at their next summit in March.

The United States and our international partners stand with European leaders as they move to put in place a comprehensive solution. And we have welcomed the IMF's role in helping to contain the crisis and its impact on the U.S. recovery and global economy by providing advice and helping to design programs for the most vulnerable European countries, as well as providing a minority share of funding in certain circumstances. However, while the IMF should continue to play a constructive role in Europe, IMF resources cannot substitute for a strong and credible European firewall and response. The challenge Europe faces is within the capacity of the Europeans to manage and the Administration has been clear with our international partners that we are not seeking additional funding for the IMF.

By promoting greater stability and safeguarding against further deterioration of economic conditions, the IMF supports the global economy, and with that, U.S. growth, jobs, and exports. The IMF has played, and can continue to play, an important role in the European crisis response. With its wealth of experience and independent judgment, the IMF sets strong economic conditions that help return countries to sustainability. In this regard, the IMF has unparalleled credibility providing external assessments of reform programs. And through our role on the IMF board as the largest shareholder, the U.S. plays an important role shaping the terms and policies of adjustment programs. It is in our national interest to retain that leading influence in the IMF.
In 2009 rapid Congressional support for IMF action helped stabilize the global recovery and ensured continued U.S. leadership in the institution.

The IMF has played this critical role in every major post-war financial crisis while consistently returning to the United States and other IMF members any resources –with interest—that it has temporarily drawn upon.

Conclusion

Europe is an important partner and ally strategically and economically. The euro-area crisis remains the foremost challenge to global growth, and to our domestic recovery. We will continue to actively engage with our European partners as they work to put in place a comprehensive solution to restore market confidence and ensure the health and resilience of the euro area. This is important to safeguard American jobs and protect our overall economic recovery.

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