Testimony of

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I. Introduction

Chairman McHenry, Ranking Member Quigley, other members of the Subcommittee, it is an honor to testify before you today to discuss the economic and fiscal challenges facing Europe and the potential implications for the United States. My name is Bill Dudley, and I am President of the Federal Reserve Bank of New York.

Let me preface these remarks by stating that the views expressed in my written and oral testimony are solely my own and do not represent official views of the Federal Reserve Board, the Federal Open Market Committee ("FOMC") or any other part of the Federal Reserve System. Additionally, because I am precluded by law from discussing confidential supervisory information, I will not be able to speak to the financial condition or regulatory treatment or rating of any individual financial institution.

The Federal Reserve seeks to promote financial stability in order to enable U.S. businesses and households to maintain their access to credit and to ensure sustained economic growth. Although the U.S. economy is currently expanding at a moderate pace, we face significant downside risks, mostly relating to the sovereign debt crisis in Europe. Because developments in Europe will have an important bearing on the prospects for growth and jobs here in the U.S., the Federal Reserve is monitoring the situation there closely. This is also why we have taken special steps, in cooperation with other central banks, to support the flow of credit to households and businesses. I welcome the opportunity to testify on these matters today.

II. Europe

Within the European Union, seventeen countries share a common currency, the euro. The situation in the euro area is very unsettled, with pressure on sovereign debt markets and local banking systems. The euro area has the capacity, including the fiscal capacity, to overcome its challenges. However, the politics are very difficult, both because the problem has many dimensions, and because many different countries and institutions in the euro area have to coordinate their actions in order to achieve a coherent and effective policy response.

Europe's leadership has affirmed its commitment to the European Union and its single currency monetary union on numerous occasions. And the leadership is working to achieve greater policy coordination in areas such as fiscal policy. Putting all the countries using the euro on a clearly sustainable fiscal path would help restore market confidence. Assuming that Europe ultimately succeeds in managing this situation, a stronger union will emerge that will be viewed as more robust and resilient. This would be a welcome development for the U.S.

If, in contrast, Europe were not to be fully successful in charting an effective course, this could have a number of negative implications for the U.S. In particular, there are three possibilities that I would like to highlight for the Subcommittee today.

First, if the European situation were to deteriorate, then the euro area would face even more serious fiscal and economic challenges. As a result, growth within the euro zone would weaken and this would lead to less demand for U.S. goods and services that are exported to Europe from companies and workers here. This would hurt growth here in the United States and would have a negative impact on U.S. jobs. It is important to recognize that the euro area is the world's second largest economy after the U.S. and an important trading partner for us. Also, Europe is a significant investor in the U.S. economy, and vice versa. Thus, what happens in Europe has significant implications for our economy.

Second, if the European situation were to deteriorate, this could put pressure on the U.S. banking system. The good news is that U.S. banks are much more robust and resilient than they were a few years ago. U.S. banks have bolstered their capital significantly, built up their loan loss reserves, and have significantly larger liquidity buffers. Also, the direct exposures of U.S. banks to the countries in Europe that are facing the most intense fiscal challenges are actually quite modest.

The bad news is that the exposures of the U.S. banks climb quite sharply when one also considers the exposures to the core European countries and to the overall European banking system. This means that if the crisis were to broaden further and intensify, this could put greater pressure on U.S. banks' capital and liquidity buffers.

Third, if the European situation were to deteriorate further, financial markets would likely become more stressed. This could tighten the availability of credit to U.S. households and businesses. It could also cause equity prices to fall and this would have a negative impact on Americans' pension and 401(k) holdings. This tightening of financial conditions would damage the U.S. recovery and result in slower output growth and less job creation. At a time that U.S. unemployment is very high, this is a particularly unacceptable outcome. In the extreme, U.S. financial markets could become so impaired that this would dry up the flow of credit to households and businesses.

III. U.S. Dollar Swaps

In terms of what actions the official sector in the United States has taken or could take with regard to Europe, I wish to emphasize that any and all such actions pursued by the Federal Reserve are motivated by the mandates Congress has given to the Federal Reserve to promote price stability and maximum sustainable employment here in the United States.

