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Commissioner
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to the International Monetary and Financial Committee

on behalf of the European Commission

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The world economy is emerging from the brink of collapse. Signs of the economic recovery are getting increasingly apparent and fears of a prolonged recession are fading. The extraordinary concerted policies agreed in London and now in Pittsburgh have helped to contain the crisis, by stabilising the banking sector and stimulating effective demand. Global trade is resuming, after the virtual freeze in world trade witnessed in the last quarter of 2008.

The worst of the crisis is probably behind us, but there is no room for complacency. The crisis has left some lasting damage and in the coming years growth is likely to remain relatively subdued. The underlying strength of the recovery is still to be tested, and the economic potential of advanced economies has been lowered. Implementing jointly co-ordinated policies will make a difference and translate into higher world growth rates in the medium term.

The EU economy appears to be at a turning point. Signs of improvement in the economic situation have become increasingly apparent since the start of the autumn and fears of a prolonged, deep recession are fading. Although there is still a high degree of uncertainty with significant headwinds present, tailwinds have gained strength more recently. In particular, important policy interventions have succeeded in achieving some stabilisation in the financial system and in providing support to economic activity. Notably, data for the second quarter indicate a significant easing in the pace of contraction of EU GDP and the Commission's new forecast suggests a slightly positive GDP growth in the second half of this year. The question is whether this positive surprise reflects mostly one-off factors – or whether it is the start of a sustained recovery.

There are several reasons to be moderately optimistic about the **near-term outlook**. Financial conditions have improved markedly over the summer with a number of financial indicators returning to pre-crisis levels. With the global (non-EU) economy stabilising, the outlook for external trade is more encouraging. The inventory cycle is set to turn (although progress is uneven across countries). Both business and consumer confidence indicators have continued to improve in recent months across almost all sectors and countries, which also bodes well for the near-term outlook. Last but not least, the implementation of several already announced discretionary measures is planned for the current quarter. However, uncertainty remains high and the recovery is likely to be very gradual.

Looking ahead, uncertainty is rife. In view of the currently favourable earnings' conditions of banks, **financial repair** is key for the sustainability of the recovery otherwise the present **recovery could prove volatile and sub par**. The full impact of the economic crisis on labour markets and public finances is, at least partly, still to be faced. Rising unemployment could weigh on consumption, while ample spare capacity and an anaemic credit supply might restrain investment. A further negative feedback loop can therefore not be ruled out. The financial crisis could also have long-lasting adverse effects on potential growth. On the other hand, policy measures could prove more effective in restoring financial health, thereby supporting economic activity, and in improving the functioning of the economy. Summing up, the strength of the recovery could surprise on the upside in the near term, but its sustainability is yet to be tested.

Fiscal policy in Europe continues to provide a very substantial contribution to stabilise the economy. The implementation of the European Economic Recovery Programme (EERP) is on track and our overall fiscal injection into the EU economy in 2009 and 2010 is projected to amount to around 5 percent of GDP. The rise in government deficits reflects not only the stimulus packages in the framework of the EERP but also the functioning of automatic stabilisers in the EU economy. The response of government expenditure and revenue to the fall of economic activity is crucial to alleviate the economic and social cost of the crisis and to bolster aggregate demand.

The fragile nature of the recovery necessitates that EU Member States fully implement the measures as envisaged in their stimulus plans. These measures should suffice as our economies are not any longer in free fall. The medium-term fiscal challenges resulting from the crisis are daunting and any proposals for more stimuli would stifle our economic growth in the future.

Fiscal responsibility has been one of the main successes of Economic and Monetary Union. The extraordinary crisis measures undertaken in the last twelve months were necessary but could derail the fiscal progress we have made. Budgetary developments could become unsustainable, inciting inflation and hampering efficient resource reallocation. Therefore, we attach great importance to the design, communication and timely implementation of a comprehensive exit strategy, not only in Europe but also internationally. By devising appropriate **exit strategies** we will anchor expectations of a return to long-term stability and market-oriented economic policies, thereby ensuring maximum effectiveness of ongoing extraordinary support measures.

A comprehensive **exit strategy** should entail both the phasing out of short-term temporary crisis-related support measures and the phasing in of structural with a longer-term horizon to put public finances on a sustainable footing and bolster potential output while at the same time addressing the policy challenges of ageing, climate change, and globalisation. Considering the global nature of the crisis and the context of large global imbalances, the spill-over effects across borders call for coordination of policies at a global level. Within the EU, the benefits of coordination are particularly strong considering the intensity of economic interlinkages.

