For release on delivery
9:30 a.m. EDT
March 21, 2012

Statement by

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before the

Committee on Oversight and Government Reform

U.S. House of Representatives

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Thank you, Chairman Issa, Ranking Member Cummings, and other members of the Committee for inviting me to testify about the economic and financial situation in Europe and the actions taken by the Federal Reserve in response.

Developments in Europe and Their Effects on the U.S. Economy

For almost two years, developments in Europe have had an important influence on the tenor of global financial markets and on the global economy more generally. The combination of high debts, large deficits, and poor growth prospects in several countries using the euro has raised concerns about fiscal sustainability and, consequently, led to sharply higher sovereign borrowing costs--initially for Greece, but subsequently for other euro-area countries as well. Pessimism about these countries' fiscal and economic situations, in turn, has undermined confidence in the strength of European financial institutions, increasing the cost and difficulty those institutions have faced in obtaining funding and reducing their willingness to supply credit.

The difficulties in the euro area have affected the U.S. economy. The European Union accounts for roughly one-fifth of U.S. exports of goods and services. Not surprisingly, U.S. exports to Europe over the past two years have underperformed our exports to the rest of the world. In addition, weaker demand from Europe has slowed growth in other economies, which has also lowered foreign demand for our products.

Financial strains in Europe have also shown through to our financial markets. During times when financial conditions in Europe were at their most turbulent, investors around the world retreated from riskier assets. In the United States, these pullbacks decreased stock prices, increased the costs of issuing corporate debt, and reduced consumer and business confidence. In addition, U.S. financial institutions that were thought to have substantial exposures to Europe saw their stock prices fall and their credit spreads widen.

In the past few months, financial stresses in Europe have lessened, which has contributed to an improved tone of financial markets around the world, including in the United States. The improvement reflects, in part, a number of actions taken by European policymakers. First, measures taken by the European Central Bank (ECB), including implementing two longer-term refinancing operations and easing collateral rules and reserve requirements, have allowed European banks to lock in funding for up to three years, thereby alleviating concerns about their near-term prospects. With the benefit of this support, European banks in turn have increased their holdings of sovereign debt, contributing to lower borrowing costs for some countries.

Second, euro-area leaders, the Greek government, and private-sector holders of Greek debt are taking steps to put Greece on a more sustainable fiscal path. Its sovereign debt has been significantly reduced, the Greek authorities are intensifying their efforts to implement fiscal and structural reforms, and the European Union and International Monetary Fund have pledged a considerable amount of new funds as part of a second assistance package. The Greek economy remains in a deep recession, however.

Third and finally, leaders of most of the members of the European Union have approved a new fiscal compact treaty that strengthens fiscal rules and their enforcement. This treaty represents a positive step toward resolving the fundamental tension inherent in having a monetary union without a fiscal union, and thus should help bolster the viability of the euro-area economy in the longer term.

Although progress has been made, more needs to be done. Full resolution of the crisis will require a further strengthening of the European banking system; a significant expansion of financial backstops, or “firewalls,” to guard against contagion in sovereign debt markets; and, critically, continued efforts to increase economic growth and competitiveness and to reduce external imbalances in the troubled countries.

Actions Taken by the Federal Reserve

The Federal Reserve has followed developments in Europe closely, and we are in frequent contact with key European policymakers. We are particularly focused on protecting U.S. financial institutions, businesses, and consumers from adverse financial and economic developments in Europe.

To help calm dollar funding markets and support the flow of credit to U.S. households and businesses, the Federal Reserve acted in concert with major foreign central banks to enhance the U.S. dollar swap facilities that were originally put in place during the global financial crisis and reestablished in May 2010. Use of the reestablished lines was limited until late last year. However, in late November, the Federal Reserve agreed with the ECB and the central banks of Canada, Japan, Switzerland, and the United Kingdom to extend the swap lines through February 2013 and to reduce their pricing, from a spread of 100 basis points over the overnight index swap rate to 50 basis points.[1]

The lower cost to the ECB and other foreign central banks enabled them, in turn, to reduce the cost of the short-term dollar loans they provide to financial institutions in their jurisdictions. As a result, usage of the swap line increased considerably, peaking at $109 billion in mid-February. The expanded use of the swap lines has helped to ease funding pressures on European and other foreign banks, lower tensions in U.S. money markets (in which foreign banks are major participants), alleviate pressures on foreign banks to reduce their lending in the

[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 websites of the other participating central banks.

