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EXAMINING THE EUROPEAN DEBT CRISIS AND ITS IMPLICATIONS

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BEFORE THE

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SECOND SESSION

ON

EXAMINING THE EUROPEAN DEBT CRISIS AND ITS IMPLICATIONS

FEBRUARY 16, 2012

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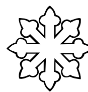

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EXAMINING THE EUROPEAN DEBT CRISIS AND ITS IMPLICATIONS

THURSDAY, FEBRUARY 16, 2012

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS
Washington, DC.

The Committee met at 10:05 a.m., in room SD–538, Dirksen Senate Office Building, Hon. Tim Johnson, Chairman of the Committee, presiding.

OPENING STATEMENT OF CHAIRMAN TIM JOHNSON

Chairman JOHNSON. I call this hearing to order. Today we will discuss an important and timely issue, the European debt crisis. As we speak, events are unfolding that will determine the future of Greece, its neighbors and the European Monetary Union.

As our largest trading partner and a vital strategic partner, events within the European Union also impact on the U.S. While I hope that the situation in Greece can be resolved in an orderly fashion, many nations across Europe, including Greece, will continue to face difficult and unique economic conditions and will have to make tough decisions.

Today, we will hear from the Treasury Department, the State Department and the Federal Reserve. Keeping the momentum going in our economic recovery is important to me and my constituents. I ask that these three agencies continue to monitor the situation in Europe closely to ensure any potential spillover effects in the U.S. are minimized.

I look forward to hearing an update on the situation in Greece, the impact of a possible agreement in Greece's fiscal situation and Greece's future in the euro zone. Second, in some European countries, we have seen resistance and upheaval in reaction to the debt crisis that could present obstacles for recovery. I would like your analysis of how the debt crisis is impacting the broader political situation in Europe.

Third, I would like to learn more about efforts to recapitalize European banks, the exposure the U.S. financial system may have to the ongoing turmoil in Europe and the strength of our banks to withstand any potential external shocks. Last, the IMF will continue to play a role in helping to find a solution for what's happening in Europe. I would appreciate your evaluation of the IMF's role in dealing with the debt crisis in Europe and how the U.S. has interacted with the Fund.

This hearing is an important part of this Committee's continued oversight efforts. Because of the Wall Street Reform Act and other

actions by the U.S. financial regulators, I believe that we are better equipped today to deal with any potential fallout from the euro zone's debt issues.

I thank our witnesses for being here today and appreciate the updates you can provide us on the situation in Europe.

Senator Shelby, your opening statement.

STATEMENT OF SENATOR RICHARD C. SHELBY

Senator SHELBY. Thank you. Thank you, Mr. Chairman. I welcome our witnesses today.

During the past year, the European Union has been embroiled, as we all know, in a fiscal crisis brought on by years of reckless Government and budget deficits and sluggish economic growth. The focus of the crisis has been on the relatively small economy of Greece, but the European Union Governments fear that it could quickly spread across the continent.

Other European countries are particularly vulnerable because of their own strained balance sheets. Portugal's debt to GDP is expected to exceed 111 percent this year. Italy's debt to GDP is about 120 percent. Meanwhile, economic growth in the euro zone has averaged between 1 and 2 percent for the last 10 years.

To contain the crisis, European leaders have taken a series of unprecedented actions. Most of these actions have required substantial backing by European taxpayers. EU leaders established the European Financial Stability Facility, which can borrow more than $500 billion from member States to loan money to countries at risk.

The IMF has also provided numerous loans to European countries. It recently bolstered a special lending facility with a capacity to lend another 500 billion. But because the U.S. is the single largest contributor to the IMF, this means that the U.S. taxpayers are probably on the hook for bailing out Europe.

In addition, the European Central Bank has stepped in with emergency interventions. The European Central Bank has purchased about 300 billion in risky sovereign debt and has provided more than 600 billion in 3-year liquidity to euro zone banks. But it looks like the bailouts and the backstops will not end there. European and IMF leaders have said there's a need for even more firewalls backed by hundreds of billions of dollars.

Despite all of these extraordinary actions, there remains a great deal of uncertainty about whether the EU has done enough to weather the crisis. I hope our witnesses today can provide an assessment of the crisis in how it is likely to play out over the next several months. Do they believe that Europe's response has been adequate, for example? Are there specific actions that they recommend be taken to stop the crisis from spreading? And given the global nature of finance, I think we should be under no illusions that our economy is somehow immune from the effects of the European crisis.

I hope that our witnesses will provide their assessments on how serious a threat the EU, the European Union, crisis is or could be to the U.S. economy. More importantly, I would like to know what they have done to protect U.S. financial systems.

If the crisis in Europe does spread to the U.S., are the financial regulators prepared and able to minimize its effect? In particular,

what has the Federal Reserve done to ensure, for example, that the U.S. banks have in place appropriate safeguards?

One of the lessons from the 2008 financial crisis was that regulators and policy makers need to take decisive and proactive steps to prevent manageable financial problems from growing into uncontrollable systematic shocks. Not only were the Federal regulators here too slow to react to the 2008 crisis, they were in some respects, coconspirators. I hope they will not be caught off guard again.

The fiscal crisis in Europe should also be a cautionary tale for this country. Europe's fate may be our own if we do not act aggressively to get our own house in order. The EU crisis shows that even advanced economies cannot avoid the consequences of excessive Government debt, high taxes and subpar economic growth.

The President's budget released this week contains the fourth year in a row of deficits over $1 trillion. And combined with the slowest economic growth in a generation, these deficits have caused our debt to GDP to soar from 40 percent to nearly 70 percent in only 4 years.

This is clearly an unsustainable path. I believe we need to get serious about controlling the Federal Government's debt while we still have the opportunity, otherwise, I believe we will share Europe's fate.

Thank you, Mr. Chairman.

Chairman JOHNSON. Thank you, Senator Shelby. Are there any other Members who wish to make a brief opening statement?

[No response.]

Chairman JOHNSON. Thank you all. I want to remind my colleagues that the record will be open for the next 7 days for opening statements and any other materials you would like to submit.

Now I will introduce our witnesses. The Honorable Lael Brainard is Under Secretary for International Affairs at the U.S. Department of the Treasury. The Honorable Robert D. Hormats is Under Secretary for Economic Growth, Energy, and the Environment at the U.S. Department of State. Mr. Steven B. Kamin is director of the Division of International Finance for the Board of Governors of the Federal Reserve System.

Under Secretary Brainard, you may proceed with your testimony.

STATEMENT OF LAEL BRAINARD, UNDER SECRETARY FOR INTERNATIONAL AFFAIRS, DEPARTMENT OF THE TREASURY

Ms. BRAINARD. Thank you, Chairman Johnson and Ranking Member Shelby. Thank you to the distinguished Members of this Committee for the opportunity to testify on the issue of recent developments in Europe and how we are engaging to limit risks to the U.S. economy.

The transatlantic partnership is an enduring cornerstone of our international engagement and alliances, as I know Bob will elaborate further. And our economic stake in Europe is immense. The euro area currently confronts difficult challenges of competitiveness, of fiscal sustainability, of liquidity.

We believe that Europe has the will and the capacity to manage these challenges effectively and it's extremely important to our recovery that they do so. Nonetheless, if the euro area were to experi-

ence a deterioration of financial conditions or further drop in growth, this would pose important risks to our recovery by reducing demand for our exports at a time when exports are more important than ever as an engine of growth.

With regard to our banking system, direct exposures of U.S. financial institutions to the most vulnerable euro area program countries are quite modest. As you know, banks have built thicker capital cushions and better liquidity buffers since our financial crisis, but our banking system still has material exposure to the core of Europe that could of course be impacted.

And finally, the globally connected nature of financial markets means that stress in European financial markets would be felt in the United States through reduced business and consumer confidence, reduced credit for small businesses and households, which would, of course, hurt our businesses, our jobs and also reduce the savings and the wealth of American families. So we have been very focused on engaging with euro area leaders as they confront these complicated challenges.

As you know, since the advent of the euro area, substantial and persistent internal imbalances emerged within the euro area with very large external deficits developing in countries such as Spain, Portugal, Ireland, Greece, offset by very large surpluses in countries like Germany. This reflected an underlying growing divergence and competitiveness.

Initially, of course, private savers were willing to finance those, but as they retreated in the wake of a sharp reversal of private flows and with internal exchange rate adjustment off the table and fiscal integration lagging far behind monetary integration, restoring sustainability now requires difficult and prolong adjustment.

The leaders of the euro area have pledged to do whatever it takes to stand behind the Euro and we believe they have the capacity and the resources to do so. It has been and will remain challenging to deliver on this pledge, of course, because it will require securing approval by 17 national parliaments for the major changes that are in contemplation.

For our part, in addition to the actions we've taken domestically to strengthen the U.S. economy, the President and Secretary Geithner and our entire economic team have worked tirelessly to underscore the critical need for quick and forceful action by Europe to restore confidence and combat contagion.

We have consistently emphasized a comprehensive four-part plan and need to address the root cause of the crisis with fundamental reforms to ensure European banks have sufficient liquidity and capital, put in place a more powerful firewall to stem contagion, and chart a sustainable path forward for Greece. They are making progress on all these fronts.

On reform, as you know, Italian Prime Minister Monti is laying the groundwork for a much more dynamic economy. Spanish President Rajoy is moving aggressively to address Spain's vulnerabilities, and the broader euro area is putting in place a fiscal compact.

The European Central Bank has taken critical actions, including lowering interest rates, providing liquidity banks and buying sovereign bonds in the secondary market. These actions, together with

the introduction of the 3-year long-term refinancing operation, have significantly eased pressures in bank funding markets.

Discussions on a successor program in Greece are ongoing, including discussions with private bond holders on a voluntary exchange. Greece has reduced its primary deficit, excluding interest, from 10.6 to 2.4 percentage points of GDP in 2 years, but it still has many reforms ahead.

Finally, and perhaps most critically, the euro area needs to strengthen its efforts to build a credible firewall to stem contagion and to assure that sovereigns undertaking difficult reforms have access to financing its sustainable rates. We look forward to the outcome of the assessment by European leaders on the adequacy of resources in their firewall at their next summit in March.

I would be happy to discuss any of these issues and the role of the IMF and any questions you might have. Thank you.

Chairman JOHNSON. Thank you. Under Secretary Hormats, you may proceed.

STATEMENT OF ROBERT D. HORMATS, UNDER SECRETARY FOR ECONOMIC GROWTH, ENERGY, AND THE ENVIRONMENT, DEPARTMENT OF STATE

Mr. HORMATS. Thank you very much, Chairman Johnson, Ranking Member Shelby, and Members of the Committee for inviting me to testify on the European debt crisis and its implications for the United States and for our relationship with Europe.

I am very much aware that in this whole area the State Department plays a sort of secondary and supporting role to the leadership of Secretary Geithner and Under Secretary Brainard, who have really been devoting huge amounts of time and attention and leadership to addressing this issue, and we very much support their efforts and have been very impressed by the amount of effort they have given to this overall subject.

It takes a lot of time, a lot of visits across the Atlantic and a lot of conversations. And Treasury has done an exemplary job in addressing these issues, but we do play a supporting role and I will try to discuss some of the areas that we are involved in.

