International Monetary and Financial Committee

Twenty-Second Meeting
October 9, 2010

Olli Rehn
Commissioner
European Commission

Statement of Commissioner Olli Rehn
to the International Monetary and Financial Committee
on behalf of the European Commission
Washington, D.C., 9 October 2010

The **economic recovery in the EU** has gained ground as of late. GDP growth in the second quarter of 2010 was particularly strong, and more balanced towards domestic demand than previously anticipated. While activity is still expected to moderate in the second half of the year, the outlook is for a slightly improved quarterly profile compared to the Spring, due to the spill-over of some momentum from the second quarter. For 2010 as a whole, real GDP growth is now projected at 1.8% in the EU and 1.7% in the euro area, a sizeable upward revision. However, the recovery remains fragile. At the disaggregated level, developments remain uneven across Member States, confirming the Commission's expectation of a multi-speed recovery, with the strong performance of Germany standing out.

Amid continued high uncertainty, **risks to the EU growth outlook for 2010** appear broadly balanced. On the upside, the rebalancing of GDP growth towards domestic demand, and the spill-over from the pick-up in activity in Germany to other Member States, may materialise to a greater extent than currently envisaged. On the downside, softer than expected external demand and further tensions in financial markets cannot be ruled out, while fiscal consolidation could weigh more on domestic demand in the countries concerned than anticipated. As for the inflation outlook, risks also appear to be broadly balanced for 2010.

The first half of 2010 saw a **moderate rise in HICP inflation**, on the back of increasing global commodity prices and upward food and energy base effects. Looking ahead, the remaining slack in the economy, subdued wage growth and low inflation expectations should keep inflation in check, notwithstanding recent exchange-rate developments and weather-related price rises in some agro-commodities. At the Member State level, inflation differentials persist, to some extent reflecting different short-term adjustment needs that have been exposed by the economic crisis. For 2010 as a whole, with price developments generally in line with expectations, revisions to the inflation forecast are minor. HICP inflation is projected to average 1.8% in the EU and 1.4% in the euro area.

Fiscal policy in Europe has provided a very substantial contribution to stabilise the economy. We attach great importance to the proper design, clear communication and timely implementation of a comprehensive exit strategy. This is key to sustain confidence in the recovery. Such a strategy should have both short-term and long-term components. In the short-term, we need to phase out short-term temporary crisis-related support measures, and introduce consolidation measures, differentiated according to the country situation. In the longer term, there should be a phasing in of structural measures to put public finances on a sustainable footing and to bolster potential output. Considering the global nature of the crisis and the context of large global imbalances, cross-border spill-overs should be addressed through coordination of policies at a global level, not least within the G-20.

It is necessary to finalize the design of such a strategy and start implementing it taking into account the situation of the global economy and individual countries' circumstances.

The **medium-term fiscal challenges** resulting from the crisis are daunting and hence a balance between stabilisation and sustainability concerns will need to be struck. Indeed substantial fiscal consolidation, going well beyond the withdrawal of the stimulus packages, is required to halt and eventually reverse the increase in debt and maintain market confidence in government solvency. Investor concerns about the ability of some Member States to deal decisively with budgetary issues has, at least temporarily, triggered a sudden and sharp reassessment of their sovereign risk, and associated to higher risk premia. Managing sovereign credit risk is essential to avoid a rise in longer-term interest rates ahead of recovery in the economy. If investor confidence in the sustainability of public finances is to be maintained, Member States will be required to meet their commitments under the excessive deficit procedures of the EU Stability and Growth Pact fully and on time.

As to **fiscal exit**, the European Council of October 2009 set out the principles of such a differentiated strategy, which were confirmed by the Ecofin Council this spring in the context of the medium-term budgetary review. It was agreed that the exit strategy should be coordinated across countries in the framework of consistent implementation of the EU Stability and Growth Pact; and there should be a timely withdrawal of the fiscal stimulus. Provided that the Commission forecasts continue to indicate that the recovery is strengthening and becoming self-sustaining, fiscal consolidation in all EU Member States should start in 2011 at the latest. The planned pace of the fiscal consolidation should be ambitious, and will have to go well beyond the benchmark of 0.5% of GDP per annum in structural terms in most Member States. Important flanking policies to the fiscal exit will have to include strengthened national budgetary frameworks for underpinning the credibility of consolidation strategies and measures to support long-term fiscal sustainability. In addition, structural reform efforts should be strengthened to enhance productivity and to support long-term investment. The fiscal plans presented by Member States are largely in line with agreed principles, but contain risks due to optimistic macroeconomic assumptions and a lack of specification of consolidating measures.

