Daniel K Tarullo: International response to European debt problems

Testimony by Mr Daniel K Tarullo, Member of the Board of Governors of the Federal Reserve System, before the Subcommittee on International Monetary Policy and Trade and Subcommittee on Domestic Monetary Policy and Technology, Committee on Financial Services, US House of Representatives, Washington DC, 20 May 2010.

The original speech, which contains various links to the documents mentioned, can be found on the US Federal Reserve System's website.

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Chairman Meeks and Chairman Watt, Ranking Members Miller and Paul, and other members of the subcommittees, thank you for the invitation to participate in this hearing on the European sovereign debt problems and related international stabilization efforts.

Coming as it does on the heels of the financial crisis that began in 2007, and with economic recovery here in the United States proceeding at only a modest pace, the European sovereign debt problems are a potentially serious setback. It is thus important to understand the evolution of the financial turmoil in Europe, the European policy response, and the implications for the United States. After presenting some views on these subjects, I will describe the action taken by the Federal Reserve last week in support of efforts to contain the crisis.

Evolution of the crisis in Europe and the European policy response

Although the sovereign debt crisis in Europe may have appeared to erupt virtually overnight, its origins were long in the making. For years many market participants had assumed that an implicit guarantee protected the debt of euro-area members. For a number of euro-area countries, including those most under pressure now, this presumption may have led to a systematic underpricing of risk, which made debt cheaper to issue than it probably should have been. Although strictures against excessive fiscal deficits and debts were built into the Maastricht Treaty, the European Union (EU) has had relatively weak mechanisms to enforce them, as EU officials themselves have recently acknowledged. Little provision was made for fiscal transfers across members of the euro area in the event that financial support for members became necessary. The global financial crisis created an environment in which the presumed EU guarantee was more likely to be tested, as stimulus measures and lost revenue led to sizable fiscal deficits and the rapid accumulation of debt across euro-area members.

Nowhere were these problems with the EU's fiscal framework more evident than in Greece. Greece's entry into the euro area in 2001 was associated with a sharp decline in Greek government borrowing costs. Remarkably, the spread of Greek 10-year bond yields over those on German bonds fell below 30 basis points for a number of years. Despite these low borrowing costs, Greece was consistently unable to meet EU budget deficit targets or to reduce its sizable debt, putting the government's finances in a very precarious position at the onset of the global financial crisis.

Many date the start of the acute phase of the current problems to the revelation last fall that the Greek government's deficit for 2009 was likely to be several times larger than previously thought – it is now estimated at near 14 percent of gross domestic product (GDP) – and that its debt would significantly exceed 100 percent of GDP. In response, the Greek government announced substantial fiscal consolidation plans involving sizable increases in revenue and sharp wage cuts for government workers. However, concerns about the plan's feasibility, especially as growth prospects worsened, combined with what financial market participants took to be inconsistent signals from other European countries about the possibility of support, undermined the market's belief in an implicit guarantee. As a result, a sharp widening of spreads, rating downgrades of Greek debt, and stresses in the Greek banking system followed. By mid-April, it was clear that Greek financial institutions and the Greek government were rapidly losing access to market financing, just as sizable redemptions on the government's debt were looming.

After attempts at smaller and less well-defined support mechanisms for Greece failed to stabilize markets, EU and International Monetary Fund (IMF) leaders announced on May 2 a joint €110 billion support package. This international financing package is the largest ever extended to a single country and amounts to about 50 percent of Greece's GDP. In return, Greece was expected to implement an aggressive, front-loaded consolidation program to reduce its budget deficit from double-digit rates to less than 3 percent of GDP between now and 2014, with one-half of that reduction occurring this year alone.

The announcement of this package did not stave off market pressures, and by then the concerns of investors had already moved well beyond Greece. Doubts about the feasibility of the contemplated pace of Greek fiscal consolidation and concerns about the fiscal and financial situation in other vulnerable euro-area countries, especially Portugal and Spain, combined to move the situation closer to a crisis. Pressures were also beginning to be felt in dollar funding markets in Europe. Nascent signs of dollar shortages, a shortening of lending tenors on the interbank market, and increasing concerns about counterparty risk for many European financial institutions brought back memories of developments during the recent global financial crisis. More visible was the sharp decline in the euro in foreign exchange markets and plunging stock markets worldwide.

In response to these rapidly deteriorating financial conditions, in the early hours of Monday, May 10, European leaders announced a much broader package of stabilization measures than that previously announced for Greece alone.

One set of initiatives addresses sovereign risk. The European leaders announced the establishment of a European Financial Stabilization mechanism that would be based on up to €60 billion in European Commission funding and a special purpose vehicle that could raise up to €440 billion in additional funds in capital markets with guarantees provided by member state governments. Moreover, the IMF stated that it stood ready to cooperate with the EU, in accordance with established IMF lending programs and procedures, if requested by euro-area members. According to the EU, total available support through loans and credit lines, including potential bilateral IMF loans to member countries, could be as large as €750 billion (approximately $900 billion). In addition, the EU and the IMF announced final approval and funding for the earlier announced Greek rescue package in an effort to assuage concerns about the country's financing needs.

