**EMBARGOED UNTIL DELIVERY**

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**"United States-European Union Economic Relations: Crisis and Opportunity"**
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Chairman Menendez, Ranking Member Corker, distinguished members of the committee, thank you for the opportunity to speak with you today about one of the most important challenges facing the global economy.

The Transatlantic relationship is a critical anchor of America's economic and national security. European allies are essential partners in our strategic engagements around the world, from the historic changes underway in the Middle East and North Africa to addressing Iran and North Korea. U.S. financial and trade linkages with Europe are strong, and we hope to make them stronger still by moving forward with an ambitious Transatlantic Trade and Investment Partnership agreement.

But even as our own economy continues to heal, U.S. companies are adversely affected by weak business and consumer demand across Europe. Three years into the euro area crisis, the risk of protracted stagnation represents one of the most important challenges to the global economic outlook.

Since the beginning of the crisis, President Obama has actively engaged with European leaders, urging action to restore financial stability and support growth. Secretary Geithner and Secretary Lew have shared experiences from our own crisis response and recovery plan, emphasizing the importance of addressing market challenges decisively and retaining flexibility to calibrate monetary and fiscal policy to the pace of recovery.

Euro area leaders deserve credit for the difficult steps they have taken to restore financial stability and address the risk of cascading defaults and exit. Spain and Italy are now able to borrow at rates that are significantly lower than they were a year ago.

Now the focus must shift from stabilization efforts to supporting demand growth in order to avoid protracted stagnation and address record levels of unemployment, especially among Europe's young people.

Since the end of World War II, European leaders have been engaged in a historic project to build a closer union. At the birth of the euro over a decade ago, political leaders understood they were making a choice with historic consequences when they permanently ceded control over monetary policy and exchange rates. Europe's crisis has confirmed that monetary union without the requisite fiscal and financial integration leaves the euro area vulnerable.

Looking back at the creation of the euro, it is clear that some risks were anticipated, while others were not. Fiscal risks were broadly anticipated, but no mechanism for fiscal risk sharing was created to address unexpected shocks. Financial integration was identified as a goal, rather than flagged as a potential risk, allowing the growth of large scale banks with extensive cross border linkages without commensurate centralization of supervision and resolution authority.

And the extensive debate that took place on the creation of the euro largely ignored the risk of external imbalances within the euro area. Even today, while large external deficits are flagged as risks, there is little discussion of how addressing surpluses in countries that export substantially more than they import might help ease the sharp compression of demand now underway in deficit countries.

It was very significant when we saw the European Central Bank (ECB) and European leaders join together in support of a strategy anchored by critical financial commitments to ensure that countries undertaking reforms retain access to market financing and to assure banks have access to liquidity and hold credible capital. These commitments decisively boosted confidence and restored stability to financial markets.

One of the lessons of our own crisis is that restoring financial stability, while critical, is just the first step for the economy to heal. The focus of the policy debate in Europe must now shift from restoring financial stability to developing a plan to boost demand and employment.

Domestic demand in the euro area is now lower than at the low point of the global crisis in 2009 in real terms. All of the recovery in European output since that time has come from net exports. That is not sustainable for a region that accounts for almost 20 percent of the world economy.

In 2012, demand contracted by over 2 percent across the euro area. Unemployment has reached the highest level in at least 20 years with over half of young people out of work in countries such as Spain and Greece. This poses political risks no less than economic risks.

Decisive action is needed now to restart demand and avoid the risk of protracted stagnation.

First, we welcome discussions on strengthening credit access for small and medium sized enterprises in southern Europe. The severe credit crunch in southern European countries is undermining economic activity and weakening the small business sector, traditionally a major engine of job creation. In the face of weakening growth and continuing disinflation, we welcome the ongoing discussion at the ECB about additional measures to improve the transmission mechanism and address elevated borrowing costs and unclog credit channels for small businesses in southern Europe.

