International Monetary and Financial Committee

Seventeenth Meeting
April 12, 2008

Statement by Joaquin Almunia on behalf of the European Commission

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

Washington, 12 April 2008

The global growth outlook is overshadowed by the **current financial turmoil**. Since our last meeting, economic uncertainty has increased and the real economies of advanced countries are more and more affected by the financial turmoil. The risk that the US will fall into a recession in 2008 has increased, and real GDP growth in the euro area is also slowing down, although less rapidly than in the US. Activity in emerging markets has been holding up but will not remain immune should global growth weaken significantly. Inflation has been an increasing world-wide concern because of soaring commodity and food prices. Policymakers are thus confronted with numerous challenges and will need all their acumen to restore confidence and to limit the fallout to the real economy.

The potential for a serious turmoil in the international financial system has existed for several years, as ample global liquidity, financial innovation and the search for yield increased the willingness of investors to assume increasing levels of risk. The result was a compression in risk premia to historically low levels and stretched valuations in most asset markets. The effects of the deleveraging process are spreading to the real economy.

In the EU, the effects of the turmoil have been evident but have been mainly confined to the financial sector. Nevertheless, growth in the EU economy is likely to be affected both directly and indirectly by the turmoil. Despite the expected slowdown in growth, the EU economy is in a relatively favourable position to absorb the effects of the financial turmoil, having strong fundamentals and no significant macroeconomic imbalances. On this basis, there is no need for policy activism in the EU, where the more appropriate approach is to maintain a firm commitment to stability-oriented monetary and fiscal policies and growth-enhancing structural reforms. In particular, the **Lisbon Strategy** for growth and jobs provides the right structural policies and policy instruments to help the EU economy weather the current financial tensions.

The EU has drawn important lessons and is implementing a road-map of actions of both a regulatory and non-regulatory nature. These actions focus on four main objectives:

- improving transparency in the markets, notably concerning banks' exposures relating to securitisation and off-balance sheet items;
- improving asset valuation standards, especially with respect to illiquid assets;
- strengthening the EU's prudential framework, e.g. with respect to the treatment of large exposures, banks' exposures to securitisation as well as liquidity risk management (in this respect, the Commission is encouraged to come forward with a proposal to amend the Capital Requirements directive by September 2008); and
- improving market functioning (including the role played by credit rating agencies).

These objectives and the related actions are consistent with parallel work underway in international fora, in particular in the Financial Stability Forum.

The EU Heads of State and Government confirmed these four objectives in March and insisted on the need for banks to promptly disclose their losses to help restore confidence, and

on the need to further strengthen the financial stability framework through enhanced prudential supervision and improved tools for financial crisis management (including early +warning mechanisms). They agreed that the primary responsibility to address the weaknesses in financial markets lies with the private sector, but indicated a readiness to take regulatory and supervisory actions where necessary.

With respect to the **EU economy,** many of the downside risks identified in the European Commission's Autumn 2007 forecast have materialised, including a further significant rise in oil prices, higher inflation and a strengthening in the euro exchange rate. The effect of the turmoil on credit growth has varied across the Member States, with lending to corporates and households still relatively robust in the euro area as a whole but much less so in the United Kingdom. The baseline scenario in the Commission's interim forecast of 21 February indicates that EU GDP should grow by 2.0% in 2008, while euro area GDP should grow at 1.8%. However, the risks to this baseline scenario are significant and tilted to the downside. The Commission will issue its next forecast in late April.

The financial turmoil and the ensuing uncertainty complicate the conduct of **monetary policy**. So far, the monetary policy responses of the US Federal Reserve and the ECB have differed considerably. Contrary to the US Federal Reserve, the ECB has not lowered its interest rates. This is consistent with current conditions. The US Federal Reserve is facing both a liquidity crisis and a recession, while the ECB is facing primarily a liquidity crisis. Crucial for the future path of monetary policy in the euro area will be the upcoming wage negotiations and the developments in inflation expectations.

