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Commissioner
European Commission

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to the International Monetary and Financial Committee
on behalf of the European Commission
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Backed by a broadening economic recovery, the European Union is in the midst of an ambitious, intensive and comprehensive programme of economic governance and regulatory reform, which has been necessitated by the exceptional depth of the recent crisis.

The **economic recovery in the EU** continues to make headway. After a strong performance in the first half of 2010, real GDP growth in both the EU and the euro area slowed down in the second half of last year. The deceleration was expected and in line with a soft patch in global growth and trade, which reflected the withdrawal of stimulus measures and the fading of positive impulses from the inventory cycle.

Looking ahead, according to the Commission interim forecast released on 1 March, **EU GDP growth in 2011** is set to gather pace, despite lingering vulnerabilities in financial markets. This outlook is supported, inter alia, by better prospects for the global economy and by upbeat EU business sentiment. Moreover, developments in profitability, order books, lending to households, saving ratio also point to a gradually firming pace of domestic activity. The encouraging progress in economic sentiment stands in contrast with the tensions observed in some sovereign-bond markets in the EU since autumn.

Amid still high uncertainty on the global recovery, **risks to the EU growth** outlook at the time of the Commission interim forecast appeared broadly balanced for 2011. Since then, events in Japan and in the MENA region have added further uncertainty to the global economic outlook, and have also increased downside risks to European growth in the short term.

The **sovereign debt crisis** has hit hard some euro area countries. To counter it, in an unprecedented joint effort with the IMF, financial assistance programmes with a strong conditionality on fiscal, structural and banking issues have been put in place. In Greece, large fiscal consolidation efforts have been made. In Ireland, the implementation of the programme centred on fiscal consolidation and banking sector restructuring is on track. The economic and financial crisis in Portugal takes place in a very difficult political context. The country has requested EU financial assistance on April 6th. EU finance ministers have taken note of this request; and mandated the Commission and the European Central Bank to launch immediately negotiations regarding a financial assistance programme in cooperation with the IMF.

Important progress has also been made on EU **financial backstops** to improve the flexibility and pricing of financial assistance instruments of the existing instruments. An agreement has been reached to establish a **permanent stability mechanism** that will serve to safeguard the financial stability of the euro area. The European Stability Mechanism (ESM) will replace the role of the European Financial Stability Facility (EFSF) and the European Financial Stabilisation Mechanism (EFSM) in providing external financial assistance to euro-area Member States after June 2013. Access to ESM financial assistance will depend on adherence to **strict policy conditionality**. The agreed lending capacity of EUR 440 billion of the EFSF will be made fully effective.

In response to the crisis, the European Union is also 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. While the first ten years of the euro have been a success, the crisis exposed a number of shortcomings in the policy framework. Windfalls accumulated during good times have not been sufficiently used to create room for manoeuvre when times turn bad.

A **comprehensive package of legislation** has been proposed to address these issues. The aim is to agree on the legislation by June 2011. The package includes inter alia (a) the introduction of an expenditure benchmark in the preventive arm of the Stability and Growth Pact; (b) the introduction of a numerical benchmark for debt reduction in the corrective arm; (c) minimum requirements for national fiscal frameworks; (d) a new framework to prevent and correct macroeconomic imbalances, as well as (e) timely and effective enforcement mechanisms including financial sanctions both in the preventive and in the corrective arms of the SGP and, as a last resort, in the macroeconomic imbalances framework. Moreover, to further strengthen the economic pillar of the Economic and Monetary Union, Heads of State of the euro area, joined by six non-euro area Members agreed a number of priority policy objectives to foster competitiveness and employment, enhance the sustainability of public finances and to reinforce financial stability (so called Euro Plus Pact).

Fiscal prudence is important, not only in order to address the significant long-term challenge of ageing, but also in the light of existing market concerns about public finance sustainability. There is a consensus that the most urgent task for the EU is to restore confidence by preventing a vicious cycle of unsustainable debt, disruption of financial markets and low economic growth. Therefore ambitious fiscal consolidation is required, beyond the withdrawal of the stimulus measures which were necessary to tackle the recent financial and economic crisis, in order to halt and eventually reverse debt accumulation and restore sound budgetary positions. All EU Member States started consolidation in 2011 at the latest. In several Member States consolidation is ongoing since last year. That consolidation should remain differentiated across countries as regards timing, size and accompanying policies. In countries with particularly severe fiscal challenges, consolidation should be frontloaded and indeed numerous Member States have accelerated the implementation of their consolidation plans. In general, annual structural fiscal adjustments should go well beyond 0.5% of GDP. Consolidation should be growth-friendly and hence combined with the implementation of structural reforms of pensions, healthcare and labour markets aiming at increasing potential growth.

