



International Monetary and Financial Committee

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**Statement by Mr. Almunia
European Commission**

**Statement of Commissioner Joaquin Almunia
to the International Monetary and Financial Committee
on behalf of the European Commission**

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Since our last meeting the financial turmoil has turned into a major financial crisis which starts spilling over into the real economy. The continuing deleveraging by financial institutions is restricting credit supply to companies and households, and economic uncertainty is increasing. The US is probably entering into a recession. EU economic activity is contracting, Activity in emerging markets has been holding up well so far but recent developments show it can not remain immune to the slowdown in advanced economies. Inflation is still high in most regions of the world on the back of elevated commodity and food prices, although it is expected to moderate. This meeting of the IMFC is thus of great importance since it can send a strong and stabilizing message and reassure market participants on the determination of policy-makers to provide adequate, comprehensive and coordinated responses to the challenges the world economy is facing.

Conditions in the international financial system have deteriorated significantly since the Spring 2008 meetings. The **financial crisis** is now the most serious since the 1930s. The dramatic events over the past weeks have spurred substantial government actions in both the US and in Europe. Investor confidence has fallen to such a level that a spontaneous recovery is no longer likely. The freeze in the inter-bank money markets, as well as the contraction of the commercial paper market is threatening to affect the entire economic system. Private sector solutions remain preferable, and should be promoted. However, given the scale of the systemic problems, decisive public action was needed and is still needed to break the cycle of asset writedowns, pressure on share prices and banking crises. Uncertainty regarding the value of banks' assets and thus their solvency remains the core problem so that public fund injections or guarantees can only be effective if financial institutions fully disclose and address their losses. In this respect, governments can play a key role by ensuring that incentives are properly aligned. However, to halt and reverse the financial distress and restore trust, an integrated strategy, simultaneously addressing three integrated issues, is called for: (1) policy-makers should stand ready to recapitalise viable banks; (2) governments should be ready to swap assets of viable banks for treasury paper; and (3) governments should expand considerably their deposit insurance protection for individuals and consider to guarantee senior and subordinated guarantees of banks. Moral hazard issues cannot be disregarded, but potentially adverse incentives associated with public interventions must be weighed against the risk that inaction could result in a prolonged freeze in the financial system. Such a freeze could have dire effects on the real economy and ultimately require even more pronounced public intervention later on. In addition, deteriorating conditions on the real side could adversely affect the already tenuous conditions in financial markets, giving rise to an adverse feedback loop. Our aim must be to keep repercussions on the real economy as limited as possible.

The **October 2007 ECOFIN roadmap** remains the basis of the EU policy response to the financial crisis. It is broadly consistent with corresponding initiatives at the global level, i.e. notably G7 initiatives, which are largely based on the recommendations of the Financial Stability Forum. The Commission is playing its full part to ensure that the ECOFIN Roadmap is delivered on time. In terms of legislative initiatives, the Commission has recently put forward changes to the Capital Requirements Directive. These amendments are designed to

limit risk exposure and improve supervision of banks that operate in more than one country. These new rules will fundamentally strengthen the regulatory framework for EU banks and the financial system. Moreover, the Commission intends to adopt a legislative proposal introducing a robust external oversight regime for credit rating agencies in November, and is actively monitoring progress on transparency and valuation issues. In view of current market developments, we need however to consider additional efforts to reinforce supervisory, regulatory, and crisis management arrangements in the EU. We have agreed to accelerate the implementation of the ECOFIN roadmap, so as to be more effective in tackling the growing problems of the financial sector.

The ECOFIN Council conclusions of 7 October 2008, by taking a number of measures at EU level concerning deposit protection, accounting standards, and flexibility in state aid decisions, aim at strengthening the EU financial sector in this difficult period. Moreover, by outlining a number of principles which should guide national actions, we will ensure a consistent strategy at EU level to tackle the financial crisis. The European Commission will enact the necessary legislation on deposit guarantee schemes and on accounting standards before the end of October. Furthermore, the Commission will issue guidance concerning compatibility of recapitalisation and guarantee schemes with EU state aid rules. The European Parliament is working closely with the Commission and has assured that it will cooperate to have the legislation passed swiftly.