During the political campaign, President, then Candidate Obama spoke in Berlin and made the point that America has no better partner than Europe, and that that is true today. Europe is, and remains, America's partner of first resort and its staunchest ally. The strategic alignment between the United States and Europe, rooted in shared history and values, has never been closer in addressing both international threats and internal challenges.

America, since the days of Presidents Truman and Eisenhower and Secretaries Marshall, Acheson, and Dulles, has recognized that a united and prosperous Europe is of enormous interest and importance—indeed vital importance—to the United States, and we have also recognized since the days of Jean Monnet and Robert Schuman that closer economic integration in Europe was an essential underpinning to a stronger Europe and its ability to be a robust ally to the United States. We understood then, as we do now, that a prosperous Europe was important and remains important for a prosperous America. It was in the 1950s when we supported the Marshall Plan, and it is today.

What I would like to comment on very briefly today are two things that we are working on, one, our transatlantic work toward a common agenda for economic growth and recovery primarily through what we call the TEC—the Transatlantic Economic Council, and the regulatory cooperation that it is engaged in.

The Transatlantic Economic Council, or TEC, established in 2007, led by the White House and the European Commission, engages senior European economic policy makers and our own economic policy makers to promote economic growth and job creation, in particular by addressing regulatory barriers and fostering innovation.

One of the highlights of the last meeting was a comprehensive work plan on electric vehicles and associated infrastructure. If the U.S. and the EU can together create compatible high quality transatlantic standards and regulations, our countries can encourage other nations to adhere to them and reduce the clutter of disjointed unilateral standards that impede trade and serve as protectionist devices.

We also have a U.S.–EU high level working group on jobs and growth. This is going to look at creative solutions to address ways in which U.S.–EU trade and investment relations can be even stronger than they are and promote growth on both sides of the Atlantic. We are quite aware that there are differences in some areas, but what we have in common, we share in common, is far greater than the differences that we have, and increased trade and investment on both sides of the Atlantic can produce growth in both of our regions.

Then let me now focus on just a few areas of foreign policy where we work together. We continue to cooperate with Europe to address challenges that confront both of us around the globe. On Iran, we see no evidence that Europe's economic crisis has made European Governments less willing to impose vigorous sanctions. On the contrary, since 2011, EU member States have moved to expand dramatically measures against the regime in Iran and indeed in Syria.

In Libya, NATO allies, together with Arab and other partners, work to support the Libyan people and prevent a major catastrophe. In Afghanistan, with nearly 40,000 European troops on the ground alongside our own, we have built and sustained NATO's largest ever overseas deployments, and we will continue to support the Afghans as they assume full responsibility for their own security by the end of 2014.

In Syria, the EU has joined us in steadily ratcheting up our pressure on the Asad regime.

On Russia, the United States and the EU worked together on the negotiations for Russia's accession to the WTO, which we think can enhance trade between all of our countries. We still have to address the issue of terminating the application of Jackson-Vanik to Russia, which will be discussed in various sessions to come. But we do look forward to working with this Committee on that, because we think increased trade with Russia can be another means to stimulate growth to growth on both sides.

So in conclusion, let me thank you very much for holding this hearing. We look forward to working with Members of the Committee, to supporting our colleagues in the Treasury in this very

important area, important from a financial point of view, important from an economic point of view, and because Europe is just a critical ally, extremely important also from a national security and a foreign policy point of view.

Thank you very much, Mr. Chairman, Ranking Member, and Members of the Committee.

Chairman JOHNSON. Thank you. Mr. Kamin, you may proceed.

STATEMENT OF STEVEN B. KAMIN, DIRECTOR OF THE DIVISION OF INTERNATIONAL FINANCE, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Mr. KAMIN. Thank you, Chairman Johnson, Ranking Member Shelby, and Members of the Committee for inviting me today to talk about the economic situation in Europe and the actions taken by the Federal Reserve in response to this situation.

In the past several months, European authorities have provided additional liquidity to banks, bolstered bank capital requirements, developed rules to strengthen fiscal discipline, and explored means of enlarging the euro area financial backstop. Stresses in financial markets have eased, but these markets remain under strain.

The fiscal and financial strains in Europe have spilled over to the United States by restraining our exports, depressing confidence and adding to pressures on U.S. financial markets. Of note, foreign financial institutions, especially those in Europe, have found it more difficult to borrow in dollars. These institutions make loans to U.S. households and firms, as well as to borrowers in other countries to use those loans to purchase U.S. goods and services. Thus, difficulties borrowing dollars by European institutions may make it harder for U.S. households and firms to get loans, and for U.S. businesses to sell their products abroad. Moreover, these disruptions could spill over into U.S. money markets, raising the cost of funding for U.S. financial institutions.

To address these risks to the United States, on November 30th, the Federal Reserve announced jointly with the European Central Bank, or ECB, and the Central Banks of Canada, Japan, Switzerland, and the United Kingdom that it will revise, extend and expand its swap lines with these institutions. The measures were motivated by the need to ease strains in global financial markets, which if left unchecked could impair the supply of credit to households and businesses in the United States and impede our economic recovery.

Three steps were described in the announcement. First, we reduced the pricing of the dollar swap lines from a spread of 100 basis points over the overnight index swap rate to 50 basis points over that rate. This has enabled foreign central banks to reduce the cost of dollar loans they provide to foreign institutions in their jurisdictions. This, in turn, has helped to alleviate financial strains in the global economy and put foreign institutions in a better position to maintain their supply of credit, including to U.S. residents.

Second, we extended the closing date for these lines from August 1, 2012, to February 1, 2013, demonstrating that central banks are prepared to work together for a sustained period to support global liquidity conditions.

Third, we agreed to establish swap lines in the currencies of other participating central banks. These lines would allow the Federal Reserve to draw foreign currencies and provide them to U.S. financial institutions on a secured basis. U.S. financial institutions are not experiencing any foreign currency liquidity pressures at present, but we judged it prudent to make such arrangements should the need arise in the future.

Information on the swap lines is fully disclosed on the Web sites of the Federal Reserve Board and the Federal Reserve Bank in New York.

I also want to underscore that the swap transactions are safe and secure. First, the swap transactions present no exchange rate or interest rate risk because the terms of each drawing or payment are set at the time the draw is initiated.

Second, each drawing on the swap line must be approved by the Fed, providing us with control over the use of the facility. Third, the foreign currency held by the Fed during the term of the swap provides an important safeguard. Fourth, our counterparties are the foreign central banks, not the private institutions to which the central banks lend. The Fed's history of close interaction with these central banks provides a track record justifying a high degree of trust and cooperation. Finally, the short tenor of the swaps means that positions could be wound down relatively quickly were it judged appropriate to do so.

Notably, the Fed has not lost a penny on these swap lines since they were established in 2007. In fact, fees on these swaps have added to the earnings that the Fed remits to taxpayers.

To conclude, since the changes we made to our swap line arrangements, the amount of dollar funding through the swap lines has increased substantially and measures of dollar funding costs have declined. Ultimately, however, a sustained further easing of financial strains here and abroad will require European authorities to follow through on their policy commitments in the months ahead. We are closely monitoring events in Europe and their spillovers to the U.S. economy and financial system.

Thank you again for inviting me to appear before you today. I will be happy to answer any questions you might have.

Chairman JOHNSON. Thank you. I would like to thank all of our witnesses for their testimony. As we begin questions, I ask the clerk to put 5 minutes on the clock for each Member.

This is for all the witnesses. What are the major sources of risk from the euro zone crisis for the U.S. economy? What are you doing to ensure our financial institutions and markets are prepared for these risks and to ensure that the crisis does not spill over to the U.S.?

Under Secretary Brainard, let's start with you.

Ms. BRAINARD. Thank you, Mr. Chairman. With regard to sources of risk, I think you can divide them into three basic categories. First, of course, is direct exposure of our financial system. Two, the financial system of Europe, and they are—I think Chairman Bernanke has testified, and perhaps Steve can elaborate further, but our banks are in much more resilient positions today than they have been 2 years ago due to much stronger capital buffers, better loan loss reserves and stronger liquidity buffers.

Direct exposures to what is termed the periphery, the smaller program countries, is really quite modest. But exposures to the core of Europe and simply the large size of the European financial system and the overall system means that we still are monitoring those exposures. Our supervisors are monitoring those exposures very carefully and for us at the U.S. Treasury, our first priority remains preventing the deterioration of conditions in Europe.

The second broad channel of exposure, if you will, is through our extensive trade linkages with Europe. Europe is the second largest euro area in Europe, more broadly. It is the second largest economy in the world. We have 15 percent of our exports going to Europe, and as you know, many of your States have higher percentages of exports, counting for hundreds of thousands of jobs that are going to Europe.

And, of course, the third channel of transmission is through broader financial market volatility and we have seen that has abated somewhat in recent weeks, but we saw in the fall of last year that as financial market volatility rose in Europe, that transmitted here in the form of greater risk aversion. It can transmit through lesser credit availability through reduced consumer confidence, through reduced consumer spending due to declines in wealth.

And so the three sets of transmission channels are very powerful, which is why we spend so much time focused on the first best strategy, which is helping our European partners to put in place the requisite reforms which we think they have the capacity to do, the will to do, to ensure that the euro area is on a sustainable path going forward. And we have seen a number of very important steps in recent months in that regard.

Chairman JOHNSON. Under Secretary Hormats, do you have a comment?

Mr. HORMATS. No, I would just simply say that I think what Under Secretary Brainard said is quite in keeping in sync with the kinds of observations that we have made too. The Treasury has taken the lead in this and I think her analysis is exactly right.

Chairman JOHNSON. Mr. Kamin, do you have a comment?

Mr. KAMIN. Sure, I would like to add and amplify just a little bit on the comments that Under Secretaries Brainard and Hormats have mentioned.

First of all, the first thing to mention is that certainly an important line of defense is the actions being taken by European policy makers to resolve the situation. They understand the seriousness of it. They understand the risk that could be posed both to their own economy and to the global economy, and as we have mentioned in our testimonies, they have taken a large number of steps to address their problems.

That said, certainly over the past year or so there have been numerous spillovers to the U.S. economy, and those could become more pronounced were the situation to deteriorate. As Under Secretary Brainard has mentioned, the first and most obvious channel of influence has been that trade with the European economy has been weighed down by its troubles. They have purchased less of U.S. exports and that has been an important consideration weighing on U.S. recovery and jobs.

Another factor that is more amorphous, but probably important, is the fact that this turbulence in Europe has led to some declines in confidence, both in the business and the household sector, and that undoubtedly has had important effects.

And then finally on the financial side, there is really quite a host of different channels that link our two regions and these are ones that Under Secretary Brainard has mentioned, but just to repeat, the direct exposure of U.S. financial institutions to the most embattled Governments in Europe is relatively small and manageable. But our institutions do have exposures to banks in core Europe, those outside the periphery—which themselves are exposed to the peripheral Europe, and that is an important issue of concern.

Another one is the fact that our money market funds, which again have substantially reduced their exposures to the peripheral European economies and have reduced to some extent their exposure to core Europe, nevertheless retain material exposures.

