

William C Dudley: Opening remarks for the Transatlantic Economic Interdependence and Policy Challenges Conference

Opening remarks by Mr William C Dudley, President and Chief Executive Officer of the Federal Reserve Bank of New York and Chairman of the Committee on the Global Financial System (CGFS), at the Transatlantic Economic Interdependence and Policy Challenges Conference, Federal Reserve Bank of New York, New York City, 22 April 2013.

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It is my pleasure to welcome you to today's conference on transatlantic economic interdependence and policy challenges. We have a great program today with many distinguished speakers from academia, and the private and public sectors. In particular, I would highlight the keynote speech following lunch by Olli Rehn, the vice president of the European Commission.

We live in a global economy with a global financial system, yet macroeconomic policy and regulation and supervision have a decidedly national orientation. This creates a challenge for all of us as we seek to balance our domestic needs against the benefits from having a harmonized and integrated global system. We can do better through international cooperation and coordination both on macro policy and on regulation and supervision, rather than trying to "go it alone."

As the two largest economies in the world, the United States and the European Union have a shared stake in the vitality of the global economy. Without growth in both our regions, the global economy will not prosper and we will not be able to satisfy the aspirations of our citizens.

Today I want to focus on some of the challenges that we both face. As I see it, significant progress has been made in the United States and Europe in recovering from the worst financial crisis since the Great Depression and the deep recession that followed, but more still needs to be done.

On the regulatory side, there is considerable good news worth highlighting. In particular, substantial progress has been made in strengthening the global capital and liquidity standards for internationally active banks. This should make the failure of large firms much less likely. Also, the financial system is being rebuilt to make it more resilient and robust. For example, the requirement that over-the-counter (OTC) derivatives be standardized and centrally cleared whenever possible should strengthen the global financial system. Similarly, the global set of principles for financial market infrastructures has been updated and strengthened.

Moreover, some tentative steps have also been made so we can better deal with the failure of systemically important financial firms on a cross-border basis. Key attributes for resolution regimes have been promulgated by the Financial Stability Board. Efforts are underway to implement national regimes consistent with these standards and that can work together in a coordinated way on a global basis.

But more needs to be done. The impediments to an orderly cross-border resolution still need to be fully identified and dismantled. This is necessary to eliminate the so-called "too big to fail" problem. The Basel III capital and liquidity requirements need to be fully implemented. Also, cross-border regulatory cooperation needs to be further enhanced. This includes greater exchange of confidential supervisory information so that national regulators can be fully informed about the conditions of the banks that operate within their borders. It also requires efforts to ensure a level playing field across jurisdictions so that the focus is on promoting safety and stability rather than trying to protect, favor, or shield national champions.

In terms of the macroeconomy, there is both good and bad news. In the United States, the good news is that the economic outlook appears to be gradually improving. The household sector is far along in the deleveraging process, the housing sector is recovering, the banking system is healthier and credit conditions are easing, the corporate sector is highly profitable and awash in cash.

Monetary policy has been effective at fostering easier financial market conditions, even with short-term rates pinned at the zero bound. To provide the appropriate degree of accommodation, the Federal Reserve has recently moved to an outcome-based approach in which the use of our tools is explicitly tied to developments in the economy and economic outlook. Currently, as part of this strategy, we are purchasing \$85 billion of longer-term Treasuries and agency mortgage-backed securities each month. After reviewing the efficacy and costs of this program, I have concluded that that efficacy has been as high or higher than I expected at the onset of the program and costs the same or lower.

Nevertheless, the United States could be doing better. The U.S. fiscal policy program, for example, does not appear well-calibrated to the current set of economic circumstances. We have too much fiscal restraint in the short term, and too little consolidation in the long term. The degree of fiscal restraint this year (about 1¾ percent of gross domestic product [GDP] in 2013) is quite large relative to the forward momentum of the economy. Thus, we have a tug-of-war between the improving economy and the current large negative fiscal impulse. How this tug-of-war gets resolved – which force dominates – won't be known for some time. In other words, the level of uncertainty about the near-term outlook in the United States remains quite high.

