Written Testimony of Secretary Tim Geithner
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Chairman Issa, Ranking Member Cummings, and members of the Committee, thank you for the opportunity to testify today on developments in Europe. Europe is a key strategic and economic partner of the United States, and we have an enormous stake in the success of European efforts to restore financial stability and secure growth. The U.S. recovery is getting stronger, but the strength of our recovery will depend in part on events beyond our shores, as we saw last year when U.S. growth was buffeted by headwinds from Europe.

Since that time, European leaders have taken a series of steps to address the crisis and we are encouraged by the progress to date. We hope Europe will build on that progress with additional actions to calm the financial tensions that have been so damaging to global economic growth and put in place a stronger framework of policies and institutions to make the European Monetary Union viable over the longer term and help the member countries to strengthen economic growth.

The European Policy Response

With our encouragement and the support of the IMF, Europe's leaders have put in place a comprehensive strategy to address the crisis. This strategy has the following key elements:

- Economic reforms in the member states to restore fiscal sustainability, restructure the banking systems, and improve competitiveness and growth prospects;

- Institutional reforms, including the "Fiscal Compact," that establish stronger disciplines on the fiscal policies of the member states to limit future deficits and debt as a share of GDP;

- A coordinated strategy to recapitalize the European financial system, with government guarantees of funding; and

- A "firewall" of funds to provide financial support to governments that are undertaking reforms to help assure access to financing on sustainable terms.

These efforts by governments have been reinforced by a substantial amount of support from the European Central Bank.

The European economies at the center of the crisis have made very significant progress.

The causes of the crisis were years in the making and were very different across the continent.

After the establishment of monetary union in 2000, interest rates across the union fell significantly, with rates converging toward Germany's. This was accompanied by a substantial rise in borrowing. In Greece, government spending and borrowing rose dramatically. In Portugal, Spain, and Ireland, private debt expanded. And in all these countries, as well as Italy, the competiveness of the private sector eroded significantly, relative to Germany.

With the exception of Greece, fiscal profligacy was not the primary cause of the crisis.

In Ireland and Spain, the governments actually ran fiscal surpluses, while the private sector borrowed too heavily, inflating a housing bubble. Italy's large public debt is a legacy of a different era. By the early 1990s, the country embarked on serious fiscal consolidation, maintaining primary surpluses (i.e., the government's total revenues exceeded total expenditures, excluding interest payments on debt) between 1992 and 2008.

As the crisis intensified, however, public deficits expanded everywhere, and fears of cascading defaults by government, the collapse of the financial system, or the unraveling of the euro itself caused a broader financial panic across much of the continent, with the governments of many countries losing the ability to borrow at sustainable interest rates without support.

Over the course of the last eighteen months, the countries in crisis have put in place very tough and far-reaching reforms to address the underlying causes of the crisis.

Greece has reduced its structural budget deficit, which measures the underlying deficit adjusted for the effects of recession on revenues and expenditures, by nearly 12 percentage points of GDP since 2009, according to the IMF. Ireland, Portugal, and Spain have reduced their structural deficits by between 4.5 and 5 percentage points over the same period. In Italy, where the structural deficit expanded by much less, the government has shaved off 1¼ percentage points of GDP. Each of these governments has further plans in place to move closer to a sustainable fiscal position over the medium term.

These fiscal reforms are only part of the solution. The harder challenge is to address the erosion in competitiveness and restore reasonable rates of economic growth, a challenge made more difficult by the fact that in a monetary union, the member states do not have their own monetary policies or currencies that can adjust, and in Europe today, there is no mechanism for fiscal transfers to help cushion economic shocks.

The five countries at the center of the crisis are also putting in place measures to restore competitiveness. The Italian government has begun to implement reforms to improve the business environment, and developed plans to reform the country's labor laws. Spain has introduced reforms to increase the dynamism of its private sector. Greece, Portugal, and Ireland have also introduced a range of competitiveness-enhancing reforms, including plans for privatization, and labor market reforms and pension reductions.

And these countries are also acting to restructure and repair their banking systems. Spain is restructuring its financial sector, reducing the number of savings banks from 45 to 15. In Ireland, bank recapitalization of €70 billion is now complete and the deleveraging of the system

– which aims to reduce banks' loan-to-deposit ratios by almost 20 percent over three years – is proceeding as planned.

For these economic reforms to work, policymakers in the Euro Area will have to be careful to calibrate the mix of financial support and the pace of fiscal consolidation. The reforms will take time and they will not work without financial support that enables governments to borrow at affordable rates and keeps the overall rates of interest across the economy at levels that won't kill growth.