Another set of initiatives addresses market liquidity. Specifically, the European Central Bank (ECB) announced that it was prepared to purchase government and private debt securities to ensure the depth and liquidity of euro area debt markets that were considered dysfunctional. In addition, the ECB expanded its liquidity provision facilities, including offering full-allotment operations for three- and six-month loans. Finally, as I will discuss in more detail later, to forestall an emerging shortage of dollar liquidity, the Federal Reserve reopened temporary U.S. dollar liquidity swap lines with the ECB and other major central banks.

The effect of the announcement on bond markets was immediate. Bond spreads for the peripheral European countries narrowed substantially, at least partly reflecting purchases of government securities by euro-area central banks. The ECB's enhanced liquidity provisions, including dollar credit from the liquidity swaps, have contained stresses in the European interbank market and provided an important backstop for these markets. Stock markets also initially rebounded strongly following the announcement of the European package; however, their declines over the past week serve as a reminder that investors are aware that this package cannot ultimately relieve the need for real, and likely painful, fiscal reforms in some euro-area countries.

Potential ramifications for the U.S. economy

Financial markets in the United States have been buffeted by the European problems. Over the four-week period leading up to May 6, just prior to news that EU members would be meeting to craft the most recent package, broad U.S. stock price indexes declined and implied volatility on equities rose sharply, reflecting some increased aversion to risk. The flight to quality also showed through to U.S. Treasury yields and the foreign exchange value of the dollar, with the 10-year Treasury yield declining 50 basis points over the four-week period and the dollar climbing more than six percent against the euro. Following the announcement of the May 10 package, Treasury yields moved back up slightly and equity prices rebounded, but these moves were subsequently reversed and the dollar rose further against the euro.

These effects on U.S. markets underscore the high degree of integration of the U.S. and European economies and highlight the risks to the United States of renewed financial stresses in Europe. One avenue through which financial turmoil in Europe might affect the U.S. economy is by weakening the asset quality and capital positions of U.S. financial institutions. There are, to be sure, good reasons to believe that these institutions can withstand some fallout from European financial difficulties. In the past year, the Federal Reserve has pressed the largest financial institutions to raise substantial additional capital. Moreover, the direct effect on U.S. banks of losses on exposure to one or more sovereigns in peripheral Europe – which, in the current context of sovereign debt concerns, is generally understood to mean Greece, Portugal, Spain, Ireland, and Italy – would be small. According to the Federal Financial Institutions Examination Council, almost all U.S. exposure to peripheral European sovereigns is held by 10 large U.S. bank holding companies, whose balance sheet exposure of $60 billion represents only 9 percent of their Tier 1 capital.[1] However, if sovereign problems in peripheral Europe were to spill over to cause difficulties more broadly throughout Europe, U.S. banks would face larger losses on their considerable overall credit exposures, as the value of traded assets declined and loan delinquencies mounted. U.S. money market mutual funds and other institutions, which hold a large amount of commercial paper and certificates of deposit issued by European banks, would likely also be affected.

In addition to imposing direct losses on U.S. institutions, a heightening of financial stresses in Europe could be transmitted to financial markets globally. Increases in uncertainty and risk aversion could lead to higher funding costs and liquidity shortages for some institutions, and forced asset sales and reductions in collateral values that could, in turn, engender further market turmoil. In these conditions, U.S. banks and other institutions might be forced to pull back on their lending, as they did during the period of severe financial market dysfunction that followed the bankruptcy of Lehman Brothers. The timing of such an event in the current instance would be unfortunate, as banks generally have only recently ceased tightening lending standards, and have yet to unwind from the considerable tightening that has occurred over the past two years. Moreover, aggregate bank lending, particularly to businesses, continues to contract. The result would be another source of risk to the U.S. recovery in an environment of still-fragile balance sheets and considerable slack. Although we view such a development as unlikely, the swoon in global financial markets earlier this month suggests that it is not out of the question.

Another means by which an intensification of financial turmoil in Europe could affect U.S. growth is by reducing trade. Collectively, Europe represents one of our most important trading partners and accounts for about one-quarter of U.S. merchandise exports. Accordingly, a moderate economic slowdown across Europe would cause U.S. export growth

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[1] See Federal Financial Institutions Examination Council, “E.16 Country Exposure Lending Survey and Country Exposure Information Report.”

to fall, weighing on U.S. economic performance by a discernible, but modest extent. However, a deeper contraction in Europe associated with sharp financial dislocations would have the potential to stall the recovery of the entire global economy, and this scenario would have far more serious consequences for U.S. trade and economic growth. A resultant slowdown in the United States and abroad would likely also feed back into the health of U.S. financial institutions.