And then finally, I think it's very important to underscore in this situation that a lot of the channels of spillover from Europe to the United States may occur less by impacting direct credit exposures than through more amorphous channels of financial sentiment.

What we have seen is that in situations where the European financial situation has deteriorated, that has triggered a retreat from risky assets around the world, leading to declines in stock prices, increases in credit spreads and reductions in the availability of credit. And all those factors have played a role and could play a more pronounced role were the situation to worsen.

So now in terms of the responses of the Federal Reserve and other regulators have made, well first of all, most prominently, as I have mentioned in my testimony, the swap lines that we provided and reduced the cost of have been one way that we have been able to channel dollar liquidity to European and other institutions.

Along with that, we have been keenly aware of the need to increase the resiliency of the U.S. financial system to all manner of shocks, including debt from Europe, and thus, we have been working, as Under Secretary Brainard has mentioned, with our banks to improve—to increase their capital positions and improve their risk management practices.

Along those lines, we have been working with the banks we regulate on ongoing stress tests to make sure that their risk management systems are up for the chance of handling some pretty severe shocks.

Thank you.

Chairman JOHNSON. Under Secretary Brainard, Secretary Geithner has said that the U.S. has no plans to provide additional resources to the IMF, as evidenced by the absence of—or question the President's current budget proposal.

What is the role of the IMF and the ongoing crisis in Europe and the role of the U.S. in the IMF?

Ms. BRAINARD. I want to say just first that we believe that the IMF has been playing and should continue to play a constructive role in support of Europe's own efforts to address the crisis in the euro area. The IMF brings to the table unsurpassed technical expertise. It brings to the table tremendous credibility in assessing the viability of countries' reform programs. And in the three pro-

gram countries it has provided a minority share of financing, and we think that is appropriate.

But while the IMF should continue to play a constructive role in Europe, we believe that IMF resources cannot and should not be a substitute for a strong European firewall and we have been very clear that we do not intend to seek further funding for the IMF from Congress this year.

Chairman JOHNSON. Senator Shelby.

Senator SHELBY. Thank you. I would like to get into the condition of some of the banks in Europe. You alluded to it. I think it is common knowledge that most of the banks in Europe, the big banks, are undercapitalized and they are having trouble—they will have trouble meeting the Basel III mandate and so forth.

What has the European Bank done? Have they loaned money to these banks for their capital? What have they done, a 3-year loan? Explain what they have done there.

Mr. KAMIN. Well, there have been a number of actions that have been taken by European authorities in order to address the situation of the European banks.

Senator SHELBY. Can you speak into the mike just a little?

Mr. KAMIN. Oh, I am sorry. So, to begin with, as you mentioned, the ECB has stepped up their provision of lending to these banks and these are the actions that have garnered the most attention recently——

Chairman SHELBY. Is that a 3-year loan?

Mr. KAMIN. Yes. Originally, they started off offering loans of shorter maturities, working up to a year. And they found that the uptake on those loans was not great, or as great as they might have anticipated, and then in December they announced that they would offer, at least to start, two auctions of 3-year loans that were basically at their main refinancing rate of interest, which is currently around 1 percent, although that rate could move up over time.

So when they offered that auction later in December, they basically received substantial bids and ended up lending 489 billion Euros, which is a very substantial amount. And that action, along with the other actions being taken by European authorities, appears to have been very helpful in alleviating the immediate funding pressures that were facing European banks.

Now, offering liquidity is not the same thing as recapitalizing the banks.

Senator SHELBY. Two different things.

Mr. KAMIN. Those are different things. And so the European authorities have on a parallel track taken a number of measures to improve their capital positions as well. Most prominently, a little bit earlier in the fall, the European Banking Authority set out a requirement that all European banks would be required to achieve a 9 percent of core tier one capital requirement.

Senator SHELBY. In what year will they be required to do that?

Mr. KAMIN. That will need to be met by the middle of this year. And they have already been required to submit plans to the EBA, European Banking Authority.

Senator SHELBY. Where is that capital going to come from?

Mr. KAMIN. Well, that is an excellent question and one that created a lot of concern among markets because there was a lot of fear that the way that capital ratio would be achieved is through deleveraging, selling off assets, maybe reducing loans, and thus, making the recession worse.

In the event—so December 1st, the EBA estimated that the amount of capital that would be required by the banks would come in somewhere in the neighborhood of 115 billion Euros, which is a substantial, but not exorbitant sum. More recently, after having received capital plans from a broad range of European banks, their assessment was that the broad bulk of the capital raising would not come through deleveraging *per se,* but through other measures, to increase capital, such as retained earnings and the like. And that is kind of where things stand at the moment.

Senator SHELBY. You are not telling us here today that the European banks are in good shape though, are you?

Mr. KAMIN. Since we do not regulate and supervise those banks, that is a difficult—I would not want to go that far. I am only explaining how things have been proceeding. I take the point that the health and position of European banks is an incredibly important part of revealing confidence in the euro area institutions more generally, and so obviously that situation is one we are monitoring very carefully.

Senator SHELBY. How many of our big banks regulated by the Federal Reserve here are exposed in Europe? We have seen other data up here that shows more exposure than has been said here today, not just to Greece, but to Portugal, Spain, and so forth.

Mr. KAMIN. I am not in command of the specific numbers on a bank by bank basis. Obviously——

Senator SHELBY. Can you get that information to the Committee?

Mr. KAMIN. I would have to consult with my colleagues. That seems like——

Senator SHELBY. In other words, that would be a decision for the Federal Reserve?

Mr. KAMIN. I would think so. So I would have to consult with my colleagues on the issues of the——

Senator SHELBY. Wouldn't you think they would be wanting to share this with the Senate Banking Committee?

Mr. KAMIN. I would think that they would want to. I would want to obviously consult among others with our Counsel.

Senator SHELBY. Secretary Brainard, tell me exactly what the IMF is doing? We are the largest contributor to the IMF, the American taxpayer. Are they using the IMF as a bailout of Europe? Isn't that what they are really doing, underlying all of this? That is what a lot of people think. And if they are not, explain why not.

Ms. BRAINARD. Senator Shelby, it is a good question. I think you are right; there is a lot of misimpression out there——

Senator SHELBY. A lot of concern.

Ms. BRAINARD. ——about the IMF's role. I think what we believe is that by virtue of being the largest shareholder in the IMF, we have a very unique ability to influence policies and reforms that are being undertaken in crisis-stricken countries and that ability to shape those outcomes——

Senator SHELBY. Does that include the European Union?

Ms. BRAINARD. Including in some of the euro area countries that have gone to the IMF, Greece, Portugal, Ireland. And that matters to us because, of course, as we have just been saying, the spillover to our economy could be quite large. And so it is very important for us in order to protect our recovery at a fragile time and to protect our jobs.

The primary role that the IMF is playing as a partner to the European area institutions is helping to create viable programs, helping countries commit to and undertake reforms that will fundamentally address the problems of slow growth, lack of competitiveness, that dog them for the years leading into the crisis. And we think the IMF brings unparalleled credibility to that task and unparalleled technical knowledge.

The role that the IMF plays and the role of the U.S. in the IMF give us an ability to shape outcomes in Europe that we would not otherwise have, and I think that is why in 2009, Congress moved very rapidly to provide support for the IMF's actions that were really pivotal in turning around the global economic crisis and helping to protect our recovery.

We continue to think that the IMF's role in Europe and our role in the IMF are very protective of American national interests, even as we believe the IMF has adequate resources, and that we do not see any need for the U.S. to provide additional resources to the IMF at this time.

Senator SHELBY. Quickly, my time is running out. Secretary Hormats, how can the European Union stay together when you have productive countries that work until they are nearly 70 years of age, like Germany, and others, and save and so forth, and you have a lot of other countries that borrow and borrow, do not save, do not produce; how can they stay together?

A lot of people think the European Union as we know it cannot stay together; it will not work.

Mr. HORMATS. Well, two points. One, as I mentioned in my testimony, it is very important from an American point of view, we have encouraged over the course of decades a more united, more cohesive Europe. So the economic unity of Europe is very important to us.

The second point relates to the direct question you have asked, and that is, as Lael has pointed out, the United States is doing a great deal to work with these countries to help them support the kinds of changes they need from a financial point of view. But it is very much up to them to address, particularly those that are least competitive, their competitive challenges.

Money alone is not the answer. It can get them over this period. However the issue of competitiveness has to be addressed, but it is not easy to address. I do not want to create any impressions that it is. But many of these Governments understand that a fundamental problem, even aside from the financial part, is their lack of competitiveness, vis-a-vis countries in Northern Europe and indeed very competitive countries elsewhere in the world.

So what they need to do is make changes like reforms in their labor markets and other reforms that will enable them better to compete on this world stage with other countries in Europe and other countries around the world. And they need to take the time

that they are going to be able to get through the kind of support that they are receiving, or in some cases are about to receive, to make fundamental changes.

That will depend on political leadership, explaining to the people in these countries that they cannot continue to operate in a global economy that is becoming more and more competitive unless they change their institutions, their practices, in some cases, their psychology, to be much more competitive in this global environment.

This is a challenge. Certainly it is a challenge for the Greek Government. It is a challenge for other Governments. Prime Minister Monti has addressed this in a very forthright way since he has come into office—to explain the need for the Italian people and the Italian Government, the Italian system, to become more competitive. The Government of Spain has made similar statements to its own people, the Government of Ireland, indeed many others.

So competitiveness is very important. If you look at Germany, they have done a lot of things over the years to make their labor force more competitive, and their business environment more competitive. And it is very doable, but it is very difficult and it requires political leadership and a recognition by citizens of these countries that money alone is not the answer. They have to make very serious domestic changes to be more competitive now and into the future, and start the effort right away and make it a national commitment. Without that, their competitiveness simply will not rise to the requirements required in this more competitive global environment.

Chairman JOHNSON. Senator Reed.

Senator REED. Thank you very much, Mr. Chairman. Secretary Brainard, have you an operational plan for the worse case that has been staffed and game planned out with you, Treasury and the Federal Reserve? Have you gone down to that level of planning for the possibility? And this is all in the wake of thinking back a few years when some people thought that the system could absorb the Lehman bankruptcy and that they could not.

What level of planning have you undertaken?

Ms. BRAINARD. Well, Senator Reed, I think that having just been through a very fundamentally disruptive financial crisis of our own, we are aware of how quickly market dynamics can shift the channels of transmission through which contagion can spread, and the absolute need for a proactive and decisive action.

We have, of course, along with our colleagues on the Financial Stability Oversight Council, which has repeatedly and continuously looked at events in Europe with a view to protecting our economy, so we have tried to, as deeply as possible, understand the potential sources of instability in Europe and to provide the best possible advice through many channels of communication through the various decision nodes in the euro area system.

So we are working with the Fed—and I am sure Steve can comment on this as well—as with other members of the Financial Stability Oversight Council, and we are trying to both understand in as much detail as possible potential exposures, potential vulnerabilities, trying to be as proactive as possible in sharing our views of what is most effective in preventing a further deteriora-

tion, and of course, trying to put in place policies and mechanisms that will be protective of our system.

Senator REED. Let me ask in a slightly different way before I ask Mr. Kamin, which is, you made a point that I think is very important, is that one of the things the Europeans have to do, regardless of whatever happened to Greece, is create a firewall, several different policies, techniques, institutional arrangements.