When the Federal Reserve System was created by Congress in 1913, it was given the responsibility of providing liquidity to the financial system in times of stress in order to shield the economy, to the extent possible, from the severe effects of financial instability on economic activity and jobs. While the economy and the markets have evolved substantially in the century since then, this basic principle continues to guide our efforts today. Central banks around the world have an important lender of last resort role. This role is important in order to protect the economy against financial instability.

In today's globally integrated economy, banks headquartered outside of the U.S. play an important role in providing credit and other financial services in the U.S. – providing a total of about $900 billion in overall financing within the U.S. For these banks to provide U.S. dollar loans, they have to maintain access to U.S. dollar funding. At a time when it is already hard enough for American families and firms to get the credit they need, we have a strong interest in making sure that these banks can continue to be active in the U.S. dollar markets.

Banks headquartered outside the U.S., like banks that are headquartered here, make extensive use of dollars in their financing activities. In part, this is due to the fact that the U.S. dollar is the world's number one currency – a status that brings with it many benefits for our country. It is in the U.S. national interest to make sure that non-U.S. banks that are judged to be sound by their central bank are able to access the U.S. dollar funding they need in order to be able to continue to finance their U.S. dollar assets. If the access to dollar funding were severely impaired, this could necessitate the abrupt, forced sales of dollar assets by these banks, which could seriously disrupt U.S. markets and adversely affect U.S. businesses, consumers, and jobs.

One way we can help to support the availability of dollar funding is by engaging in currency swaps with other central banks. This has been used as a policy tool dating back to 1962. Recently, the Federal Open Market Committee decided to re-launch this tool, cooperating with five other central banks. Our intention is to create a credible backstop to – but not supplant – private markets. Banks with surplus dollars are more likely to lend to banks in need of dollars if they know that the borrowing bank will be able to obtain the dollars it needs to repay the loan, if necessary, from its central bank.

This action is designed to support financial stability, avoid an unnecessary tightening in financial conditions, and support economic activity and jobs in the United States. In particular, by reducing the cost of dollar funding via the swap lines last month, we reduced the pressure on banks in Europe to abruptly liquidate their U.S. dollar assets. Thus, this step will help to insulate U.S. markets from the pressures in Europe and support the availability of credit to U.S. households and businesses. European banks are particularly active in areas such as trade finance, project finance, energy lending and municipal finance – a sharp contraction of the financing they provide would be harmful for the U.S. economy as a whole, including for U.S. exporters, firms working on infrastructure projects, the energy industry and hard-pressed state and local governments across the country.

U.S. financial institutions currently do not face difficulty obtaining liquidity in short-term funding markets. However, were conditions to deteriorate, the Federal Reserve has a range of tools available to provide an effective liquidity backstop for such institutions and is prepared to use these tools as needed to support financial stability and to promote the extension of credit to U.S. households and businesses.

In sum, I am hopeful that Europe can effectively address its current fiscal challenges. The Federal Reserve is actively and carefully assessing this situation and the potential impact on the U.S. economy. At this time, although I do not anticipate further efforts by the Federal Reserve to address the potential spillover effects of Europe on the United States, we will continue to monitor the situation closely.

Thank you for your invitation to testify today, and I look forward to your questions.

WILLIAM C. DUDLEY
Biographical Summary

William C. Dudley became the 10th president and chief executive officer of the Federal Reserve Bank of New York on January 27, 2009. In that capacity, he serves as the vice chairman and a permanent member of the Federal Open Market Committee (FOMC), the group responsible for formulating the nation's monetary policy.

Mr. Dudley had been executive vice president of the Markets Group at the New York Fed, where he also managed the System Open Market Account for the FOMC. The Markets Group oversees domestic open market and foreign exchange trading operations and the provisions of account services to foreign central banks.

Prior to joining the Bank in 2007, Mr. Dudley was a partner and managing director at Goldman, Sachs & Company and was the firm's chief U.S. economist for a decade. Prior to joining Goldman Sachs in 1986, he was a vice president at the former Morgan Guaranty Trust Company. Mr. Dudley was an economist at the Federal Reserve Board from 1981 to 1983.

Mr. Dudley received his doctorate in economics from the University of California, Berkeley in 1982 and a bachelor's degree from New College of Florida in 1974.

Mr. Dudley serves as chairman of the Committee on Payment and Settlement Systems of the Bank for International Settlements. He is a member of the Board of the Directors of the Bank for International Settlements and the Board of Trustees of the Economic Club of New York.

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