Moreover, in the light of the concerns about sovereign risks, since this Spring several Member States have accelerated further and frontloaded consolidation, and any other Member States where risks are particularly high have also been invited to consider taking action. A delicate balance must be struck between averting adverse market dynamics through frontloading of consolidation and securing the conditions most conducive to successful fiscal consolidation. To that end, the current fiscal exit strategy has been strengthened further. In particular, (a) both fiscal and macro-financial risks should be taken into account when determining the country-specific start and pace of consolidation; (b) the composition of consolidation should be growth-friendly; (c) consolidation will be accompanied by growth-enhancing structural reforms.

The **sovereign debt crisis** has also had a profound impact on the EU exit strategy. In light of recent developments in sovereign debt markets and related problems in the banking sector, the withdrawal of fiscal stimulus has been brought forward to 2010 while the withdrawal of central bank liquidity support measures has been reversed. The Commission strategy in the area of State aid remains appropriate to the current situation. Indeed, the exit process started in 2010 is sufficiently gradual and flexible to take account of the specificity of the situations in different Member States and to allow an adequate reaction to unexpected adverse market developments where necessary. The correct timing of the different steps in the exit process is of pivotal importance. They can only be taken when macro-economic conditions and financial markets have stabilised enough to absorb them without resurgent stress. Yet, keeping support to the financial sector at current levels in place for too long – apart from being untenable from the perspective of public finances - would enable banks with structural problems to unduly postpone the necessary restructuring processes and lead to growing competitive imbalances and distortions. The resulting delay of a return to normal market conditions would constitute an obstacle to the recovery process itself.

Macro-financial risks have become less system-wide and more concentrated in individual Member States. The possibility of contagion across highly interconnected markets and economic sectors means that the EU financial system as a whole remains exposed. In the euro area, yield spreads on sovereign bonds in many Member States have widened due to investor concerns about budgetary sustainability. In spite of sovereign market tensions, many Member State governments – within and outside the euro area – have successfully sought to meet high gross financing needs. Investors' perception of sovereign risk have contributed to a negative loop between public finances and banking sector developments. In the first half of the year, banks have recorded in aggregate very strong profits due to buoyant interest income and a decline in provisioning for loan losses. The EU-wide stress test in July indicated that solvency in the banking sector is fairly robust. However, pockets of vulnerability exist and the improvement in banks' capital ratios has slowed during the year.

In reaction to the crisis, the European Union is pursuing ambitious plans to strengthen and widen its **economic governance framework** with an aim to anchor macroeconomic stability and the sustainability of public finances even more strongly at the core of the Union. The crisis made clear that windfalls accumulated during good times have not been sufficiently used to create room for manoeuvre when times turn bad.

A comprehensive package of legislation to address these issues is currently under discussion. This package includes (a) renewed emphasis on public debt and fiscal sustainability in the Stability and Growth Pact. The Pact should better take into account debt developments, both in the preventive and the corrective arm; (b) embedding the Treaty obligations into national fiscal frameworks; (c) the surveillance of macroeconomic imbalances and integrated surveillance in Europe 2020. To that end, and also to better integrate fiscal policies at the European and the national levels, a 'European semester' is being introduced; (d) timely and effective enforcement mechanisms including sanctions both in the preventive and in the corrective arms of the SGP and, as ultima ratio, in the macroeconomic imbalances. The rules for euro area Member States should be particularly strict.