The **Stability and Growth Pact** is the appropriate framework for coordinating fiscal policies of EU Member States. In particular, for Member States subject to the excessive deficit procedure (EDP), the deficit targets and the structural adjustments should be fully consistent with a timely correction of the excessive deficits and not lead to a back-loading of the necessary adjustment. In the context of the newly started cycle of policy coordination called European semester, countries should present in their forthcoming Stability and Convergence Programmes concrete multi-annual consolidation plans including specific deficit, revenue and expenditure targets and the strategy envisaged to reach these targets. All Member States should keep the growth of expenditure net of discretionary revenue measures clearly below the medium-term rate of potential GDP growth until they have reached their medium-term budgetary objective, while prioritising sustainable growth-friendly expenditure and promoting efficiency of public spending. The Stability and Convergence Programmes should be based on cautious growth and revenue forecasts.

The EU's **comprehensive reform package for the financial services sector** incorporates several key areas: better supervision, better regulation for financial services, greater consumer and investor protection, and the development of appropriate mechanisms for crisis management to minimize the cost to taxpayers and disruptions to the financial system and the economy as a whole. These objectives should be achieved while at the same time fostering and deepening the single market for financial services, as well as increasing financial stability on a long-term and global basis.

On 1 January 2011, a **new supervisory framework in the EU** was established. This marked a major step in the implementation of the EU's reform agenda. The European Commission continues to make progress towards completing work on legislative proposals intended to improve, strengthen, and ensure the future stability of financial institutions and markets. The European Commission is also looking to revise certain aspects of Community law in order to harmonise regulation for investment services.

Progress is also made with respect to **financial market repair** and we are working to ensure that banks and financial institutions return to viability. This is crucial if the sector is to contribute to the economic recovery. The 2011 EU-wide stress test exercise, coordinated by the European Banking Authority, will provide critical insights and examine the health and resilience of the EU banking sector. The upcoming exercise will be even more severe and more consistent in its application across individual banks, also thanks to an enhanced degree of disclosure and a rigorous peer review process.

Financial regulation and supervision reforms should be appropriately coordinated not only within the EU but also at the global level in order to maintain a level playing field. The EU and its global partners must ensure that interactions between various regulatory measures or differences in approach avoid distortions and do not provide opportunities for arbitrage.

Turning to **inflation**, euro area annual headline HICP has picked up since the autumn of 2010 and currently stands at 2.6 percent (March 2011). The increase largely results from rising oil and other commodity prices. Core inflation has so far remained moderate but headline inflation is expected to remain above 2 percent throughout 2011. It is important to prevent second-round effects and more broad-based inflationary pressure over the medium term. Inflation expectations have increased but remain anchored in line with longer-term averages.

Foreign exchange markets have continued to display considerable volatility over the past months, though less than at the height of the crisis. Changes in investors' risk sentiment have been a major factor affecting volatility. Looking forward, the relative paths of GDP growth, inflation and monetary policy among the major advanced economies could play a larger role for exchange rates and will also impact capital flows. In the short run, however, uncertainty due to the situation in Japan and events in the Middle East and North Africa remains high, so the sensitivity of exchange rates to changes in risk aversion might remain relatively elevated for still some time. The resilience of the euro to the sovereign debt problems of some Member States of the euro area has increased significantly over the past year. This reflects the underlying positive economic momentum in the euro area as a whole, as well as differences in the expectations for monetary policy in the major advanced economies. Disorderly movements in exchange rates should be avoided going forward in view of their adverse implications for economic and financial stability. The Chinese renminbi remains significantly undervalued making a re-balancing of global growth more difficult.

The macroeconomic and financial situation of the **South Mediterranean countries** directly affected by the political crisis remains vulnerable. Support for investments in infrastructure and for the private sector is badly needed for economic modernisation, growth and job creation. Both the EIB as well as the EBRD can play a role here. The Commission supports the proposal to increase the ceiling for EIB external lending mandate in the Mediterranean region by EUR 1 billion. It also supports the extension of EBRD operations to Egypt and possibly other countries in the region in close co-operation with EIB.

The EU values the discussions in the IMF on **reforming the international monetary system**. The resilience of the system could be markedly improved by the conduct of appropriate macroeconomic and macroprudential policies. IMF surveillance as well as the G20s Mutual Assessment Programmes will have an important role to play to detect and address national **imbalances** that could spill over to the rest of the world. As we see a skewed international adjustment process as one of the main reasons for frictions in the IMS, we call for a progressive move towards **market-determined exchange rates** in systemic economies. Developing a roadmap to broaden the SDR basket, with conditions to be fulfilled, could support this. Strong and at times **volatile capital flows** raise justified concerns, as does the risk of sudden reversals. Sound domestic policies in recipient countries, including macroeconomic, prudential and exchange rate policies, are paramount to cushion the potential negative effects of large capital inflows. Source countries should also not neglect spillover effects of their policies in terms of capital outflows. We therefore favour a successful outcome of the IMF and G20 discussions to develop guidelines on capital flow management.