Meanwhile, the long-term fiscal outlook for the United States is still troubling. So far, partisan divisions in Washington have limited progress in reaching the type of “grand bargain” needed to put the United States on a sustainable long-term fiscal path, though of late we have at least seen some renewed talk about this. Nor have we yet deployed a comprehensive set of policies to support the rebalancing of the U.S. economy toward a growth path based more on business investment, trade and broad-based income gains than the type of asset price gains and credit-fuelled consumption, which dominated the last business cycle.

For Europe, the near term macroeconomic outlook seems less bright. The good news is that the peripheral countries have made substantial efforts to bring down their structural budget deficits. They have also made some progress in improving their international competitiveness, though there remains an opportunity for further structural reforms in labor and product markets – and not just in the periphery – to increase productivity and strengthen long term growth prospects.

The European Central Bank's (ECB) introduction of the outright monetary transactions (OMT) program has reduced financial market tensions considerably in the peripheral countries, so that sovereign debt funding costs in those countries are at more reasonable levels. The risk that interest rates in the periphery could spiral upward has been significantly diminished. Also, the commitment to European integration remains strong, a factor that U.S.-based analysts and investors do not always sufficiently appreciate. Over the past few years, when the situation has been the most bleak, the choice in favor of the Union with the euro at its core has always won out.

The bad news is that the eurozone is still in a recession and the political support for further rounds of budget-tightening has clearly lessened. The eurozone financial system is being fragmented and the partial easing of pressure on peripheral sovereign debt markets has not translated into a corresponding easing in private-sector borrowing costs in these nations. If growth does not resume relatively soon, then the political support for continued fiscal and structural adjustment could further erode.

In Europe, a key challenge is to strengthen the economic foundations of monetary union at the system level. This needs to be done in a way that combines deeper integration with good incentives and governance so that it can be broadly supported by both the core and

peripheral countries. In this respect, it is important to recall that the architects of EMU from the outset defined it as a project of Economic and Monetary Union.

I view the task of transitioning to a pan-European banking union with the ECB as the primary overseer of the European banking system as a critically important next step. Successfully moving to a pan-European banking union would generate a large number of benefits:

- It would demonstrate a commitment toward greater integration that would enhance the credibility that monetary union is indeed irreversible.
- It would help to sever the link between the fiscal position of individual governments and the health of their banks.
- By eliminating the scope for national bias, it would strengthen market confidence that large hidden losses are not likely to be buried within the banking system.
- It would move against fragmentation and promote re-integration of the European banking system.
- It would help to make monetary policy more effective in supporting activity in the peripheral countries. A critical problem in Europe right now is that private borrowing costs are very low in countries like Germany where the economy is operating close to full capacity, but quite high in countries like Italy and Spain – which are struggling in terms of economic performance. The monetary policy transmission channels in Europe are impaired. Banking union would make them work better.
- It would underscore the fact that a euro is a euro and will remain a euro throughout Europe, reducing perceptions of redenomination risk. This would make depositors less prone to move their funds from the periphery to the core and strengthen the resiliency of the system against shocks.
- It would help foster greater integration of the European economy, with potentially significant macroeconomic benefits.

In short, banking union has the potential to make a powerful contribution to eurozone stability and growth, both in the short term and in the long term.

Now, will moving to a pan-European banking system be easy? Of course not. It will require a common set of standards to be applied across the whole system. This may well reveal shortcomings among particular banks and the burden is not likely to fall evenly across the European Union. It will be important to identify the sources of capital that will fill any such holes in order to ensure ongoing stability and to avoid constraining the availability of credit.

The process of banking union appropriately begins with a single supervisory mechanism. But, a common resolution authority and integrated deposit insurance framework that is both credible and consistent with good incentives are likely to be required, as well. The task at hand will likely require each country to give up a small amount of sovereignty with respect to banking oversight so that the outcome is viewed as fully credible. In my view, this is a critical next step in the “one money, one market” project underlying the EU agenda.

I'd now like to introduce Ambassador Vale de Almeida as our next speaker. The ambassador has been here in his current role since August 2010. Prior to his current appointment, he worked as a director general at the European Commission (EC) and has had a long and distinguished career at the EC dating back to 1982. So he is extraordinarily well-versed to speak on the issues of interdependence and the policy challenges we face. Welcome Ambassador Vale de Almeida.