To a global crisis our answer should also be global. We welcome the coordinated move on 8 October by the ECB, the Federal Reserve and other central banks to cut interest rates. The IMF should accelerate its surveillance efforts and proceed further in macro-prudential surveillance as well as in the establishment of an early warning system. This would permit it to move rapidly to a more encompassing and forward looking global financial framework. The G8 should also take appropriate measures aimed at the strengthening of such a framework.

After a period of growth above potential **EU economic activity** has contracted in the second half of 2008 for the first time since the euro was introduced. This reflects a combination of the ongoing crisis in financial markets, a surge of inflation in recent months, and a severe housing market correction in some Member States, which has not yet run its full course. These shocks have hit the euro area at a time of slowing world growth and of a strong euro appreciation.

Indeed, the **outlook for the EU economy** has turned exceptionally uncertain in the most recent weeks. Events are unfolding in a manner that is both rapid and unpredictable. Confidence among financial market participants has collapsed, slowing markedly the flow of credit. Central banks have been required to step up their efforts to avert a global liquidity squeeze. On the real side, the most recent leading indicators point to a further slowing of activity in the third quarter of 2008. Although uncertainties are even higher regarding economic developments in 2009, growth in the euro area is expected to remain weak and clearly below potential. As stressed in the European Commission's latest interim forecast, risks to the growth outlook remain on the downside. The most recent developments have clearly reinforced that view.

Supported by the easing of commodity prices, the presently high inflation is on a downward trend and longer-term inflation expectations are stabilising at a lower level consistent with price stability. If confirmed, these new developments could justify some monetary easing in the near term.

The financial crisis is also darkening growth prospects globally and global growth is expected to slow down markedly, as the October 2008 World Economic Outlook clearly shows.

The recent **oil price** increases in the past years appear to be largely a result of a structural shift in oil supply and demand rather than a temporary phenomenon, even though portfolio shifts are likely to have contributed to amplify price movements. While the sharp decline in recent weeks reflects the expected rapid deterioration of the world economic situation, in the medium term oil prices are expected to remain high. Therefore, the major policy response must be to press ahead with long-term measures that will facilitate the structural adjustment towards a low carbon and highly energy-efficient economy. At the same time, short-term and targeted policy measures to help alleviate the impact of high prices on the most vulnerable groups have been taken.

Food prices have peaked in the first half of this year, and are expected to decline somewhat going forward. The associated inflationary pressure is diminishing already, which is especially welcome in some of the larger emerging or developing economies, where food represents a large share in the consumption basket of households.

Foreign exchange markets are also going through a new phase of volatility. As long as the financial crisis lasts, there is a heightened risk of abrupt exchange rate moves. During the past weeks exchange rates have reacted strongly to financial sector developments and policy efforts to safeguard financial stability, resulting in high volatility. Looking at the broader picture, the euro is still on the strong side in real effective terms. Its real effective exchange rate remains somewhat above the long-term average, and estimations of equilibrium (real effective) exchange rates point in the same direction.

Large **global current account imbalances** remain a concern. The higher level of commodities prices over the past year has led to wider current account surpluses in oil exporting countries and larger deficits in many oil importing countries. However, the improvement of the US current account deficit and the much lower level of the dollar have somewhat reduced the risks of a disorderly correction of global imbalances in the short term. However, any worsening of the financial crisis may have unpredictable consequences on foreign exchange markets. While a moderate adjustment in global imbalances is expected to take place in 2008, they are nevertheless projected to remain large.

In the coming years a number of countries are set to adopt the euro, on the basis of their progress in achieving a high degree of sustainable convergence. This will require enhanced **EU surveillance** on these countries, both with regard to their fiscal position and the structural reforms they are going to implement. Membership of the euro area contributes to fostering prospects for long-term growth and stability, and a continued commitment to policy discipline helps fully reap the benefits of the single currency.

Despite the importance of a global trade agreement, in particular at this difficult juncture, progress on the **Doha Development Agenda (DDA)** negotiations has been limited. Much is at stake and a successful deal will have to be formed on the basis of a balanced level of ambition requiring one final move in concert by all of the key players. A positive deal would provide much needed confidence to the markets.