Federal Reserve responses to the crisis

Notwithstanding the fact that European sovereign debt problems could have negative consequences for U.S. and global economic growth, successful resolution of these problems ultimately rests predominantly on effective European policy actions. The Federal Reserve has only a limited, though important, role to play by helping to prevent liquidity pressures from intensifying and leading to a more widespread freezing up of financial markets, including in the United States. To counter growing strains in dollar funding markets in Europe, last week the Federal Reserve re-established dollar liquidity swap lines with a number of foreign central banks following the receipt of information on the large support package developed by European leaders.[2]

The liquidity lines, which were authorized by a unanimous vote of the Federal Open Market Committee, are structured similarly to those that were put in place during the financial crisis. As you know, central bank swap transactions have a long and well-established history, and their use by the Federal Reserve and other central banks goes back to the Bretton Woods era of fixed exchange rates. In their current vintage, they are used by foreign central banks to relieve or forestall temporary liquidity pressures in their local dollar funding markets. Foreign central banks draw on these lines by selling foreign currency to the Federal Reserve in exchange for dollars. The foreign central banks then lend these dollars to financial institutions in their jurisdictions. At maturity, the foreign central bank returns the dollars back to the Federal Reserve in exchange for its own currency at the same exchange rate that prevailed at the time of the initial draw, and pays interest as well.

The loans provided by the foreign central banks to institutions abroad are offered at rates that would be above market rates in normal times. As such, when market conditions are not greatly strained, demand for dollar liquidity through the swap lines should not be high, as market alternatives would be more attractive. Likely for that reason, the dollar liquidity offerings by foreign central banks to date have elicited only a modest demand.[3] However, even in such instances, the existence of these facilities can reassure market participants that funds will be available in case of need, and thus help forestall hoarding of liquidity, a feature that exacerbated stresses during the global financial crisis.

Even if usage increases significantly, the risks to the Federal Reserve, and by implication the risks to the U.S. taxpayer, are minimal. U.S. interests are safeguarded by the foreign currency held by the Federal Reserve during the term of the swap. Moreover, our exposures are not to the institutions in the foreign countries ultimately receiving the dollar liquidity but to the foreign central banks. Over the life of the previous temporary swap program (from December 2007 to February 2010), all swaps were repaid in full, and the Federal Reserve earned $5.8 billion in interest. Finally, the Federal Reserve bears no market pricing risk in these drawings, since the swaps are designed so that fluctuations in exchange rates or interest rates have no effect on the payments made at the end of the transaction.

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[2] Swap facilities were reestablished with central banks in Europe (the ECB, the Bank of England, and the Swiss National Bank), Japan (the Bank of Japan), and Canada (the Bank of Canada). The agreements establishing these facilities can be seen at Federal Reserve Bank of New York, "Central Bank Liquidity Swaps."

[3] Amounts outstanding on the swap lines are posted weekly at Federal Reserve Bank of New York, "Federal Reserve Foreign Exchange Swap Agreements."

Conclusion

The agreement of the Federal Reserve to reinstate foreign exchange swap arrangements was designed not to insulate banks and investors from losses they may incur, but as a prudent effort to help minimize the risk of financial turmoil in Europe, with the consequences that would ensue for the global financial system, including the United States. In the worst case, such turmoil could lead to a replay of the freezing up of financial markets that we witnessed in 2008. With unemployment remaining quite high, and with continued need for balance sheet repair by many businesses, financial institutions, and households, it is particularly important that the United States not sustain a significant external shock.

The policy measures announced by European authorities a week and a half ago elicited a quick, strongly favorable market reaction, holding out hope that further financial disruptions can be averted. However, as reflected in the negative turn of equity markets later in the week, and continued tight funding in some European markets, uncertainties are still clouding financial markets. Market participants continue to seek clarification of the terms and scope of the measures broadly outlined by the relevant European countries and institutions.

In Europe, a key near-term priority is to continue work to prevent a drying up of liquidity by providing both euro-denominated and, through the dollar liquidity swaps, dollar-denominated credit to financial institutions. But, even if effectively implemented, this support, along with the support for sovereign debt markets provided by the other components of the EU package, will not solve the sovereign debt problems; it will only provide time to make necessary policy adjustments. Lasting beneficial effects will require credible action to bring fiscal deficits under control. For the EU as a whole, it seems clear that the mechanisms of the European Economic and Monetary Union need further development if it is to achieve its intended aims. Last week, the European Commission issued a communiqué outlining plans to enhance surveillance and develop a crisis management framework. I would anticipate a robust debate over these and related matters in the coming months.

The United States is in a very different position from that of the European countries whose debt instruments have been under such pressure. But their experience is another reminder, if one were needed, that every country with sustained budget deficits and rising debt – including the United States – needs to act in a timely manner to put in place a credible program for sustainable fiscal policies.

Thank you very much; I would be pleased to answer any questions.