Are we likewise, in an abundance of caution, thinking in terms of what firewalls we might have to have in place should there be a serious deterioration in Europe?

Ms. BRAINARD. Well, in the wake of the Dodd-Frank Act and a number of changes that were made in response to the financial crisis, we are, obviously, and the Financial Stability Oversight Council is keeping very close tabs of what capacities we have to respond to crises.

This Committee is more familiar than anybody with the kinds of capacities that each part of the financial supervisory and policy making authorities have to both prevent and respond to crises. And so we have made sure to be both very aware of what possible contingencies could arise and the mechanisms that we have in our system to again protect our recovery, protect our financial system, protect our jobs.

Ms. REED. Mr. Kamin, your comment, one point you might mention, because my time is dwindling down, where you talked about the transmission mechanism. One of the most difficult to gauge is the derivatives, the exposures by American institutions to counterparties that might have exposures in Europe.

Do you feel that the Federal Reserve has detailed information on those types of indirect exposures which became very critical in the 2008 crisis, particularly in the context of AIG; I don't have to remind you?

Mr. KAMIN. Thank you, Senator. So first of all, I will underscore the points that Under Secretary Brainard noted, which is that, you know, several of the regulatory agencies under the auspices of the FSOC are obviously very alert to all manner of risks that could affect the U.S. financial system, and obviously we have taken very close look at Europe and we are monitoring debt very closely and giving thought to the broad range of policies that could be undertaken in response.

With that said, it is important to underscore the very first line of defense against any type of shocks is to make sure that the financial system is very resilient. And that is why we have been working so closely with the institutions we regulate, not only to make sure that their capital and liquidity positions are well buffered, but also to ensure that their own risk management systems are well calibrated to deal with any manner of very large shocks.

So that is a very important focus of our attention. Obviously, as you point out, derivatives exposures are very important and we have been working, talking very closely with the banks to look at their derivative exposures, and to ascertain that they are within appropriate limits and that there are not concentrations of derivative exposures in the system so that we do not have a repeat of

some of the unwelcome developments that took place during the last financial crisis.

Senator REED. Thank you. My time is up.

Chairman JOHNSON. Senator Corker.

Senator CORKER. Thank you, Mr. Chairman, and I thank each of you for your testimony. I saw the two secretaries recently, I guess, at a meeting with a lot of European officials and while a lot of times we—sort of the main Europe in many ways for being a dollar—a day late and a dollar short, I get the sense they may actually do the things they need to do to work through this and I think there is a strong commitment to that and certainly hope it happens.

And candidly, they are beginning to address many of the issues that we in our own country are not yet willing to address and I know that is because they are in a crisis mode. We are not yet in that crisis mode, but moving there fairly quickly. But I appreciate your leadership in that regard.

Secretary Brainard, I very much appreciate the stance you all have taken with the IMF. I know there are a lot of concerns up here about maybe additional requests, but I think the way you have handled the IMF has caused them to have to focus on Europe, solving Europe a little bit more, and I think any time they feel there may be additional funding coming, it may lessen the degree of strength they have behind what they are trying to push Europe to do. So I thank you for that very much, in clearing up today that again, that there is going to be no request.

And Director Kamin, on the swap lines, I know there have been concerns there, but I think people realize now that when you swap, you unwind that swap at exactly the same rate you entered into it. They are short term. The European Central Bank is behind that, and then all the countries, and I think people realize now that there is probably less risk involved in that than they first thought.

The one thing I would like to focus on though is there is—the issue of issuing credit in Europe is still a problem. And we watch each week as the various countries issue debt and see whether it has cleared. And yet there is wide concerns being issued by foreign Governments about a rule that we put in place, the Volcker Rule, because they realize that there is going to be a lot less liquidity in their own currencies—in their own debt, excuse me.

You know, I was not a proponent of Volcker Rule. I did not think there was any reason to pursue it, but I do think there is a way to fix the Volcker Rule and move away from the prop issue and focus on at least maintaining liquidity. A lot of foreign Governments have been concerned that we selfishly, self-centeredly allowed treasuries and mortgage-backed securities to be excluded from the Volcker Rule, which I think gives a pretty good indication that our Treasury secretary and our Fed chairman did not think the Volcker Rule as written was a very good idea.

But is there a way that you think we could fix the Volcker Rule so that we do not create a lack of liquidity for these foreign Governments that are very concerned about our relationship with them in that regard now?

I will start with you, since you are with Treasury.

Ms. BRAINARD. Well, we are—we have received, of course, the supervisor agencies that are undertaking the rulemaking. Also received foreign comments, as well as domestic comments on the potential impact of the Volcker Rule and consistent with our statutory responsibility to coordinate the rulemaking process, we have helped arrange discussions between the independent rule rating agencies and foreign Governments to express those concerns.

Our general view, of course, is that there is currently a public comment period that has been extended for purposes of receiving comments.

Senator CORKER. Let me ask it a little differently——

Ms. BRAINARD. Yeah.

Senator CORKER. ——so I can get an answer before the time runs out. You think there's a way that we can cause the Volcker Rule to be altered so that the market making components that are very valuable to these foreign Governments that are issuing debt can continue? Yes? No?

Ms. BRAINARD. The statute, as you know, exempts U.S.——

Senator CORKER. I have already stated that, right.

Ms. BRAINARD. ——sovereigns and does not exempt foreign sovereigns. I think I would really have to hand it over to the rulemaking agencies, who are probably not yet in a position to comment on it, to talk about how their rulemaking comments——

Senator CORKER. Well, let me go there, since we are running out of time. Thank you so much. I appreciate it.

Mr. Director, do you think there's a way to craft the Volcker rules so we do not have this unintended consequence, although I think for some people it was intended, but the unintended consequence of causing debt by foreign Governments to become illiquid, along with corporate bonds and everything else in that category?

Mr. KAMIN. Senator Corker, we appreciate the difficulty of this issue and we have certainly received the comments from foreign Governments on that. My colleagues at the Federal Reserve are carefully considering these issues and we are working on it further.

Senator CORKER. I appreciate the nonanswers that I have received and I think that does speak to the difficulties of it and even though you gave me a nonanswer, I thank you for your service.

Chairman JOHNSON. Senator Bennet.

Senator BENNET. Thank you, Mr. Chairman. And I want to thank all of you for your service, as well and for being here today.

I want to pick up on what Senator Corker's initial observation was, to ask you to give us a better sense of the domestic politics in these countries. You know, looking at—you mention, Madam Secretary, that in the end 17 parliaments are going to have to ratify these changes. For all I know, in some cases there are going to be popular referenda.

I wonder if you get a sense of what the timeline is for when that work has to be accomplished, but also what the equities are that people are wrestling with over there between the need for posterity and fiscal responsibility, the need to get these economies moving again. Because in my limited experience here, what I have come to understand is how incapable we have been of addressing the fiscal challenges that this country is facing.

I can only imagine how complex that is when you are talking about all of these countries in Europe. And then a follow-on would be how do they view our current wrestling match, or lack of a wrestling match around solving our own fiscal problems here?

Anybody that would like to take any of that.

Ms. BRAINARD. Well, I think that the deadlines, the timelines that the Europeans have set themselves on, things like the fiscal compact, are quite tight. They need to get through a number of votes over the next few months in order to stand up the new permanent crisis response fund.

They will also need to take a number of parliamentary votes over the next three to 4 months. And then as you say, national parliaments also have to put in place the requisite fiscal reforms and structural forms. The structural forms are in many cases the more difficult and the more controversial in countries that have really seen a fundamental deterioration of competitiveness over the last decade or so.

I think if you look across Europe, we, of course, recognize that political changes are slower than markets and so I think we all would like to see it move faster, but the truth, that there have been very remarkable strides forward in a very short period of time.

If you look from Italy to Spain, if you look at the kinds of changes that the German Bundestag has needed to approve, these are difficult votes, as you know, from our votes here in the U.S. on the various mechanisms needed to address the financial crisis. And so we have to, I think, give them a great deal of credit for the actions they have taken.

With regard to the U.S., I would say that the challenges faced by Europe are fundamentally in many respects different from those faced by the United States. Europe went into a monetary union with incomplete fiscal institutions and really no mechanisms for undertaking internal transfers and probably inadequate product market, labor market mobility to be able to withstand this kind of reversal of sentiment, and they are now working very diligently on those challenges.

The United States, in many regards, we have a unified Government. We have a very effective and credible central bank. We saw a lot of collaboration, moved very quickly to address problems in the financial system with support from Congress during the crisis. We have seen our financial system come back very quickly, but we should not allow those advantages to lull us into a false sense of complacency, and that is why the President wants to work with Congress to put the Nation on a fiscally sustainable path.

We still need to protect our economy as an insurance policy, in particular against potential spillover from Europe, and that is why the payroll tax cut, the unemployment measures were so important in the short run, but by the same token, getting our debt down, getting our deficits down over the medium run are critical to the long-term competitiveness of America.

Mr. BENNET. Thank you. Mr. Secretary, do you have anything you would like to add before time runs out here?

Mr. HORMATS. I will be very quick. Just to focus on the structural adjustment point that you mentioned. I do think that is one of the things. In the midst of all the other financial discussions

that have been going on, there needs to be, now that some progress is being made at least on some aspects of that, a lot of focus on the structural changes to improve their competitive capabilities and to improve the structure of European cooperative institutions in order to work together to deal with some of the longer term fiscal problems that Europe has. It was sort of an incomplete union and now they have to take a number of measures to complete it, to strengthen fiscal cooperation in Europe.

And each of these individual countries, the ones that have gotten into trouble, in large measure it is in part because of their large amounts of borrowing, but in part because they really did not do enough to strengthen their competitive capabilities and therefore, they fell further and further behind, which meant they had to resort more and more to borrowing.

To the degree that they can strengthen their competitive capability and do better in terms of earning more in international markets and improving the competitive capability of their workforce, they will be less dependent on the kinds of programs that got them into this problem, and the kinds of financial flows that got them into this difficulty in the first place.

It takes time, because each one of these requires a measure of pain and requires a measure of political sacrifice. But the longer term consequences of their not making these sacrifices internally will be even worse and more painful than the short-term difficulties they may have in getting over this period.

So they may have to sacrifice some short-term pain in the near term to improve their longer term outlook.

Senator BENNET. I think much could be said about that here.

Mr. HORMATS. Many countries one can say that about, but I think you have to have a longer term vision and the political process has to come together in these countries. And I think Greece, for instance, is one example. In Italy and many others the political system seems to realize that they have to pull together to tell people that some tough measures need to be taken in the short term in order to improve things in the long term. And if they do not take the tough measures in the short term, things will only get worse in the long term.

Even if they do get more money, without such measures they will get worse because the money will not buy them fundamental answers to their fundamental competitor problems.

Senator BENNET. Thank you, Mr. Chairman.

Chairman JOHNSON. Senator Merkley.

Senator MERKLEY. Thank you, Mr. Chair.

Director Kamin, you were talking about—looking at the banks and looking at the concentration of credit default swap exposure and funding, there was no significant concentration that poses any—I think it was appropriate or within appropriate boundaries. You were speaking to U.S. banks in that commentary, I believe.