In an environment of heightened uncertainty, it is all the more important that IMF members continue to work for an open investment environment and refrain from protectionist measures.

Several noteworthy developments have occurred over the past months, which I will address now.

At the Spring European Council in March 2008, EU Member States acknowledged the beneficial contribution of **sovereign wealth funds** (SWF) to the EU economies, both in spurring growth and employment and in stabilizing financial markets. In this regard, EU Member States reiterated their commitment to an open investment environment. At the same time, they expressed a heightened need for reassurance in particular at the level of transparency, governance and accountability of SWF. To this end, the EU has participated actively in the work carried out in the OECD and has strongly supported the initiatives of the International Working Group of SWFs (IWG-SWF). In this respect, the European Commission has contributed to the dialogue between SWFs, originating countries and recipient countries and welcomes the Generally Accepted Principles and Practices issued by the IWG-SWF.

It is now important that the GAPP is effectively implemented by a sufficiently large number of SWFs. It is equally important that a standing group is established to monitor the implementation of the GAPP. Together with the engagements already taken by recipient countries at the OECD Ministerial -to be further worked out in the coming months - the GAPP is a major success that demonstrates SWFs and recipient countries are strongly committed to the preservation of an open investment environment, and intend to act accordingly.

We welcome the Managing Director's focus on enhancing the **IMF's surveillance** efforts and further governance reforms. Indeed, IMF surveillance provides a very helpful complementary role to the EU's own surveillance framework. We fully support the IMF in its efforts to implement the 2007 Bilateral Surveillance Decision. In this regard the IMF should assess the entire array of policies that impact upon on the external stability of a country. The Commission sees the Statement on Surveillance Priorities as a valuable tool to focus IMF surveillance and we will follow with close interest its implementation. The Commission looks forward to the report by the eminent persons group on the IMF's governance and decision-making procedures by the spring of 2009. We acknowledge the efforts of the IMF to put its financing on a sounder basis and hope that IMF members will honour their commitments towards the IMF meeting its budget.

Similarly, the Commission welcomes the World Bank's reform efforts to improve voice and representation. In particular, the Commission supports improved ownership by developing and transition countries which will enhance both responsiveness to their priorities and the continued legitimacy and future efficiency of the World Bank as a global institution. In this respect the proposals of doubling the basic voting rights of the shareholders and adding an African Chair at the Board in addition to the present 24 seats seem appropriate in a first stage.

Making progress towards the **Millennium Development Goals** remains a priority on the EU's policy agenda. 2008 though will be a challenging year. High food and oil prices are increasing poverty. Past gains in macroeconomic stability in many countries could easily be jeopardised as demand for their main export commodities weakens and conditions on financial markets tighten. It is therefore paramount that economic policies in developing countries continue with growth and stability oriented policies while protecting the most vulnerable. The EU, as the largest provider of official development assistance (ODA) in the world, will continue to support governments in these efforts by delivering on its ambitious aid promises and by promoting the sustainability of debt in developing countries. The African continent, where

progress on the Millennium Development Goals is significantly lagging behind, is a particular focus of EU development policies.

The EU is actively contributing to the implementation of the Bali Action Plan in order to reach an ambitious agreement on **climate change** in Copenhagen in 2009. The legal implementation of an EU energy and climate policy package, which includes the objective to reduce EU greenhouse gas emissions by 20% by 2020 in relation to 1990, and to up to 30% depending on the ambition of the international agreement, should be concluded before the end of the year. The EU is also aiming to contribute to efforts towards a coherent international financial architecture on climate change. Adequate and predictable flows of finance should leverage private finance and maximise the effectiveness, efficiency and equity of activities and be based on sound governance structures and acceptable by all parties. While financing and investment needs for mitigation should be predominantly met by the private sector and carbon markets, adaptation actions will require more public funding mainstreamed into development programmes.

The **fight against money laundering and the financing of terrorism** continues to be a high priority for the EU, where robust anti-money laundering and counter-terrorism financing (AML/CTF) framework is in place. The EU also provides technical assistance on AML/CTF to a number of third countries. In this context, the Commission welcomes and supports the regular assessments of member countries' strategies and measures by the IMF and the World Bank. This evaluation helps identify key areas where efforts and assistance need to be concentrated.