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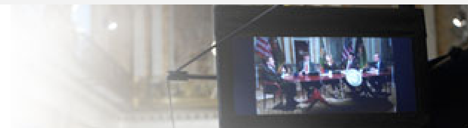

Remarks by Under Secretary Brainard before the Boston Economic Club

4/25/2012

As prepared for delivery

BOSTON - Good afternoon. It is a pleasure to be back in Boston. I want to thank Chip Case for asking me to be here.

Last weekend, finance authorities from around the world convened in Washington for meetings of the G20 and IMF. And next week, we will travel to Beijing for the fourth Strategic and Economic Dialogue. Our overarching objective is to ensure a favorable external environment to support America's recovery at a challenging time.

Recovery from financial crisis presents a special challenge under any circumstances. But our recovery has faced a number of external shocks that have greatly magnified this challenge, ranging from elevated oil prices to supply chain disruptions in the wake of Japan’s earthquake and tsunami to recurring bouts of financial stress in Europe.

Increasingly, we are seeing signs of resilience: Americans returning to work, banks lending, corporate profits surging, and deleveraging proceeding faster than in many other countries. The U.S. recovery is getting stronger, but its strength remains sensitive to events beyond our shores. We are working multilaterally and bilaterally to protect our recovery by addressing risks in Europe and by encouraging a more sustainable pattern of demand growth within and across the major economies. On this point, China is central.

Europe remains the greatest risk to the U.S. recovery as well as to the global economic outlook. Our economic stake in Europe is immense. The euro area accounts for over 13 percent of U.S. goods exports and over 20 percent of U.S. service exports. Europe's financial system has extensive reach to markets in every region. And sentiment in the United States remains sensitive to financial headwinds emanating from Europe.

European leaders have signaled their intent to do whatever it takes to reinforce the foundations of their currency union. And they have taken significant steps to do so -- steps that would have seemed out of reach only a few years ago. But the euro area is in the initial stages of what is likely to be a long and difficult path of adjustment, reform, and institutional development, and important risks remain.

The crisis in the euro area is at times described simply as one of sovereign over borrowing. But the roots of the crisis are more complex, just as achieving a lasting solution will require determined action on a number of fronts over a sustained period.

It is worth remembering that, with the striking exception of Greece, in many countries, fiscal indiscipline was not the primary cause of the crisis. Italy ran primary surpluses for 17 straight years preceding the crisis, Ireland almost exclusively posted fiscal surpluses from 2001 to 2008, while the Spanish government maintained its deficit in line with Maastricht criteria before its fiscal balance swung into surplus in 2005. The subsequent deterioration in Spain’s fiscal position reflected its response to the global financial crisis and the slowdown in its housing sector. For Ireland, the collapse of private demand after a large property boom and deep losses in its outsized banking sector losses triggered its adverse debt and deficit dynamics.

Countries have found themselves vulnerable to financial market stress as a result of excessive leverage associated with the under pricing of risk that coincided with the establishment of the monetary union in 2000. And in all of the countries experiencing stress, the competiveness of the private sector eroded significantly relative to Germany since the advent of the euro.

In response, European leaders are undertaking significant reforms. Fiscal consolidation at the national level is taking place within an overarching "fiscal compact." Structural reforms are underway to correct the erosion of competitiveness. Short term crisis response funds have been established to ensure countries have access to financing while reforms are still taking root. The European banking authorities have set higher capital ratios for European banks. And the European Central Bank (ECB) has supplied ample liquidity, helping to ease strains in funding markets.

Recent market volatility provides a sobering reminder that Europe still faces considerable challenges, and the reforms underway will take time to yield results. Successfully navigating the next phase will hinge on the willingness and ability of European leaders and the ECB to act creatively, flexibly and aggressively to support countries as they implement reforms and restore market confidence. Efforts in the months and years ahead will need to address deeper fiscal integration and risk sharing, greater cross border cooperation on bank supervision and recapitalization, and addressing internal imbalances.

Many countries are facing the need for sharp cuts in public spending at a time of weak private sector demand. It will be critical to strike a careful balance to avoid a downward spiral of austerity and recession or setting back the cause of reform. It will be important that countries under pressure are given space in the short term coupled with greater credibility on the medium-term fiscal path. This approach, combined with innovations to the region’s fiscal governance, will help to enhance the fiscal integrity of the monetary union. In the U.S., we have pursued a strategy of providing short term support to the recovery while laying out a path to put the nation's debt on a declining path once growth is restored.

While the establishment of an effective mechanism that ensures fiscal discipline is important to underpin macroeconomic stability, so too is preserving room for countercyclical policy responses. Countries representing roughly one-third of euro area GDP are undertaking the hard work of shrinking their budgets and reshaping their economies. Only a small group of member states retains the scope to implement countercyclical fiscal policy with the heightened market scrutiny and borrowing costs brought on by the crisis.