In addition, the EU is pursuing an **ambitious overhaul of the regulatory and supervisory framework for financial services and products** in response to inefficiencies that emerged from the financial crisis. 2010 and 2011 are critical years for implementing the remaining G20 financial reforms, and for keeping the momentum we have achieved by delivering robust, internationally coordinated reforms. It is essential that we hold banks and other financial intermediaries accountable, minimize future risks for taxpayers, and develop the appropriate tools to deal with systemic risks arising from too-big-to-fail institutions. In this context the Commission welcomes the ambitious agreement on capital and liquidity requirements for the banking sector reached by the Basel Committee in September. The EU has continued to make significant progress in developing solutions that are not only appropriate in the EU context, but also compatible with the broader requirements of a global, interconnected financial and economic system.

A new EU supervisory framework (based on a two pillar approach comprising the European Systemic Risk Board and the European System of Financial Supervisors) will become operational since the beginning of 2011. The new bodies will monitor and assess risks to the stability of the financial system as a whole and enhance coordination among supervisors for three systemically important sectors: banking, insurance, and securities. In addition, the EU is also working diligently to address the issue of bank capital requirements, limit pro-cyclicality, and extend the perimeter of regulation to include OTC derivatives, hedge funds, and credit rating agencies. The EU also seeks to improve crisis management rules and cross-border cooperation, which includes discussions on bank resolution and deposit guarantee schemes (a legislative proposal was presented by the Commission in July), as well as work to determine the financial sector's potential contributions to the cost of the crisis.

Changes in risk sentiment – both in relation to the global economy and with respect to the sovereign debt crisis in the euro area – were the main driver of **exchange rates** this year. While concerns about sovereign debt primarily led to a depreciation of the euro against the dollar and the yen, the relative growth, inflation and monetary policy outlook had a visible impact on exchange rates in periods of lower market volatility and risk aversion. Going forward, risks of excess volatility and disorderly movements in exchange rates should be avoided in view of their adverse implications for economic and financial stability. In this respect, the Chinese authorities are encouraged to implement soon a more flexible exchange rate regime for the renminbi.

Turning to the IMF policy agenda, we remain concerned about the lack of progress on advancing **the IMF's quota and voice as well as governance reform.** We need to progress urgently on defining the elements of the package otherwise we see the risk of an institutional crisis of the IMF. The EU is willing to advance the discussions on quota and voice substantially but expects that other parties involved also show flexibility and pragmatism on these issues. We agree that the visibility of emerging markets and low-income countries should be increased at the IMF. This would comprise both an increase in the quota share of those countries as well as more representation on the IMF's Executive Board through appropriate changes by constituencies led by advanced European countries. In order for the quota shift to work out all overrepresented countries will need to contribute to the shift, while they should not become underrepresented as a result of the reform. Foregoing by underrepresented advanced countries should be on the basis of a fair burden sharing among that group. The voice and representation of low-income countries needs to be preserved.

We are encouraged by the progress of the IMF on **strengthening its mandate**. The IMF's lending framework should now meet the demands by most of its members. We strongly support developing the complementarity of IMF financial assistance and assistance afforded by regional financial arrangements further. The EU financial assistance programmes already aim at that through the implementation of joint programmes with the IMF. The successful cooperation between euro area authorities as well as the IMF on combating spill-overs from the global crisis to some EU Members has been instrumental in restoring confidence in Europe and holds some valuable lessons for our partners. We continue to believe that strong surveillance is a precondition for limiting the degree of crisis proneness. Therefore, sound macroeconomic and macro-prudential management as well as a strong surveillance process are of great importance. Making the Financial Sector Assessment Program mandatory for systemically important countries was a first major step. More needs to follow, including more engagement of the IMF with regional policy makers. We are still concerned about the lack of traction of IMF policy advice. We think that this could be achieved by enhancing the role of the IMFC appropriately.

World trade is clearly recovering. However, protectionist pressures still represent a considerable risk as unemployment remains high in many countries and the room for stimulus through macroeconomic policy becomes more limited. This underlines the importance that trading partners remain faithful to the stand-still and roll-back commitments agreed within the G20 and of concluding the Doha Development Round. We strongly support an urgent, ambitious and balanced conclusion of the Doha Development Round.