United States, and boost confidence at a time of considerable strain in international financial markets. In recent weeks, as market conditions have improved, usage of the swap lines has fallen back to about $65 billion.

I would add that the swaps are very safe from the perspective of the Federal Reserve and the U.S. taxpayer. They present no exchange rate or interest rate risk; each drawing has a short maturity and must be approved by the Federal Reserve; they are collateralized by the foreign currencies for which dollars are swapped; and our counterparties are the foreign central banks, not the foreign commercial banks that receive the dollar loans.[2]

In addition to its actions to reduce pressures in global markets for dollar funding, the Federal Reserve has collaborated with other agencies--both bilaterally and through the Financial Stability Oversight Council--to monitor the potential vulnerabilities of U.S. financial institutions and to work to enhance their resilience in the face of possible shocks to the global economy. Notably, U.S. financial institutions have very limited direct net credit exposures to the most vulnerable euro-area countries, and U.S. money market funds also have almost no exposure to those countries.

U.S. financial institutions do have some gross exposure to potential losses arising from sales of credit default swap (CDS) protection referencing European sovereign debt. However, for the large U.S. dealer banks, these sales have been more than offset by purchases of protection, which would imply that in the event of a sovereign default, U.S. financial institutions would be net recipients of CDS payouts. These positions still carry some risk in that some U.S.

[2] 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 website, 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.

banks' counterparties might conceivably fail to make good on their obligations, but such risk is mitigated by the fact that the counterparties to large U.S. dealer banks for sovereign CDS trades are dispersed, primarily across large financial institutions. And in the vast majority of cases, these institutions post collateral to each other to help minimize possible losses.

Although U.S. banks have limited exposure to peripheral European countries, their exposures to European banks and to the larger, "core" countries of Europe are more material. Moreover, European holdings represented 35 percent of the assets of prime U.S. money market funds in February, and these funds remain structurally vulnerable despite some constructive steps, such as improved liquidity requirements, taken since the recent financial crisis. U.S. financial firms and money market funds have had time to adjust their exposures and hedge their risks to some degree as the European situation has evolved, but the risks of contagion remain a concern for both these institutions and their supervisors and regulators. In particular, were the situation in Europe to take a severe turn for the worse, the U.S. financial sector likely would have to contend not only with problems stemming from its direct European exposures, but also with an array of broader market movements, including declines in global equity prices, increased credit costs, and reduced availability of funding.

To address these broader risks, we have been working closely with large U.S. financial institutions. Most recently, on March 13, we released results from our Comprehensive Capital Analysis and Review (CCAR)--a supervisory assessment by the Federal Reserve of the capital planning processes and capital adequacy of large, complex bank holding companies.[3] As part of this exercise, bank capital positions were evaluated under a hypothetical stress scenario that involved a deep recession in the United States (with unemployment reaching 13 percent) and a

[3] See Board of Governors of the Federal Reserve System (2012), "Federal Reserve Announces Summary Results of Latest Round of Bank Stress Tests," press release, March 13, www.federalreserve.gov/newsevents/press/bcreg/20120313a.htm.

notable decline in activity abroad, combined with sharp decreases in both domestic and global asset prices. This exercise was designed to capture both the direct and indirect exposures and vulnerabilities of U.S. financial institutions to the economic and financial stresses that might arise from a severe crisis in Europe. The results show that a significant majority of the largest U.S. banks would continue to meet supervisory expectations for capital adequacy despite large projected losses in an extremely adverse hypothetical scenario.

Conclusion

The recent reduction in financial stresses in Europe is a welcome development for the United States, given the important trade and financial linkages connecting our economies. However, Europe's financial and economic situation remains difficult, and it is critical that the European leaders follow through on their policy commitments to ensure a lasting stabilization. I believe that our European counterparts understand the challenges and risks they face and are committed to take the necessary steps to address those issues.

For our part, the Federal Reserve will continue to monitor the situation closely, work with our financial institutions and foreign counterparts to enhance the resilience of our financial system, and be ready to use our tools to help stabilize U.S. markets should the situation require such action.

Thank you. I would be pleased to respond to your questions.