Have you looked at the exposure of the major banks in Europe to the credit default swaps? I'm speaking specifically about swaps on Spain, Portugal, Ireland, Italy, the big five.

Mr. KAMIN. We obviously do not have quite as much information about those as we do about our own institutions, so I cannot speak definitively on that.

Senator MERKLEY. Let me put it—so the answer is no?

Mr. KAMIN. I do not know.

Senator MERKLEY. You do not know?

Mr. KAMIN. I do not know. I do not know of any particularly market concentrations of CDS exposure among European banks that would pose a threat, but I cannot at the same time discount the possibility.

Senator MERKLEY. So the answer is you do not know?

Mr. KAMIN. The information we have is fragmentary and so I would not want to rely on that heavily.

Senator MERKLEY. So the answer is you do not know.

Mr. KAMIN. It is something in between that.

Senator MERKLEY. OK, well, every other expert said we do not know, so if the Fed has special insight to share with the world on this, it would be helpful. And your comment is it is fragmentary, we are not sure, but we are not too worried; is that what you are trying to convey?

Mr. KAMIN. Well, I think maybe I will retreat back to I do not know.

Senator MERKLEY. OK. OK. Thank you. As we look at this issue of these swap lines with the European banks, and essentially we are putting out the short-term swaps of dollars for Euros, what kind of timeline are those on? Do those happen on a daily basis, a weekly basis, what kind of period before the swap returns?

Mr. KAMIN. The auctions are weekly. The terms vary, but there is the usual maturities at 1 week and 3-month. Those are where a lot of the preponderance is.

Senator MERKLEY. So do we find ourselves in a situation we are essentially rolling that over pretty continuously? Because if we do not roll it over, there is a charge of dollars on the European side. That is a challenge. So even if they are short term, if they are being rolled over, they create kind of a long-term engagement.

And the question I want to raise here, do we end up in a situation where essentially if the Euro falls and they are in a hell of a spot if we do not continue the swaps, so it really kind of becomes a long-term commitment on a risky currency?

Mr. KAMIN. Well, as I pointed out in my testimony, we do—the Federal Reserve does have the option of basically approving drawings as they are made on a weekly basis and this gives us the security that if we foresee events down the road which are problematic, that we could wind down these positions.

And the situation that you alluded to, that will be the decision for the FOMC. It would have to address that as the situation came up and a lot of issues would come to play like the ones that you have raised.

Senator MERKLEY. But there is risk that as we try to unwind those positions that we accentuate the crisis and it is a hard thing to manage. It is a challenging picture.

Mr. KAMIN. Well, one most likely way that those positions are unwound is the way that they were unwound after the last crisis, which is that after the crisis eased and banks found other means of funding themselves, more attractive than swaps, then they went ahead, repaid the swaps and the lines unwound automatically.

Senator MERKLEY. I thought I would turn—I thank you very much. I thought I would turn to the Volcker Rule since my colleague from Tennessee brought it up, and just clarify market making. There is absolutely no restriction on market making. That is not the issue the Europeans are raising. They are not raising the market making. They say we want the banks to be able to use their considerable assets to invest in these products, that is, to invest the same way IMF Global invested.

The question of the Volcker Rule is are we going to allow that proprietary trading inside the structure of a repository lending institution, or are we going to put up a firewall and say you got to do it on the other side of the firewall? So since you all didn't clarify that for my colleague, I thought I would clarify it, and if I am wrong, please, I will open up the panel and have someone explain how it works otherwise.

Please, Madam Secretary.

Ms. BRAINARD. As you know, we strongly support the overall thrust of the rule, which is to ensure that the safety net is not extended to activities for which it was never intended, and prop trading, of course, is among those activities.

I think the comments from foreign authorities have gone to the compliance costs of making those distinctions. And again, I think those rules are sitting with the rulemaking agencies who are taking them into account in their rulemaking process.

Senator MERKLEY. Thank you. Thank you all.

Chairman JOHNSON. Under Secretary Brainard and Under Secretary Hormats, what effect will the austerity measures have on economic growth within Europe, especially Greece?

Ms. BRAINARD. Mr. Chairman, the measures that Greece is undertaking, both on the fiscal side to run a primary surplus within a short number of years, and on the structural side to vastly increase its competitiveness, will over the medium term put Greece on a stronger path of growth, a more dynamic economy and an economy that is less saddled with debt.

The short run, however, is very daunting for the Greek people and they continue to be, from everything we have seen, very committed to the euro area. But I think, of course, these are very difficult reforms that they are undertaking. And we support the euro area as it works to support Greece during the period that those reforms are being put in place.

More broadly, we think there is some space within the euro area for some countries to support growth, and that that would help ease the impact on growth of the reforms that are being taken in the countries that most need to address external imbalances and fiscal imbalances. There has been some talk by European leaders about a growth agenda, but again, I think we think there is more scope in the short run for the internal dynamics of the euro area to be eased somewhat by stronger growth in the surplus countries.

Mr. HORMATS. I would agree with Lael. I would just like to add one point to this and that is that we, over countless years, have seen countries go through very severe adjustments when they get into balance of payments, difficulties of the kind that a number of European countries are facing today, and they take very severe measures to get out of them.

But over a period of time, and you can point to examples from Indonesia to South Korea to Turkey to a number of other countries, of countries that have gone through very difficult adjustment periods and have done two things. One, they have gone through the financial part of the adjustment, but two, they have used the period of time that they have had as the result of getting support from other countries to make very substantial internal changes that have enabled them to be far more competitive and to have far stronger economies and indeed to have higher rates of growth than they had going into the crisis.

And I think that while in Greece there are demonstrations and there are a great many concerns now, if you look at the record of countries that have undertaken very tough adjustment programs and done them well and used the time to be more competitive, their growth rate and their ability to create jobs over the medium term has been quite impressive, and therefore, while we look at this troubled environment today, the prospects of doing the right things with support from Europeans and others and making the internal changes can lead to higher growth and job creation over the medium and longer term.

Other countries have done it. We have seen this in various parts of northern Europe and we can see it again if they do the right kinds of things.

Chairman JOHNSON. Senator Shelby.

Senator SHELBY. Thank you. You know, we talk about all the time of rescuing this country, of rescuing this bank or rescuing a lot of banks by loaning them money, so to speak, or loaning this country more and more money, money that will probably never be paid back, for example, Greece, and they are not by themselves. I think of ourselves. That money, Greece can't pay that money back. There is no way to pay it back, I mean unless they appreciate their currency, and they cannot do this with being in the European Union. I think a lot of economies are of that opinion.

What bothers me here, or maybe this is a concern me—will we, we in America, learn anything from the European crisis? Because we are going down the same road, debt, politics of expectancy, you know, promising more than we are paying for and so forth.

Madam Secretary, you touched in your testimony on some priority dealing with reform. Reform is tough and you have seen a little bit of it in Greece with the demonstration. That is just probably the beginning. But what does Europe have to do? Four things you mentioned and I just want to reemphasize them, to get their house in order, otherwise they are just going to muddle down the road. What are those four things? And some of them are tough.

Ms. BRAINARD. Very tough. They need to undertake fiscal reforms and structural forms in particular countries.

Senator SHELBY. What do you mean by that, just for the audience?

Ms. BRAINARD. So for a country like Greece that really did have an unsustainable public sector, they need to——

Senator SHELBY. And noncompetitive, right?

Ms. BRAINARD. They both have a—they both had an unsustainable public sector and big competitiveness problem

emerging. So in the case of Greece, they have both big fiscal reforms they need to undertake, raise revenues, cut expenditures.

Senator SHELBY. Huge Government, a lot of people working for the Government?

Ms. BRAINARD. They have a very large public sector relative to the size of the economy. No comparison with most other advanced economies that you are familiar with. And, of course, they have also a lot of rigidities in their product and labor markets that they are working to undertake.

I think it is very important to underscore there are big differences among the European countries. Italy, for instance, ran primary surpluses for 17 years going into the crisis.

Senator SHELBY. What do you think about primary surpluses?

Ms. BRAINARD. So essentially, they ran a surplus.

Senator SHELBY. Just sovereign?

Ms. BRAINARD. A surplus, a fiscal surplus——

Senator SHELBY. OK.

Ms. BRAINARD. ——for 17 years when you exclude their interest payments on their debt. They made a massive reduction in their overall indebtedness. Their issue going forward that Prime Minister Monti is really grappling with very forcefully is their growth needs to be greater and their competitive needs to be enhanced.

So the first is reforms, but I want to emphasize again they really are differentiated by different countries. Second is they need a stronger banking system, and in the short run they need to make sure that their banking system is getting the liquidity it requires to retain the confidence of depositors and funders.

And they are working on that and they need to strengthen their capital buffers as well, which has been talked about already. Greece, again, is a special case and they need to work right now. They are working on achieving sustainability.

And the final thing, and I just want to make sure that I am clear on this, they need to put in place a firewall that protects the larger economies like Italy and Spain from unwarranted contagion. And the whole theory——

Senator SHELBY. By firewall, give us an example.

Ms. BRAINARD. The whole theory of the firewall is if you can show that while Italy and Spain move forward on these very ambitious reforms, there is a backup——

Senator SHELBY. Including their labor markets, including their competitiveness?

Ms. BRAINARD. Across the board structural reforms. As they move forward on that, that they will be able to fund themselves at sustainable rates. Then the market confidence that comes with that firewall makes it very unlikely you ever have to tap into it.

And I want to distinguish between that and countries where they actually are borrowing from the euro area for a short period of time while they get their fiscal trajectory under control. So those are the four things we have been pushing on. And again, I want to say the Europeans have made big strides. We think they need to continue to move forward on all four fronts and we think they are committed to doing that.

Senator SHELBY. Do you believe that Germany can carry all of Europe on its back?

Ms. BRAINARD. Since the reforms that are being undertaken are really a collective endeavor on the part of all the euro area countries, and I have to say that Germany and Germany's leadership has been very clear about this, it has benefited tremendously from being a member of the euro area and appears by all measures to be extraordinarily committed to the sustainability of the euro area.

Senator SHELBY. How many countries in Europe are right now, just off hand, in a recession? I know a number of them. And which ones are, their growth has slowed down a little?

Ms. BRAINARD. I do not have the full set of countries that are in recession, but certainly the countries that have been under some financial stress have seen a big deterioration in the growth prospects and the IMF is forecasting deterioration in the coming years. So that would include Greece, Ireland, Portugal, Spain, and Italy.

Senator SHELBY. Thank you, Mr. Chairman.

Chairman JOHNSON. I would like to thank the witnesses for your testimony and for being here with us today. I ask that you keep us updated as events unfold in Europe.

This hearing is adjourned.

[Whereupon, at 11:26 a.m., the hearing was adjourned.]

[Prepared statements and responses to written questions supplied for the record follow:]

PREPARED STATEMENT OF CHAIRMAN TIM JOHNSON

Today we discuss an important and timely issue: the European Debt Crisis. As we speak, events are unfolding that will determine the future of Greece, its neighbors, and the European monetary union.

As our largest trading partner and a vital strategic partner, events within the European Union also have an impact on the United States.