Second, events in Cyprus only serve to underscore the importance of moving forward with full banking union. Europe is making progress on the single supervisory mechanism, but it cannot stop there. An effective, credible banking union should include not only a single supervisory mechanism but also a common resolution authority, recapitalization capacity, and credible deposit insurance. Banking union requires some degree of risk sharing between members.

The upcoming bank stress tests and asset quality reviews are a critical opportunity to restore confidence in bank balance sheets and restart credit to starving local economies. Our experience suggests that the credibility of stress tests is enhanced when there is a strong backstop in place, permitting capital to be built without a further downward spiral of deleveraging.

We also have learned from our own experience that it is much easier to wind down banks in an orderly manner when there is a well-established legal framework for resolution that clearly prioritizes deposits, buttressed by a strong system of deposit insurance. There must be sufficient loss absorbing capital as well as long term debt that can be bailed in.

In addition, European leaders should do more to recalibrate the pace of fiscal consolidation. As we know from our experience, course correction can make an important difference. Recent evidence has shown that continued sharp fiscal consolidation risks further undermining demand, especially when the scope for conventional monetary easing is limited. The consolidation path should be stretched out in some countries, and those with fiscal space should shift to supporting demand. We welcome indications that France, Spain, and the Netherlands will be given additional time to meet their budget targets, but there is room to do more in the near term.

Finally, surplus countries should contribute more to demand. Rebalancing is hard to sustain when it rests wholly on the compression of demand in deficit countries. Increased demand in Europe's strongest economies would not only provide relief to weaker euro area economies, but would also help spur the world economy. In countries where current account surpluses remain above 6.0 percent of GDP, spurring private demand in areas such as faster wage growth and greater homeownership can make an important contribution.

For our part, the U.S. recovery is gathering strength by the day. But over the past few years we have seen how closely tied American jobs and growth are to financial conditions in Europe and around the world.

During these years, we have seen in concrete terms the value of the International Monetary Fund (IMF) in protecting America's economic and national security.

When financial conflagrations have broken out among our trading partners, the IMF has acted as the first responder; it has built firebreaks to limit contagion even as it has helped our trading partners stabilize and heal their economies. The IMF's actions have helped shelter the U.S. economy from headwinds abroad and protect U.S. jobs, exports, and the savings of American households.

The IMF has helped our European partners stabilize and strengthen the foundations of their monetary union over the past three years. We have been closely engaged through the IMF and directly in encouraging European leaders and the ECB to put in place a joint strategy buttressed by a strong firewall to enable countries to undertake necessary reforms, while cleaning up bank balance sheets and ensuring ample liquidity. The primary value of the IMF's close engagement has been through technical expertise and credibility; Europe itself is providing the lion's share of the financing. The IMF is now calling for Europe to implement a strategy to boost demand and

combat unemployment, which is important not only for Europe but also for recovery in the United States and the world.

The IMF is an important partner in strengthening our national security. The IMF is now helping to address longstanding impediments to sustainable and inclusive growth that are essential in securing democratic transitions in Arab Spring countries such as Tunisia and Yemen and to anchor economic stability in countries such as Jordan and Morocco.

The IMF helps to enforce transparency and strengthen market discipline. It plays a central role in setting norms and standards for the smooth functioning of the market-based system of international trade and finance that is at the core of U.S. prosperity and stability. This creates new opportunities for U.S. businesses as they expand and sell products to new markets overseas, which supports additional jobs here at home.

As the global economy undergoes a profound reconfiguration, with new economic powers increasingly exercising their influence, it is more important than ever for us to renew our leadership of the international financial system. That is why we have asked Congress, in the President's budget, to safeguard U.S. leadership in the IMF by approving the 2010 quota and governance reforms. The budget proposal will expand the core quota resources of the IMF—with no net new U.S. financial commitment to the IMF—while preserving the U.S. veto and enhancing the legitimacy of the institution. Today, U.S. approval is the only remaining step needed for these important reforms to go into effect.

At its founding, the United States had more influence on the IMF's design and operations than any another country. Today, it is vital we safeguard our influence in the face of rapid shifts in the global economy, working together to strengthen demand and growth in Europe and here at home.