Well-functioning markets are essential to attenuate the current surge in **energy and agricultural commodity prices**. Thus, it remains important to refrain from distortionary policies that prevent adjustment of consumption in response to the higher energy prices. Moreover, the EU climate change and energy policies will contribute to reducing energy demand. The EU has also responded to soaring agricultural prices with various ad-hoc adjustments of its Common Agricultural Policy (CAP) to facilitate the additional supply of agricultural commodities. A general review of the state of CAP is forthcoming.

Developments in **global current account imbalances** have been mixed since the 2007 Annual Meetings. While the US current account deficit has declined, current account surpluses in China, Japan, and emerging Asian economies have continued to rise. Current account surpluses of the oil-exporting economies in the Middle East have also increased further. The euro-area's external balance, in contrast, has moved from a surplus in 2004 to a small deficit today. All countries involved in the multilateral consultations have taken steps in line with the agreed strategy over the past year. However, the progress made to date has been insufficient and global imbalances are far from having been satisfactorily addressed. Our priorities in Europe - which are also desirable from a multilateral perspective - centre on further reforms in product, labour, and financial markets. These reforms will raise the euro area's potential growth rate, lift domestic income, and increase the euro area's capacity to absorb imports from other parts of the world. Other actors should step up their efforts to implement the agreed IMFC strategy.

Exchange rates should reflect economic fundamentals. Excess volatility and disorderly movements in exchange rates are undesirable for economic growth. Recent exchange rate moves are an issue of concern. The increased volatility in foreign exchange markets, which has accompanied the financial turmoil, points to the risk of exchange rate overshooting. The

euro's real effective exchange rate is approaching a level where it would clearly no longer be in line with economic fundamentals. Euro area authorities have noted with great attention that the US authorities have reaffirmed that a strong dollar is in the interest of the US economy. In order to contribute more strongly to the rebalancing of global current account imbalances, the currencies of the countries with the largest current account surpluses should appreciate more substantially in effective terms.

Large current account surpluses have resulted in a surge in foreign reserves in some countries, which often finance **Sovereign Wealth Funds** (SWF). At the Spring European Council in March 2008, EU Member States acknowledged the beneficial contribution of SWF to the EU economies, both in spurring growth and employment and in stabilizing financial markets. **Therefore SWF are very welcome in Europe.** At the same time, a heightened need for reassurance is felt amongst recipient countries, in particular at the level of transparency, governance, and accountability. The EU is of the opinion that a global multilateral approach is to be preferred to unilateral ones. We support the G7 initiative to launch a deeper dialogue among ourselves and with the main countries sponsoring SWF. We back the IMF's market-based endeavours to develop voluntary practices, which we prefer to formal regulation. We also welcome the OECD work aimed at identifying best practice frameworks for recipient countries, which would allow the free flow of foreign direct investment to continue. Both IMF and OECD initiatives should be developed in close cooperation with all parties involved, including the sponsor countries of SWF, and with the full participation of the European Commission. Cooperation and a comprehensive dialogue between policy makers in the developed world and the emerging countries are needed to ensure that the public continues to support open markets and avoid any protectionist backlash.

The **Lisbon Strategy for Growth and Jobs** is the backbone of Europe’s efforts to tackle structural economic weaknesses and challenges in the EU by implementing coordinated structural economic reforms. Since its re-launch in 2005, a number of important measures have been implemented in EU countries and there is some evidence that such reforms have started delivering tangible results, especially in labour markets. 17.5 million new jobs have been created since the beginning of 2000, of which 6.5 million were created in the last two years alone, and the unemployment rate has fallen steeply from 8.6% to 6.9%. As a result, EU unemployment is now at its lowest in 25 years. This has been accompanied by robust productivity growth - 1.5% in 2006, up from an annual growth rate of 1.2% between 2000 and 2005. Nevertheless, the impact of economic reforms on European performance could have been even better had Member States gone further with reforms. Our objective now is to focus on reform implementation.