While I hope that the situation in Greece can be resolved in an orderly way, many nations across Europe including Greece will continue to face difficult and unique economic conditions and will have to make tough decisions.

Today we will hear from the Treasury Department, the State Department, and the Federal Reserve. Keeping the momentum going in our economic recovery is important to me and my constituents. I ask that these three agencies continue to monitor the situation in Europe closely to ensure that any potential spillover effects in the U.S. are minimized.

I look forward to hearing an update on the situation in Greece, the impact of a possible agreement on Greece's fiscal situation, and Greece's future in the euro zone.

Second, in some European countries we have seen resistance and upheaval in reaction to the debt crisis that could present obstacles for recovery. I would like your analysis of how the debt crisis is impacting the broader political situation in Europe.

Third, I would like to learn more about efforts to recapitalize European banks, the exposure the U.S. financial system may have to the ongoing turmoil in Europe, and the strength of our banks to withstand any potential external shocks.

Last, the I.M.F. will continue to play a role in helping to find a solution for what's happening in Europe. I would appreciate your evaluation of the I.M.F.'s role in dealing with the debt crisis in Europe, and how the U.S. has interacted with the Fund.

This hearing is an important part of this Committee's continued oversight efforts. Because of the Wall Street Reform Act and other actions by the U.S. financial regulators, I believe that we are better equipped today to deal with any potential fallout from the euro zone's debt issues. I thank our witnesses for being here today, and appreciate the updates you can provide us on the situation in Europe.

PREPARED STATEMENT OF LAEL BRAINARD

UNDER SECRETARY FOR INTERNATIONAL AFFAIRS, DEPARTMENT OF THE TREASURY

FEBRUARY 16, 2012

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 U.S. 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 U.S. 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 euro zone. 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 sus-

tainable 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 noncompliance, 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 3-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 coun-

tries 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.

PREPARED STATEMENT OF ROBERT D. HORMATS

UNDER SECRETARY FOR ECONOMIC GROWTH, ENERGY, AND THE ENVIRONMENT, DEPARTMENT OF STATE

FEBRUARY 16, 2012

Thank you Chairman Johnson and Ranking Member Shelby, for inviting me to testify today on the European debt crisis, and its implications for the United States and our relationship with Europe.

When then-candidate Barack Obama spoke in Berlin in July 2008, he stated that one of the priorities of his presidency would be to reestablish strong transatlantic relations. Citing the daunting political, security and economic challenges of the 21st century, he stressed then that "America has no better partner than Europe."

In the more than 3 years since, and despite discussion in the media about where Europe fits in the United States' global framework and speculation that Europe is turning inward as it deals with its domestic issues, the reality that President Obama articulated in Berlin has not changed. Europe is—and remains—America's partner of first resort and its staunchest ally. The strategic alignment between the United States and Europe, rooted in shared history and values, has never been closer in addressing both international threats and internal challenges.

America, since the days of Presidents Truman and Eisenhower, and Secretaries Marshall, Acheson, and Dulles has recognized that a united and prosperous Europe is of enormous importance to the United States. And we have recognized, since the days of Jean Monnet and Robert Schuman, that closer economic integration in Europe was an essential underpinning to a stronger Europe and its ability to be a robust ally. And we understood that a prosperous Europe was important to a prosperous America. That was true in the 1950s when we supported the Marshall Plan, and it is today.

In Libya, NATO allies came together with Arab and other partners to support the Libyan people and prevent a catastrophe. In Afghanistan, with nearly 40,000 European troops on the ground alongside our own, we have built and sustained NATO's largest-ever overseas deployments. And we will continue to support the Afghans as they assume full responsibility for their own security by the end of 2014.

On Iran, along with our European allies, we share a deep and increasing concern about unresolved issues and Iran's continued refusal to comply with its international nuclear obligations. We remain committed to a dual-track policy that uses pressure to urge Iran to engage seriously on its nuclear program.

And the strength of this alliance with Europe depends heavily on the health of our economies. The statement of the European Council on January 30, 2012, clearly points to a renewed focus on jobs and growth, which provides new opportunities for U.S.–EU trade, investment and science and technology cooperation for our mutual benefit.

That is not to say that there are no differences across the Atlantic. But the reality is that we have essentially the same central objectives and are working on them together around the world.

Today, I'd like to comment on this reality in two areas:

First, our transatlantic work towards a common agenda of economic recovery and growth. This includes strengthening transatlantic trade and investment ties that reinforce our mutual recoveries, bringing emerging powers into the international

rules-based system, and reorienting the global economic architecture for 21st century challenges; and

Second, our work together in addressing the global challenges that confront us in Afghanistan, Iran, the Middle East and North Africa, and elsewhere.

Economic Recovery Through Trade and Job Creation

Today's hearing is focused on the euro zone crisis—and for good reason. We have a huge stake in the health and vitality of Europe's economies. European growth is important both for the global economy and for creating and sustaining jobs in the United States.

To put this in perspective, the value of United States goods and services exports to the European Union is about five times the value of our exports to China. Trade flows between the United States and the EU exceed $2.7 billion per day.

In addition to the steps the EU has taken to resolve the debt and banking crisis, which Under Secretary Brainard has just discussed, we also have seen a commitment, as evidenced by the results of the EU Summit on January 30, to address the current economic challenges not only through fiscal consolidation, but also by facilitating job creation and putting in place measures to assist member States in finding a path back to economic growth.

There is a lot more hard work ahead. And there are many difficult choices to make. But our European partners have laid a solid foundation on which to build, and we appreciate the enormous efforts the EU has taken to regain its economic footing.

The Obama administration is committed to expanding and deepening our economic relationship with Europe. This will help both us and our European allies sharpen our competitive edge in the global economy, and achieve our domestic objectives for economic growth and job creation. Secretary Clinton has said, "We need to forge an ambitious agenda for joint economic leadership with Europe that is every bit as compelling as our security cooperation around the world." I would like to outline for you how we at the State Department are working to expand trade and investment relations with Europe—in order to support jobs and growth on both sides of the Atlantic.

Transatlantic Economic Council and Regulatory Cooperation

The business community, consumer organizations and other stakeholders in the United States and in Europe have also been an active and vocal constituency in support of the Transatlantic Economic Council, or TEC. The TEC, established in 2007 and led by the White House and the European Commission, engages our most senior economic policy makers in joint work to promote economic growth and job creation on both sides of the Atlantic—in particular by addressing regulatory barriers and fostering innovation.

As tariffs have fallen in recent decades, nontariff measures or "behind the border" barriers to trade and investment have come to pose the most significant obstacles to our trade. Regulators in both the EU and the United States aim essentially for the same strong protections for the health and safety of our citizens, for our environment, and for our financial systems.

But differing approaches to regulation and to the development of standards can create barriers and slow the growth of trade and investment. Reducing unnecessary differences can create opportunities.

One way we are seeking to minimize the impact of unnecessary regulatory divergences on trade and investment is to examine closely our respective regulatory processes, and to try to identify ways to make them more compatible and accessible. The TEC and the U.S.–EU High Level Regulatory Cooperation Forum, led by OMB, have spurred new discussion on our respective approaches to risk analysis, cost-benefit analysis, and the assessment of the impact of regulation on trade.

Among other accomplishments, one of the highlights of the November 2011 TEC meeting was arriving at a comprehensive work plan on electric vehicles and associated infrastructure, in cooperation with the U.S.–EU Energy Council, business, standard-setting bodies, and scientists on both sides of the Atlantic.

A key component of this work plan is a decision to establish "interoperability centers" or living laboratories, which will allow scientists from both sides of the Atlantic to share data, equipment, and testing methodologies. This in turn should set a foundation for compatible approaches and regulations in both markets and lead to interoperable e-cars and related infrastructure, such as charging stations and smart grids.

While we have a common purpose on electric vehicles, success is by no means assured. It will depend heavily on the work that is done in the private sector to prioritize and develop the standards adopted for and applied to these new tech-

nologies. The standards-setting process is very complex with vital roles for Government, business, and standard-setters.

If the EU and the United States can together promote the creation of compatible, high quality, transatlantic standards in a variety of sectors or product areas in the short-to-medium term, our countries can encourage other nations to adhere to them and reduce the clutter of disjointed, unilateral standards that would impede trade and serve as protectionist devices.

Businesses then will be able to deploy technologies more effectively and more quickly across the globe, where demand for these products will only grow over time, supporting our shared desire for new sources of jobs and growth.

Additionally, common transatlantic approaches to regulation can serve as a model for other nations, in particular Russia, China, Brazil, and India. Together we can provide incentives for others to embrace science-based strategies and approaches, working toward regulatory convergence and enabling access to markets.

This is an important point. Many countries don't share our regulatory principles and, through regulation, try to make our companies less competitive in their markets or even try to shut them out.

The United States and the EU can both benefit if we work together to promote the adoption in third countries of market principles and internationally accepted rules governing trade, finance, intellectual property, and investment. Better economic policies in third countries will help ensure fair competition and market access, increasing opportunities to generate exports and jobs in the United States and Europe.

U.S.–EU High Level Working Group on Jobs and Growth

At the U.S.–EU Summit in November 2011, President Obama and EU leaders pledged to make the U.S.–EU trade and investment relationship even stronger. They called upon the TEC to create a High Level Working Group on Jobs and Growth, cochaired by the U.S. Trade Representative Ron Kirk and EU Trade Commissioner Karel De Gucht.

The purpose of this group is to identify and assess options for strengthening the transatlantic economic relationship in areas including, but not limited to: conventional barriers to trade in goods; barriers to trade in services and in investment; opportunities to reduce or prevent unnecessary nontariff barriers to trade; and enhanced cooperation on common concerns involving third countries.

All options are on the table. USTR has had initial consultations with EU counterparts and is seeking input from all stakeholders, including Congress, as it begins its work. Several major private sector organizations have issued studies or reports that make compelling arguments for an ambitious agenda in this area.

Economic Statecraft

In October 2011, Secretary Clinton announced her vision of Economic Statecraft as a central pillar of U.S. foreign policy. An important part of that is our economic relationship with Europe. That is, how we use the tools of diplomacy abroad to support trade and the rights of U.S. investors, leverage the strengths and expertise of the U.S. private sector in our economic engagement overseas, and use diplomacy and our overseas presence to grow our economy at home by attracting foreign investment to the United States.

We have established an Economic Statecraft Task Force to elevate economic and commercial diplomacy goals and to ensure that we have the right people, support tools, and engagement platforms. The Task Force covers four principal areas of work: human capital, internal tools, external engagement, and policy opportunities.

We are doing much of this work already, especially at our overseas posts, to support such programs as the National Export Initiative and Select USA, which promotes job-creating foreign investment in the United States. The State Department puts special emphasis on support for entrepreneurship. Under the Secretary's Economic Statecraft Initiative, we will scale up our efforts.

Some successes from recent advocacy include: Volkswagen's recent $1 billion manufacturing plant in Chattanooga, and Boeing's sale of 90 aircraft to Russian airline companies in 2011. In April 2011, helicopter producer Sikorsky won a contract worth up to $1.3 billion, to coproduce utility helicopters in Turkey.

