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The Eurozone Debt Crisis and Implications for the United States
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Chairman Miller, Ranking Member McCarthy, 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 and encourage swift resolution of the crisis.

The European financial crisis presents the most serious risk today to global recovery and the prospects for U.S. exports and American jobs. Reflecting our deep concern, President Obama has continued to press European leaders about their plans to resolve the crisis, and Secretary Geithner remains closely engaged with his European counterparts. It is clear that the Europeans have the resources and capacity to deal with the challenges they face. Leaders made progress over the weekend towards putting in place a comprehensive framework for tackling the crisis and will meet again on Wednesday to reach agreement on this framework. This agreement will need to be implemented quickly and firmly.

I will begin this morning by briefly reviewing recent developments in Europe. I will then outline how we see risks to the U.S. and global economies from the crisis, and how we are working at home and with our international partners to manage these risks.

The European Crisis

The macroeconomic and financial challenges faced by several European countries since the 2008 financial crisis have exposed serious structural tensions within the European Monetary Union. As members of a monetary union, the seventeen countries of the euro area share a single currency, a single central bank, and a uniform monetary policy stance. Within such a framework, an effective mechanism that ensures fiscal discipline is essential to underpin macroeconomic stability, but this was not achieved. Moreover, because individual member countries cannot adjust competitiveness through the exchange rate, markets must be flexible to serve this purpose so that countries can achieve their growth potential. Further, an adequate toolkit of crisis resolution mechanisms must be available to respond to economic and financial stress.

These broad systemic weaknesses have played out in different ways across the countries that have sought official sector support, which are often referred to as the eurozone "periphery." Greece's crisis stemmed from unsustainable growth in the public sector, fueled by low-cost cross-border finance that allowed very large fiscal deficits and public debt. Portugal's public debt is more moderate, but its private and bank debt is large and competitiveness has deteriorated. Even during periods of vibrant global expansion, Portuguese growth has been anemic. In Ireland, a pre-crisis environment of low interest rates and exuberant growth expectations fueled a boom in the property sector. Its collapse, along with a deep and prolonged recession, produced very large banking sector losses and structural fiscal deficits. Irish government support for its banking system, together with large fiscal deficits, has pushed public debt to nearly 100 percent of GDP.

Meanwhile, market concerns have spread to the fiscal situation of other member states struggling with elevated public debt levels and slow growth and to the adequacy of European bank capital in the context of slowing growth in the largest euro area economies. Such contagion has led to increasing strains on funding markets for banks and larger sovereigns in the euro area, highlighting the urgency of a comprehensive and decisive response.

In response to these challenges, Europe has been undertaking wide-ranging actions both to strengthen national policies and to reinforce the overall policy and institutional framework for the euro area.

At the country level, over the last 18 months, much of the region has embarked on accelerated fiscal consolidation, growth-oriented structural reform, and banking sector repair. In many cases when original reform plans proved insufficient, these plans were further strengthened. This is an extremely challenging agenda, which is starting to show results. However, completion will require continued, determined efforts to advance reforms combined with continued financial support over a sustained period of time.

At the Europe-wide level, European leaders have pledged to do whatever it takes to ensure the future of the euro, and have advanced on a range of fronts to reinforce the stability of the euro area framework and to tackle the crisis. Through the European Financial Stability Facility (EFSF) and other facilities, and with support from the IMF, Greece, Ireland, and Portugal have been provided with official funding over a reasonable period of time to do the very difficult reform work. Following a collective decision on July 21, euro area member states have passed legislation to expand the EFSF's effective financial capacity to €440 billion ($610 billion) and have eased the financial terms of its loans. At the same time, the EFSF's authority has been broadened to include precautionary programs, lending to countries to support bank recapitalization, and intervention in the primary and secondary sovereign bond markets. Meanwhile, the European Central Bank (ECB) has played a crucial role, providing liquidity to banks and buying sovereign bonds in the secondary market to ensure depth and liquidity in markets under stress. Not losing sight of the longer-term fixes needed to prevent future crises, the European Union (EU) has also agreed to the so-called "six-pack" of reforms to the Stability and Growth Pact (SGP) through the introduction of a broader and enhanced array of surveillance tools and enforcement mechanisms, and to introduce a permanent crisis resolution mechanism, the European Stability Mechanism (ESM).

We know from our own experience in 2008 that moving from crisis to recovery depends on swift and aggressive solutions to deal with the roots of the problem and restore market confidence. We have worked hard to convey to European leaders our sense of the need for bold solutions and to provide constructive advice on how to move forward. Secretary Geithner has traveled to Europe three times in the last six weeks alone, and President Obama is frequently in contact with leaders across the region.

