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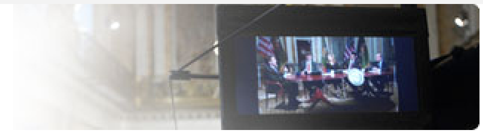

Remarks of Under Secretary for International Affairs Lael Brainard at the Council on Foreign Relations

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As prepared for delivery

NEW YORK – It is a pleasure to be at the Council on Foreign Relations.

The U.S. economy is on the mend. Private demand has now expanded for 15 consecutive quarters.

Early on, the U.S. took difficult steps needed to rebuild the capital of our financial institutions—combining tough, transparent stress tests with a backstop. The buffer against losses in our largest banks has doubled over the last four years. Our banks are now in a position to support private demand by lending to households and small firms.

Of course, ending the self-reinforcing loss of confidence and restoring financial stability was just the first chapter; it was necessary but not sufficient for recovery. Policy action was needed to jump start the recovery of private demand, followed by a careful withdrawal of public support calibrated to support the pace of recovery in private demand.

According to the CBO, we are on track to bring our deficit down significantly – to 4 percent of GDP this year – less than half its level in 2009. Our efforts to calibrate the pace of fiscal withdrawal to the pace of demand growth were vital to sustaining the recovery in the face of strong headwinds, as we saw with the payroll tax cut enacted in December 2010 and its subsequent extension through 2012. Today, there is broad agreement the sequester should be replaced by a balanced approach to better support the recovery.

But, importantly, the current consolidation comes after three years of gathering strength in private demand. The headwinds from deleveraging are now smaller, and the overall pace of growth is expected to accelerate, which is critical to finish the healing process.

Global recovery has been held back by a lack of demand growth in many of the major advanced economies and by reluctance in many emerging economies to move more quickly toward the currency flexibility needed for a durable rebalancing. It is important to guard against the risk that global recovery remains fragile and overly dependent on U.S. demand.

The key to a resilient global recovery, where growth in each country advances growth across countries, is action directed at supporting the expansion of demand at home. This has been a core focus of Secretary Lew's discussions in Europe, at the Spring Meetings, and most recently at the G-7 in the U.K.

By that key test, strengthening European demand is the most important immediate imperative in reviving global growth.

Domestic demand in the euro area is now lower than at the low point of the global crisis in 2009 in real terms. All of the recovery in European output since that time has come from net exports. That is not sustainable for a region that accounts for almost 20 percent of the world economy.

Euro area leaders deserve credit for the difficult steps they have taken to restore financial stability and address the risk of cascading defaults and exit. Spain and Italy are now able to borrow at rates that are significantly lower than they were a year ago.

But one of the lessons of our own crisis is that restoring financial stability, while critical, is just the first step for the economy to heal. The focus of the policy debate in Europe is now shifting from restoring financial stability to developing a plan to boost demand and employment.

In 2012, demand contracted 2 percent across the euro area. Unemployment has reached the highest level in at least 20 years. Decisive action is needed now to restart demand and avoid the risk of protracted stagnation.

First, European leaders are recalibrating the pace of fiscal consolidation. As we know from our experience, course correction can make an important difference. Recent evidence has shown that continued sharp fiscal consolidation risks further undermining demand, especially when the scope for conventional monetary easing is limited. The consolidation path should be stretched out in some countries, and those with fiscal space should shift to supporting demand. We welcome indications that France, Spain and the Netherlands will take additional time to meet their budget targets, but there is room to do more in the near term.

Second, the core of Europe can make a difference by rebalancing demand. Rebalancing is hard to sustain when it rests wholly on compression of demand in deficit countries. Increased demand in Europe's strongest economies would not only provide relief to weaker euro area economies, but would also help spur the world economy. In countries where current account surpluses remain above 6.0 percent of GDP, spurring private demand in areas such as faster wage growth and greater homeownership can make an important contribution.

Third, we welcome discussions on lowering borrowing costs for small and medium sized enterprises in southern Europe. The credit crunch in southern European countries makes fiscal consolidation more difficult and further erodes economic prospects. With weakening growth and disinflation, we welcome the ongoing discussion at the ECB about additional measures to improve transmission and address elevated borrowing costs in the periphery.

Finally, events in Cyprus only serve to underscore the importance of moving forward with full banking union. An effective banking union should include not only a single supervisory mechanism but also resolution authority, recapitalization capacity, and credible deposit insurance. Banking union requires some degree of risk sharing between members.

The upcoming bank stress tests and asset quality reviews are a critical opportunity to restore confidence in bank balance sheets and restart credit to starving local economies. Our experience suggests that the credibility of stress tests is enhanced when there is a strong backstop in place, permitting capital to be built without a further downward spiral of deleveraging.

We also have learned from our own experience that it is much easier to wind down banks in an orderly manner when there is a well-established framework for resolution that clearly prioritizes deposits, buttressed by a strong system of deposit insurance.

Globally too, adjustment has thus far relied too heavily on compressed demand in deficit economies, when a rotation of demand to surplus economies would enable higher growth overall. Finance ministers and central bank governors have started the challenging work of reaching agreement on how to bring exchange rate frameworks into better alignment globally. Avoiding a downward spiral of "beggar thy neighbor" policies is critical to ensure that growth strategies are mutually reinforcing.

The G-7 countries in February affirmed their commitment to rules of the game on exchange rates. The G-7 statement makes clear that domestic monetary and fiscal policy should be directed toward meeting domestic objectives using domestic instruments to ensure growth in each country supports growth across countries. G-7 members have also been clear in ruling out the pursuit of macroeconomic accommodation through the purchase of foreign assets or targeting exchange rates.

It is critical that Japan's efforts work through an expansion of domestic demand. Moreover, Japan's macroeconomic policy measures need to be complemented by the critical third arrow of structural reform.

Prior to the crisis, some large emerging economies intervened in the market to hold their exchange rates at undervalued levels, supporting export-led growth. And even now, with demand in the advanced economies weak, some G-20 members still run tightly managed exchange rate regimes and intervene in the foreign exchange market to resist adjustment.

Such exchange rate regimes put an undue burden of adjustment on those emerging economies with market exchange rates. They contribute to the weakness of demand in the advanced economies. They intensify the risk of inflation and asset bubbles in those emerging economies with undervalued exchange rates.

China's real exchange rate has appreciated since June 2010 and China's current account surplus has fallen. To achieve a durable shift to sustainable consumption-led growth, it will be important that China implement needed structural reforms to boost household demand and move more rapidly to market determination of the exchange rate and interest rates.

As G-20 countries follow through on their recent commitment not to target exchange rates for competitive purposes, it is imperative that China take additional measures to increase the flexibility of its exchange rate regime. Last year the band was widened modestly and the full band was used for the first time. But intervention subsequently has risen. China's path toward market determination implies further widening along with significantly greater transparency about reserves and intervention.

Going forward, we will emphasize action to support domestic demand to ensure that the pursuit of growth within each country advances growth across countries.

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