The process of **euro area enlargement** is ongoing. Three of the ten Member States which joined the EU in 2004 have already adopted the single currency, most recently Cyprus and Malta in January 2008. More countries are set to follow, in line with their progress in achieving a high degree of sustainable convergence. Membership in the euro area contributes greatly to fostering prospects for long-term growth and stability, but a continued commitment to policy discipline is required so as to fully reap the benefits of the single currency. In May, the Commission will assess the state of convergence in those Member States that have yet to meet the conditions for euro area entry. This will highlight the progress made and the challenges ahead.

Let me turn to some of the **key international challenges** and outline how the EU is addressing them.

The Commission welcomes the agreement on the overhaul of **IMF** quota and voice. The outcome is important for re-enforcing the legitimacy of the IMF with its membership. EU Member States have made significant concessions in the debate over the past months, which have contributed to engineering a shift of quotas from advanced to emerging market and developing countries. In order to fulfil its mandate and perform its tasks, the IMF requires a stable income stream in times when its lending activities are significantly reduced. The Commission welcomes the agreement by the IMF's Executive Board on a new financial framework for the institution. This agreement will contribute to ensuring the financial sustainability of the institution. The Commission fully supports the IMF's new surveillance framework as well as the reorientation of its priorities and encourages IMF members to assist the IMF in implementing this framework.

Eradicating poverty and achieving the **Millennium Development Goals** remains a priority objective of the EU's policy agenda. Encouraging progress was made in some regions, but Africa still lags behind in spite of the sustained economic growth that the continent has experienced over the last six years. The EU, as the largest provider of Official Development Assistance (ODA) in the world, is pursuing its efforts to deliver on its ambitious aid promises taken in Monterrey and in subsequent years. Even though global development assistance decreased in 2007, the EU's share in global ODA further increased. In order to ensure the effectiveness of its aid, the EU took a number of initiatives, with a particular focus on alignment and division of labour. The Joint African Union-EU Strategy signed in Lisbon last December represents a political partnership which addressed the MDGs as one of many interrelated dimensions, together with peace and security, governance and human rights, as well as trade and regional integration. Following the conclusion of an Economic Partnership Agreement (EPA) with the Caribbean region and several interim agreements with African and Pacific partners at the end of last year, the EU aims to conclude final EPAs with all partner regions as soon as possible. This is accompanied by an ambitious EU aid for trade strategy that will help partner countries make the most out of the opportunities of globalisation.

The **Doha Development Agenda** (DDA) negotiations are reaching a potentially critical juncture. While the months ahead are unpredictable, it is imperative that the key components are closed in the next few months. Otherwise, the window for concluding the DDA will become extremely narrow, with the risk that there will be no agreement in the near term. 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. The benefits of the DDA for the international economy are large, with the potential to create significant additional trade annually. The economic gains will, by far, outweigh the short term costs. A positive deal would also provide much needed confidence to markets that have recently been stressed by financial anxiety.

The agreement in Bali concerning the work towards a global agreement on **climate change** is a positive step forward, but it remains vital that the world community manages to keep the agreed timetable and finalise an agreement in Copenhagen in 2009. The European Union is committed to tackling these issues. In this regard, the European Commission presented in January an energy and climate policy package, which is deemed instrumental to achieving the already agreed objective to reduce EU greenhouse gas emissions by 20% by 2020 in relation to 1990. This package includes a revision and broadening of the Emission Trading System, greenhouse gas emission reduction targets for the individual Member States and policies promoting the introduction and expansion of renewable energy sources. Promotion of low-carbon technology development is an important component as well. These policies are also

undertaken in the context of the overall European energy policy objectives of increasing security of supply, ensuring competitiveness of the European economy and promoting environmental sustainability.

The **fight against money laundering and the financing of terrorism** continues to be a high priority for the EU. In the EU, a robust anti-money laundering and counter-terrorism financing (AML/CFT) framework is in place, and continuous efforts are undertaken to increase its effectiveness further. The EU also provides technical assistance on AML/CFT 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. Thanks to their expertise and global view, the IMF and World Bank continue to make valuable contributions to improving the coordination of this assistance.