Over the last weekend, the Europeans have been working to agree on specific crisis resolution mechanisms that mobilize the increased resources and greater flexibility of the EFSF with the aim of delivering a credible and comprehensive strategy to address the region's challenges in advance of the Cannes Summit. This framework, which is to be finalized on Wednesday, will need to be implemented quickly and firmly. This plan should have four parts. First, to address contagion concerns, the Europeans need to establish a convincing firewall to ensure that governments can borrow at sustainable interest rates, as they implement policies to bring down debt and strengthen the foundations for growth. Second, it will be important to take steps to ensure that European banks have sufficient funding and build capital cushions to maintain the full confidence of depositors and the availability of credit, and to ensure that banks have access to a capital backstop when needed. Third, a sustainable program will be needed for Greece as it implements its fiscal and structural reforms. Fourth, ongoing work to strengthen governance will remain essential to address the root causes of the crisis.

Risks to the U.S. Economy

We are deeply invested in the successful resolution of the current crisis in Europe because the United States has no bigger, no more important economic relationship than it does with Europe. Europe accounts for over 20 percent of U.S. goods exports and over 35 percent of U.S. service exports. Europe is the most significant "foreign source" of investment and jobs in America – the total stock of European FDI at $1.6 trillion accounts for 70 percent of all FDI in the United States.

Already, the crisis has slowed growth significantly in Europe and around the world. Amid rising uncertainty, European stock prices have lost nearly a quarter of their value in the last six months and major U.S. stock indices have declined by almost 10 percent. The volatility in financial markets has reduced risk appetite, undermined business and consumer confidence, jeopardized the availability of credit, and reduced household wealth in the United States as well as in Europe. Moreover, the continent's financial institutions have come under serious pressure; many have lost access to funding and their capital adequacy has been questioned by financial markets. These developments clearly pose serious downside risks to the outlook for the U.S. economy.

Direct exposure of the U.S. financial system to the eurozone countries most under stress is moderate but we are concerned about risks from our substantial trade and investment ties with Europe. According to the Financial Stability Oversight Council's (FSOC) Annual Report, While direct exposure to the eurozone periphery is very limited, U.S. banks' exposures to the core European banks are much larger and these banks are the primary international lenders to peripheral European borrowers. As highlighted in the FSOC annual report, the interconnectedness of financial institutions with sovereigns makes it difficult to quantify precisely all possible exposures, which in turn increases the risk that a credit event could lead to generalized declines in investor sentiment, losses of liquidity, and associated disruptions of international financial markets.

The impact on the U.S. financial system of events in Europe depends on how the peripheral European sovereign debt crisis evolves and on the resilience of U.S. financial institutions and markets. Our supervisors have for some time been working closely with U.S. financial institutions to improve their ability to withstand a variety of possible financial contagion stress events emanating from Europe. The Financial Stability Oversight Council and its member agencies will continue to carefully monitor the potential risks that could emerge from the peripheral European sovereign debt crisis.

Supporting the Recovery

Our own recovery remains fragile and all too vulnerable to disruption beyond our shores. To strengthen our economy, the Obama administration is taking actions at home to boost growth and jobs in the near-term while also putting in place a medium-term fiscal framework to reduce deficits and debt. President Obama remains committed to putting unemployed Americans back to work and continues to push numerous job-creating initiatives, including those proposed in the American Jobs Act. We are also working closely with countries around the world to ensure sustained global growth. In particular, with demand in the advanced economies likely to remain weak, it is essential for emerging markets to play a bigger role in bolstering global demand. At the recent G-20 meeting, surplus emerging market countries committed to accelerate the rebalancing of their economies toward more domestic consumption and to achieve greater exchange rate flexibility to reflect economic fundamentals. Importantly, we have worked aggressively to pressure China, in particular, to move much faster in allowing the value of its currency to appreciate more rapidly.

One key challenge in managing global risks is to ensure sufficient financing in crisis situations. In the case of Europe, European countries are appropriately contributing the bulk of financing. Europe has already committed over €286 billion ($397 billion) in support for Greece, Ireland, and Portugal, and is committing substantial additional resources to build firewalls to protect against contagion and to recapitalize banks. Eurozone and other EU member countries are also contributing through the IMF, which has provided up to one-third of the financing for crisis programs. We have welcomed the IMF's role as a source of financing and expertise in the effort to contain the crisis. With its long experience and independent judgment, the IMF sets strong economic conditions for its loans, which help return countries to sustainability.

By promoting greater stability and safeguarding against a more abrupt deterioration of economic conditions, the IMF supports the global economy, and with that, U.S. growth, jobs, and exports. Notwithstanding these commitments, the IMF continues to have a substantial arsenal of uncommitted financial resources available – $390 billion – to meet possible future needs. In addition to its involvement in Europe, the IMF has continued to offer financial support more broadly to countries all around the world representing a range of income levels.

Americans want our nation to grow and prosper, to remain secure, and to provide ongoing opportunity for their families and for future generations. To deliver this, we must not only take action domestically, but also work through international forums to leverage a robust and multilateral response to global risks. Amid the global financial crisis, we had a clear demonstration of what we can accomplish by focusing on our priorities at home and by working with our partners abroad.

We appreciate the leadership and support of this Committee on these key challenges, and we look forward to working with Congress as we engage with our international partners, challenging them to follow America's lead in undertaking the policy responses needed to strengthen the global economy.