Economic growth is likely to be weak for some time. The path of fiscal consolidation should be gradual with a multiyear phase-in of reforms. If every time economic growth disappoints governments are forced to cut spending or raise taxes immediately to make up for the impact of weaker growth on deficits, this would risk a self-reinforcing negative spiral of growth-killing austerity.

These economic reforms have been aided by actions by the ECB, which has lowered interest rates, undertaken purchases of sovereign debt in secondary markets, and provided critical funding and liquidity support for the European banking system. Last December, the ECB introduced the three-year Long-Term Refinancing Operation (LTRO) and broadened eligible collateral. Through its two lending operations in December and February, the LTRO has allotted over €1.0 trillion to hundreds of banks.

In addition, the European Banking Authority (EBA) has conducted a series of stress tests with new disclosure requirements for the banking systems of the entire Euro Area and required banks to raise capital and take other steps to build stronger financial cushions against the economic downturn and to reflect the higher risks of the assets they hold. European banks have raised more capital, but they have also been selling assets and cutting bank lending to help meet the new capital requirements, which is adding to the financial headwinds now slowing growth.

European leaders have worked with private bondholders and the IMF to restructure and reduce Greece's government debt. Fears of a disorderly Greek default played a significant role in fueling the fires of the crisis across Europe over the past two years, and Europe's leaders have, as a result, worked to contain the risk of contagion from Greece and to insulate the rest of Europe from the impact of the solutions necessary in Greece.

This mix of economic reform and financial measures has helped calm financial tensions. The cost of borrowing has fallen sharply for Italy and Spain. Concerns about bank funding problems have eased. But Europe is still only at the initial stages of what will be a long and difficult path of reform.

The most important unfinished piece of the broader financial strategy is to build a stronger European firewall to provide a backstop for the governments undertaking reforms. The existing €440 billion European Financial Stability Facility (EFSF) has made commitments totaling €192 billion. Europe's leaders have decided to establish another fund called the European Stabilization Mechanism (ESM) to succeed the EFSF starting in July 2012. They are in the process of reviewing options for expanding the combined financial capacity of these funds so

that they can make clear to financial markets that they have the financial resources available on a scale that is commensurate with future needs in the event the crisis were to intensify.

The European financial crisis has already caused significant damage to economic growth in the United States and around the world, and we have a strong interest in a successful resolution of the crisis.

The Euro Area accounts for about 18 percent of global GDP. It is a major source of financing for many emerging economies. It accounts for about 15 percent of U.S. exports of goods and services, but a larger portion of exports of many or our trading partners. When growth slows in Europe, it affects growth around the world. And when the fears of a broader European crisis have been most acute, as they were in the summer and fall of 2011 and during the spring and summer of 2010, financial markets fell around the world, damaging confidence and slowing the momentum of the global recovery.

Our financial system has relatively little exposure to the five European economies at the heart of the crisis, but we have significant financial and economic ties to Germany and France and the continent as a whole.

We have worked very closely with Europe's leaders over the past two years, and with the members of the IMF, to help support a stronger European response to the crisis.

The Federal Reserve's dollar swap lines with the ECB, the Bank of Canada, the Bank of England, the Bank of Japan, and the Swiss National Bank have played a critical role alongside the ECB's direct efforts. European banks borrowed heavily in dollars before the crisis, and many lost the ability to borrow in dollars as the crisis intensified. The Fed's swaps made it possible for Europe's banks to borrow dollars from their central banks, which has helped avoid a more rapid deleveraging, reducing the impact on financial conditions in many countries where European banks had lent heavily.

The IMF has also played an important role in Europe. The IMF has provided advice on the design of reforms, a framework for public monitoring of progress, and support for programs in Greece, Ireland, and Portugal in partnership with Europe, which has assumed the majority of the burden. These actions have helped limit the damage from the crisis to the United States and to economies around the world.

It is in the interest of the United States that the IMF is able to continue to play a constructive role in Europe. IMF resources cannot substitute for a strong and credible European firewall and response, but they can help supplement the resources Europe mobilized on its own.

The IMF has substantial financial resources available today, and it has the ability, as it has demonstrated in the past, to mobilize temporary resources if that were necessary to help contain the damage from a further intensification of the crisis in Europe. For these reasons, we have no intention to seek additional U.S. resources for the IMF. The IMF has played a 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

We are encouraged by the progress that our European colleagues have made over the last few months. We hope they are able to build on these efforts in the coming weeks and months to put in place a more durable foundation for financial stability and economic growth. We do not want to see Europe weakened by a protracted crisis. We will continue to work closely with them, and with the IMF, to facilitate further progress.