There is no mechanism for countercyclical fiscal policy at the European level. This year the euro area, in aggregate, is undertaking the most aggressive fiscal consolidation of the advanced economies despite having the smallest cyclically-adjusted fiscal deficit and the lowest growth prospects. In this respect, the lack of fiscal integration commensurate with the

degree of monetary integration deprives countries of fiscal flexibility when it is needed most.

Second, authorities must restore confidence in the region's banking systems. Here too, the country-by-country approach presents challenges. In the countries under the most pressure, we have seen linkages between governments and banks exacerbate the crisis dynamic. Market pressures have reflected concerns that a government's fiscal challenges may undermine the balance sheets of local banks, as well as concerns that fiscally-strapped governments may need to fund bank recapitalization.

The United States was able to stabilize and repair the financial system in the wake of the crisis in large part due to forceful efforts to disclose capital shortfalls coupled with temporary public injections of capital, where needed, to restore confidence. By contrast, Europe moved more slowly on stress test disclosures and measures to build capital and improve funding. As a result, many euro area banks were less resilient in the face of shocks last year.

Since that time, European authorities have taken steps to strengthen disclosures and set higher targets for capital buffers. These actions, and the critically important actions taken by the European Central Bank to strengthen liquidity, have helped to restore confidence.

But recent market volatility suggests that concerns remain about perceived linkages between sovereign and bank balance sheets at the national level.

The European banking system is highly interconnected across borders, but the institutional framework for recapitalization and restructuring remains national. The negative feedback loop between sovereign and bank balance sheets, and the deleveraging that some banks may be undertaking to meet capital ratios, could be attenuated with Europe-wide efforts at bank restructuring and recapitalization.

Members of a monetary union share a single currency, a single central bank, and a uniform monetary policy stance. Implicit in membership of a monetary union is the loss of monetary and exchange rate flexibility at the national level. In the absence of fiscal transfers, this put the onus for adjustment on internal devaluation.

Just as the G-20 has sought to create conditions for more sustainable and balanced growth globally, the euro area must also look to facilitate rebalancing within the currency union. The EU's new Macro-Imbalances Procedure maintains asymmetries, permitting surpluses of up to 6 percent of GDP, while sanctioning deficits that exceed 4 percent of GDP. Thus, while deficit countries must adjust, no corresponding reduction in surpluses is envisaged. In effect, this implies reliance on demand from outside the euro area.

European leaders face a challenging task as they strengthen the foundations of their monetary union. I am encouraged by their demonstrated ability to undertake significant institutional change while winning the support of seventeen national parliaments and sustaining a shared vision.

While we all work to address these near term challenges of restoring confidence, we cannot lose sight of the longer term challenge of rebalancing the global economy.

The buildup of household and financial leverage in many advanced economies provided a major engine of global demand growth. That engine was unsustainable and will not come back.

This shift in the sources of growth in the advanced economies in turn requires a corresponding shift in the policies of the world's largest emerging economies if the global economy is to regain its previous dynamism. With the prospect of prolonged weak demand in many advanced economies, emerging economies in surplus will increasingly need to rely on domestic sources of growth.

At the Pittsburgh summit in 2009, the Leaders of the G-20 recognized the need to rebalance the sources of global growth and committed to a Framework for Strong, Sustainable and Balanced growth. The IMF, in the World Economic Outlook published last week, noted that there has been a sharp drop in consumption relative to pre-crisis trends in deficit countries. This decline in consumption however has not been offset by higher domestic demand growth in the external surplus economies, such as China. As a result, there has been a substantial decline in global demand relative to pre-crisis trends.

In these circumstances, it is important to see stronger acceleration of growth in domestic demand in major surplus economies as well as greater exchange rate flexibility.

China has a key role to play. We are working to achieve an economic relationship with China that contributes to rebalancing and delivers greater benefits for American workers and businesses. That means rebalancing Chinese growth so that it is driven more by domestic consumers and less by reliance on overinvestment in resource intensive export industries. These objectives are broadly consistent with the goals China has set for itself.

We have seen a large reduction in China's currency account surpluses from 9 percent the year before the President took office to under 3 percent today. But this adjustment comes at a time when major cyclical factors are at play. Sustaining this process of adjustment as global growth recovers will require structural changes. A market-determined exchange rate will be a powerful tool as China rebalances. It is also important to further liberalize and open the financial sector.

For global rebalancing to succeed and our recovery to be secure, America must make corresponding changes in our growth strategy—changes that are well underway. We have made progress in raising household saving and ensuring the financial system is better capitalized and less leveraged. As our economy strengthens, we will need to do more to return the government's finances to a sustainable path. We will need to boost investment in infrastructure and innovation and education to make sure our businesses and workers remain competitive in the global marketplace.

We look forward to engaging closely with our partners around the world to ensure external conditions that support a strong and durable recovery at home.

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