Beyond advocacy for specific business deals, we are also working to level the playing field for U.S. workers and businesses in Europe and around the world, including in the agriculture sector. The volume of U.S. agricultural exports to the EU is strong and growing. Our 2011 agricultural exports to the EU were valued at $9.5 billion, up 8.2 percent from the previous year. USDA estimates that every $1 billion in U.S. agricultural exports supports about 8,400 American jobs across a variety of sectors. We at State want to help push those numbers even higher.

Business is telling us there is more we can do to help them grow in an increasingly challenging world—and we at State want to exceed their expectations. On February 21–22, Secretary Clinton is inviting 200 representatives of U.S. business support organizations and the private sector to participate in the Department's first ever Global Business Conference. This is part the Department's effort to increase engagement with the private sector and support U.S. business.

We at State want to help push those numbers even higher. Business is telling us there is more we can do to help them grow in an increasingly challenging world—and we at State want to exceed their expectations. On February 21–22, Secretary Clinton is inviting 200 representatives of U.S. business support organizations and the private sector to participate in the Department's first ever Global Business Conference. This is part the Department's effort to increase engagement with the private sector and support U.S. business.

Global Challenges

We continue to work cooperatively with Europe to address the challenges that confront us both around the globe. Slower growth and tighter budgets in Europe could have an impact on some of our foreign policy objectives, but we are actively searching for more opportunities to leverage our individual and collective resources to advance our shared goals. Whatever happens on the financial and economic front, our foreign policy message has been consistent: It is important that transatlantic partners continue to dedicate resources to key priorities, and maintain critical deployments, both military and civilian. Reduced outlays overall should not mean reduced engagement in critical parts of the world.

Europe is an indispensable partner in promoting peace and prosperity through development assistance. The EU and its member States account for over 55 percent of global net Official Development Assistance to developing countries, with aid from the fifteen wealthiest EU member States rising by 6.7 percent in 2010 to just over $70 billion.

The EU and its member States have taken the lead on post-conflict aid operations in Liberia, Burundi, the Democratic Republic of the Congo, Sierra Leone, Darfur, and Chad. The EU has also taken on lead roles in the democratic transitions occurring in its own neighborhood, in Libya and Tunisia and other transition countries in the Middle East and North Africa region.

Defense spending faces continued pressure in Europe. The Secretary of Defense told the Allies last fall that "we are at a critical moment for our defense partnership." Overall, defense spending in Europe has decreased during the past decade, but Allies are committed to keeping NATO strong through collaborative capabilities acquisitions called "Smart Defense."

Despite tight budgets, NATO allies have a strong common interest in meeting our collective security obligations and building the capabilities needed to meet 21st century security challenges. At the May 2012 NATO summit, hosted by the United States in Chicago, Allies will consider opportunities to advance our efforts on such critical capabilities as missile defense; intelligence, surveillance, and reconnaissance; and assuring the right mix of nuclear and conventional forces.

Our European allies have been critical to NATO's efforts in Afghanistan. While some feared a "rush for the exits" after NATO announced the goal of a 2014 transition to Afghan lead, in fact the Alliance has held together under the principle "in together, out together." The Chicago Summit will shape the next phase of the transition of security responsibility to the Afghan National Security Forces.

We continue to work closely with our partners in the P5+1 (the UNSC Perm 5, plus Germany) and the EU to engage Iran in serious discussions without preconditions regarding the international community's concerns about its nuclear program. As Iran has failed to show any serious sign of being ready or willing to engage, both the United States and the European Union have significantly increased our sanctions against the regime since the last round of UN sanctions in June 2010.

We believe U.S. and EU sanctions are severely affecting the regime in Iran. We see no evidence that Europe's economic crisis has made European Governments less willing to impose vigorous sanctions; on the contrary, since 2011 EU member States have moved to expand dramatically measures against the regimes in Iran and Syria, including against their financial and energy sectors, and have maintained sanctions in other cases.

Most recently, on January 23, the European Union took action to ban imports of Iranian crude oil and petroleum products, freeze the assets of the Iranian central bank, and take additional action against Iran's energy, financial, and transport sectors. These actions are consistent with the Iran sanctions in the National Defense Authorization Act of 2012, on which we deeply appreciate the close engagement between the Administration and the Senate.

We will continue to coordinate with our partners in Europe and around the world to increase sanctions pressure to sharpen the choice for the Iranian regime between continued violations of its international nuclear obligations and serious engagement with negotiations. Just last month, the EU announced a dramatic extension of its sanctions regime on Iran to include a ban on imports of crude oil from Iran, the lifeblood of the Iranian economy. The EU's new sanctions mirror the new sanctions recently passed by Congress and signed into law by President Obama on December 31, 2011.

In Libya, we cooperated closely with our European allies to pass UN Security Council resolutions 1970 and 1973, which levied sanctions against the Qadhafi regime, established a no-fly zone and maritime embargo of Libya, and provided protection for citizens under attack by their own Government. This authorization allowed us, in coalition with Europe, to take down Libya's air defense system. We then handed the mission over to NATO, which quickly assumed command and control, and conducted a flexible and precise operation that saved tens of thousands of lives. This operation demonstrated that NATO remains the world's strongest political–military alliance, capable of bringing Allies and partners together under one command structure in a time of crisis. Since the end of the Libya operation, the EU and our European allies have remained committed to a successful transition in Libya, through development assistance and capacity building.

The European Union and its member States have remained committed to a successful transition in Libya, through humanitarian and development assistance, as well as capacity building and technical training for the emerging Libyan Government.

In Syria, the EU has joined us in steadily ratcheting up the pressure on the Asad regime, including through multiple rounds of sanctions targeting individuals responsible for abuses and institutions that fill the regime's coffers. The United States and the EU have together led efforts to call attention to Syria's human rights violations, cosponsoring three Special Sessions in the UN Human Rights Council, one of which resulted in the creation of an independent Commission of Inquiry tasked to document the atrocities of the Asad regime. America and Europe stand united alongside the Arab League in demanding an end to the bloodshed and a democratic future for Syria.

Additionally, Germany, France, and the UK (E3) led efforts at the UN General Assembly in November 2011 by introducing a resolution, approved by an overwhelming majority, calling on Syria to fully comply the Arab League's initiative.

And not resting on our laurels, we are engaging actively in the Middle East and North Africa to promote our shared values of democracy, especially in this time of transformational change. In the Middle East, we have a profound stake in this process. We are making the Deauville Partnership a priority during America's G8 Presidency this year. And to make good on its promise, we will be putting forward an ambitious agenda to promote political and economic reform, trade, investment, regional integration, and entrepreneurship to help people in the region realize the better future they have risked so much to have.

And this work extends beyond the Middle East. We have to help consolidate democratic gains in places like Cote d'Ivoire and Kyrgyzstan, and support democratic openings in Burma, and wherever people lack their rights and freedom. America and Europe have more sophisticated tools than ever to support and reward those who take reforms, and to pressure those who do not.

On Russia, Europe worked with both us and the Russians last year through the long and complicated process of negotiating Russia's accession to the WTO, completing the process after 18 years of negotiation. This painstaking work resulted in an invitation to Russia to accede to this global rules-based trading system. Russia's WTO accession was a key step in putting our relations with Russia on a more constructive course, which is one of President Obama's top priorities.

Integrating Russia into the WTO has the potential to bring enormous benefits to U.S. manufacturers, farmers, and ranchers. While American exports to Russia rose 39 percent in 2011, more than twice as fast as our goods exports to the world as a whole, our exports to Russia, $8.2 billion in 2011, represents only around one-half of one percent of our total exports.

We should not underestimate the opportunity to expand U.S. exports further to a country of nearly 145 million people—the world's seventh largest economy. It's been estimated that Russia's WTO accession could result in a 20-percent increase in Russia's overall trade in manufactured goods, which could translate into a possible $2 billion increase in bilateral trade in manufactured goods with the United States. And the Commerce Department's International Trade Administration estimates that every billion dollars of U.S. exports supports over 5,000 jobs.

President Obama in his most recent State of the Union Address urged Congress to ensure "that no foreign company has an advantage over American manufacturing when it comes to accessing new markets like Russia." And to improve opportunities for U.S. companies in Russia going forward and support jobs here in the United States, we will need to secure the full benefits of the WTO deal for American business by terminating application of the Jackson-Vanik Amendment to Russia, and by extending permanent normal trade relations to Russia.

Of course we have differences with Russia. Its recent veto of a tough UN resolution on Syria was—in the words of Secretary Clinton—a travesty. And the United States remains committed to strong, transparent support for civil society and democratic principles, as the Secretary demonstrated in the wake of the Russian parliamentary elections in December, when she voiced our concerns. But at the same time, we also have had unprecedented cooperation with Russia on Iran and North Korea. Russia has also agreed to greatly expanded use of its territory and airspace as supply lines to Afghanistan. And as indicated in our trade numbers, our economic ties are also expanding.

The Jackson-Vanik Amendment—enacted vis-a-vis the former Soviet Union—long ago fulfilled its purpose with regard to Russia: to support free emigration, particularly Jewish emigration. No such barriers to emigration exist in Russia today.

If Congress does not enact the necessary legislation to terminate Jackson-Vanik with regard to Russia, when Russia becomes a member of the WTO, the U.S. does not get all of the benefits of Russia's WTO membership, even though our competitors will. This puts many of our industries at a serious disadvantage. Unlike other WTO members, the United States will not be able to turn to the WTO mechanisms, including dispute settlement procedures, or ensure compliance on other areas such as intellectual property, services or WTO rules on antidumping.

President Obama has established extending Permanent Normal Trade Relations to Russia and terminating application of Jackson-Vanik to Russia as a major priority. Congress can help level the playing field for U.S. businesses and workers by terminating application of Jackson-Vanik to Russia before Russia joins the WTO this summer. Lifting Jackson-Vanik for Russia is about providing jobs and economic growth here in America.

Conclusion

The transatlantic relationship is not just a defining achievement of more than half a century ago—it is indispensable to the world we continue to build together in the century ahead. Our predecessors planned for the future together. They acted on a belief that America, Europe, and like-minded nations everywhere are engaged in a single, common endeavor to build a more peaceful and prosperous and secure world. The world around us is changing fast, and America and Europe are charting our path forward together to deal with the challenges we face.

PREPARED STATEMENT OF STEVEN B. KAMIN

DIRECTOR OF THE DIVISION OF INTERNATIONAL FINANCE, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

FEBRUARY 16, 2012

Thank you, Chairman Johnson, Ranking Member Shelby, and Members of the Committee for inviting me today to talk about the economic situation in Europe and actions taken by the Federal Reserve in response to this situation.

For 2 years now, developments in Europe have played a critical role in shaping the tenor of global financial markets. The combination of high debts, large deficits, and poor growth prospects in several European countries using the euro has raised concerns about their fiscal sustainability. Such concerns were initially focused on Greece but have since spread to a number of other euro area countries, leading to substantial increases in their sovereign borrowing costs. Pessimism about these countries' fiscal situation, in turn, has helped to undermine confidence in the strength of European financial institutions, increasing the institutions' borrowing costs and threatening to curtail their supply of credit. These developments have strained global financial markets and weighed on global economic activity.

In the past several months, European leaders have taken a number of policy steps that have helped reduce financial market stresses. In early December, the European Central Bank, or ECB, reduced its policy interest rate, cut its reserve requirement, eased collateral rules for its lending, and, perhaps most important, began providing 3-year loans to banks. Additionally, European leaders announced and have started to implement proposals to strengthen fiscal rules and European fiscal coordination,

as well as to expand the euro area financial backstop. These steps are positive developments and signify the commitment of European leaders to alleviate the crisis.

Since early December, borrowing costs for several vulnerable European Governments have declined, funding pressures for European banks have eased, and the tone of investor sentiment has improved. However, financial markets remain under strain. Europe's authorities continue to face difficult challenges as they seek to stabilize their fiscal and financial situation, and it will be critical for them to follow through on their policy commitments in the months ahead.

Here at home, the financial stresses in Europe are undoubtedly spilling over to the United States by restraining our exports, weighing on business and consumer confidence, and adding to pressures on U.S. financial markets and institutions. Of note, foreign financial institutions, especially those in Europe, continue to find it difficult to fund themselves in dollars. A great deal of trade and investment the world over is financed in dollars, so many foreign financial institutions have heavy borrowing needs in our currency. These institutions also borrow heavily in dollars because they are active in U.S. markets, purchasing Government and corporate securities and lending to households and firms. As concerns about the financial system in Europe mounted, many European banks faced a rise in the cost and a decline in the availability of dollar funding. Difficulty acquiring dollar funding by European and other financial institutions may ultimately make it harder and more costly for U.S. households and businesses to get loans. Moreover, these disruptions could spill over into the market for borrowing and lending in U.S. dollars more generally, raising the cost of funding for U.S. financial institutions. Although the breadth and size of all of these effects on the U.S. economy are difficult to gauge, it is clear that the situation in Europe poses a significant risk to U.S. economic activity and bears close watching.

Swap Lines With Other Central Banks

To address these potential risks to the United States, as described in an announcement on November 30, the Federal Reserve agreed with the European Central Bank (ECB) and the central banks of Canada, Japan, Switzerland, and the United Kingdom to revise, extend, and expand its swap lines with these institutions.[1] The measures were taken to ease strains in global financial markets, which, if left unchecked, could significantly impair the supply of credit to households and businesses in the United States and impede our economic recovery. Thus far, such strains have been particularly evident in Europe, and these actions were designed to help prevent them from spilling over to the U.S. economy.

Three steps were described in the November 30 announcement. First, we reduced the pricing of drawings on the dollar liquidity swap lines. The previous pricing had been at a spread of 100 basis points over the overnight index swap rate.[2] We reduced that spread to 50 basis points. The lower cost to the ECB and other foreign central banks enabled them to reduce the cost of the dollar loans they provide to financial institutions in their jurisdictions. Reducing these costs has helped alleviate pressures in U.S. money markets generated by foreign financial institutions, strengthen the liquidity positions of European and other foreign institutions, and boost confidence at a time of considerable strain in international financial markets. Through all of these channels, the action should help support the continued supply of credit to U.S. households and businesses.

Second, we extended the authorization for these lines through February 1, 2013. The previous authorization had been through August 1, 2012. This extension demonstrated that central banks are prepared to work together for a sustained period, if needed, to support global liquidity conditions.

Third, we agreed to establish, as a precautionary measure, swap lines in the currencies of the other central banks participating in the announcement. (The Federal Reserve had established similar lines in April 2009, but they were not drawn upon and were allowed to expire in February 2010.) These lines would permit the Federal Reserve, if needed, to provide euros, Canadian dollars, Japanese yen, Swiss francs, or British pounds to U.S. financial institutions on a secured basis, much as the foreign central banks provide dollars to institutions in their jurisdictions now. U.S. financial institutions are not experiencing any foreign currency liquidity pressures at

[1] *See,* Board of Governors of the Federal Reserve System (2011), “Coordinated Central Bank Action To Address Pressures in Global Money Markets”, press release, November 30, *www.federalreserve.gov/newsevents/press/monetary/20111130a.htm*. Similar announcements appeared on the Web sites of the other participating central banks.

[2] The dollar overnight index swap rate is the fixed rate that one party agrees to pay in exchange for the average of the overnight Federal funds rates over the life of the swap. As such, it is a measure of the average Federal funds rate expected over the term of the swap.

present, but we judged it prudent to make arrangements to offer such liquidity should the need arise in the future.

I would like to emphasize that information on the swap lines is fully disclosed on the Federal Reserve's Web site—through our weekly balance sheet release and other materials—and information on swap transactions each week is provided on the Web site of the Federal Reserve Bank of New York.[3]

I also want to underscore that these swap agreements are safe from the perspective of the Federal Reserve and the U.S. taxpayer, for five main reasons:

- First, the swap transactions themselves present no exchange rate or interest rate risk to the Fed. Because the terms of each drawing and repayment are set at the time that the draw is initiated, fluctuations in exchange rates and interest rates that may occur while the swap funds are outstanding do not alter the amounts eventually to be repaid.
- Second, each drawing on the swap line must be approved by the Federal Reserve, which provides the Federal Reserve with control over use of the facility by the foreign central banks.
- Third, the foreign currency held by the Federal Reserve during the term of the swap provides added security.
- Fourth, our counterparties in these swap agreements are the foreign central banks. In turn, it is they who lend the dollars they draw from the swap lines to private institutions in their own jurisdictions. The foreign central banks assume the credit risk associated with lending to these institutions. The Federal Reserve has had long and close relationships with these central banks, and our interactions with them over the years have provided a track record that justifies a high degree of trust and cooperation.
- Finally, the short tenor of the swap drawings, which have maturities of at most 3 months, also offers some protection in that positions could be wound down relatively quickly were it judged appropriate to do so.

The Federal Reserve has not lost a penny on any of the swap line transactions since these lines were established in 2007, even during the most intense period of activity at the end of 2008. Moreover, at the maturity of each swap transaction, the Federal Reserve receives the dollars it provided plus a fee. These fees add to overall earnings on Federal Reserve operations, thereby increasing the amount the Federal Reserve remits to taxpayers.

Conclusion

The changes in swap arrangements that I have discussed have had some positive effects on dollar funding markets. Since the announcement of the changes at the end of November, the outstanding amount of dollar funding through the swap lines has increased substantially, to more than $100 billion, and several measures of the cost of dollar funding have declined.

That being said, many financial institutions, especially those from Europe, continue to find it difficult and costly to acquire dollar funding, in large part because investors remain uncertain about Europe's economic and financial prospects. Ultimately, the easing of strains in U.S. and global financial markets will require concerted action on the part of European authorities as they follow through on their announced plans to address their fiscal and financial difficulties. The situation in Europe is continuously evolving. Thus, we are closely monitoring events in the region and their spillovers to the U.S. economy and financial system.

Thank you again for inviting me to appear before you today. I would be happy to answer any questions you may have.

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[3] For the outstanding amount of dollar funding through the swap lines as it appears each week in the Federal Reserve balance sheet, *see, www.federalreserve.gov/releases/h41*. For other relevant information and materials on the Federal Reserve's Web site, *see, www.federalreserve.gov/monetarypolicy/bst_liquidityswaps.htm*. For weekly information on the Federal Reserve's swap transactions with other central banks, *see, www.newyorkfed.org/markets/fxswap/fxswap.cfm*. Finally, for copies of the agreements between the Federal Reserve and other central banks, as well as other information, *see, www.newyorkfed.org/markets/liquidity_swap.html.*

RESPONSES TO WRITTEN QUESTIONS OF SENATOR WICKER FROM ROBERT D. HORMATS

Q.1. Do you believe part of the reason why Greece became insolvent is because they had unrealistic and unbalanced entitlement programs? What can the U.S. learn from Greece's mistakes?

A.1. Greece presents a unique case, even within the broader euro zone crisis. Greece's low growth rate, structural weaknesses, and high debt and deficits have been issues for some time. For that reason, the Greek Government is embarked on a path of very challenging fiscal and structural reforms to restore competitiveness with the technical and financial support of its euro zone partners and the IMF. The reforms to fix these problems are complex and will take time, a key reason the U.S. has consistently advocated for a strong European firewall to ensure access to affordable financing as Greece and other euro area Governments implement reforms.

Q.2. What insight do the problems in Europe give you regarding some of the structural problems we have here in the United States? For example, with respect to our ballooning budget deficit and Federal Reserve balance sheets while the economy underperforms relative to the resources that have been applied to fix it.

A.2. It is essential that European leaders persevere in addressing the long-term challenge of reinforcing and expanding the institutions of its economic and monetary union. Even with our close economic ties, it is difficult to compare the unique policy challenges facing Europe's monetary union with the U.S. economy.

For perspective on the U.S. Federal budget we defer to the U.S. Treasury.

As an independent central bank directly under Congressional oversight, the Federal Reserve is best placed to answer questions about its balance sheet and responsibilities.

Q.3. Outside Greece, what contingency plans are in place to protect the United States banking system in the event of a string of threatened European defaults?

A.3. The Treasury and Fed as regulators and overseers of the U.S. banking system respectively are best placed to answer this question.

Throughout the crisis, the United States has urged European Governments to act decisively and conclusively to resolve the debt crisis. Over the last 2 years, we have offered our perspectives on the dangers that the sovereign debt crisis pose to global economic recovery, and we have tried to share the lessons of our own financial crisis about the importance of responding to market challenges decisively and proportionately.

Q.4. Given the brinkmanship taking place with regard to Greece's upcoming funding needs, it cannot be taken for granted they get a bailout.

- If Greece does go bankrupt or withdraws from the euro, how would that influence U.S. policy with respect to liquidity for European banks via joint agreements between the Federal Reserve and European Central Bank and with regard to IMF policy efforts?

- What policy changes would be necessary in the event of such a major failure of U.S. supported efforts?

A.4. Following last week's successful debt exchange, based on the concept of Private Sector Involvement (PSI), euro area member States formally approved the second support program of €130 billion for Greece. Member States have also authorized the European Financial Stability Facility to release the first installment of the program for a total amount of €39.4 billion, to be disbursed in several tranches. This second "bailout" program constitutes an opportunity for Greece to demonstrate strong commitment to debt reduction and reform, and to keep up the implementation momentum by rigorously pursuing the adjustment effort in the areas of fiscal consolidation, structural transformations, and privatization, strictly in line with the new program. Adherence to this program should allow the Greek economy to return to a sustainable path, which is in the interest of all nations.

For its part of the second support program the IMF Board of Directors voted on March 15, at Greece's request, to replace its existing Stand-By Agreement (SBA) with a 4-year Extended Arrangement for Greece.

Q.5. Austerity without growth is a recipe for depression. What policies would you recommend to promote the growth side of the debt reduction equation once some equilibrium is reached?

A.5. As part of the second financial support program for Greece, European policy makers are now working to fix systemic structural issues and address the lack of competitiveness. The EU is currently in the process of laying out a plan for growth that focuses on employment, productivity, and social reforms.

Going forward, policy makers in the euro area will be challenged to achieve a pragmatic balance between promoting fiscal consolidation, as mandated within the euro zone by the fiscal compact arrangement, and supporting growth. To be sure, countries must demonstrate continued resolve on fiscal and structural reforms. The United States has consistently advocated progrowth, promarket policies in Europe.