The crisis has exposed unacceptable gaps in the **global financial regulatory and supervisory frameworks**. The EU has made significant progress during recent months in a developing a more efficient regulatory and supervisory architecture, addressing the issue of bank capital requirements, and extending the perimeter of regulation – to include OTC derivatives, hedge funds, and credit rating agencies. We are working diligently to limit pro-cyclicality in the financial sector and to introduce new crisis management rules, including bank resolution and deposit guarantee schemes. In this context one of the most important steps will be the establishment of a new financial supervision framework that will be based on two pillars. The first pillar will address the weakness of current macro-prudential oversight by creating a European Systemic Risk Board. The second pillar will improve micro-supervision by establishing a new European System of Financial Supervisors.

The EU recognises the importance of properly and timely dealing with troubled assets of the banking sector. The repair of balance sheets of EU **financial institutions** is essential for restoring full confidence on markets and for supporting economic recovery. Some European Union Member States have addressed the problem by creating "bad bank" schemes. Moreover, a number of banks are undergoing a restructuring process that is aimed at restoring viability of the business strategy without state aid support and re-establishing normal and competitive market functioning. While the support measures taken have generally been crucial for safeguarding financial stability and limiting the worst effects of the crisis, they have the potential to impose a heavy burden on public finances and to distort the functioning of financial markets. We have to assess when to withdraw support measures without risking the nascent recovery of our financial sector. However this should not stop us from beginning to reflect on how the related challenges to government and central bank balance sheets can be managed most effectively and on how exit strategies should be appropriately formulated and implemented in the future.

In this context, the EU supports the suggestion that restoring **securitisation** markets is necessary to ensure appropriate financial intermediation. Nevertheless, it is essential to analyse and implement measures that would help to avoid another build-up of undue risk or a collapse of securitisation market.

Europe has also taken forceful action on the monetary front. Since October 2008, the ECB has lowered its key interest rate by cumulative 325 basis points and implemented a set of unconventional measures. Euro area HICP **inflation** has reversed its downward trend and should return back to positive territory in the coming months, in line with expectations, as the base effects stemming from past energy price developments have changed sign and the economy gradually recovers. At the same time, inflation expectations have remained well anchored in line with the ECB's objective of price stability. By this yardstick, the ECB's monetary policy has been highly successful in mitigating the impact of the crisis on the economy. The ECB has communicated its readiness to withdraw the monetary stimulus when warranted by developments in economic and financial conditions, in particular risks to price stability.

With increasing signs of stabilization of the global economy, **exchange rate** volatility and risk aversion have decreased over recent months. Against this background, the euro has strengthened against the US dollar and, to a lower extent, the Japanese yen. The euro has also strengthened in real effective terms, and currently stands at some 8 percent above historical averages. 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. Increased exchange rate flexibility in some major trading countries would contribute to such an orderly process.

Global imbalances remain a medium-term challenge for global macroeconomics and financial stability, including the risk that the world economy returns to a growth path without having substantially corrected underlying imbalances. Developments related to the current crisis, as much as they reflect more than mere cyclical adjustments, are contributing to reducing global imbalances. Despite this correction, global imbalances remain large and – as agreed in the G20 Summit in Pittsburgh all major countries and economic areas have to play their part to resolve them in a manner compatible with sustained global growth. Surveillance under the new framework for sustainable growth should be led by the IMF. The euro area dimension should be fully taken into account in this surveillance

Policy challenges ahead include maintaining resilience to risks of macro-financial instability in the short term, further working out accumulated underlying imbalances and re-establishing a robust and sustainable medium-term growth and convergence path.

The crisis has triggered important and welcome changes at the **IMF** supported by the significant political momentum of the G20. The crisis has shown all the more that we require a strong IMF that provides its member countries with economic advice and financial assistance in times of distress.

The IMF has become a trusted partner in our domestic crisis response. The European Community has extended **balance-of-payments financial assistance** to Hungary, Latvia and Romania. EC assistance is provided in conjunction with the IMF and other donors. The EU and the IMF in particular have been working closely together, including in agreeing policy conditionality underpinning the programme with the authorities. We attach great value to such close cooperation, which allows a leveraging of financial resources, a pooling of expertise and consistency in policy conditions. Private sector involvement has been an important ingredient of overall assistance strategies, with parent banks undertaking concerted commitments to maintain funding to their subsidiaries in the countries receiving official support.

In order to enable the IMF to respond effectively to the crisis, the EU has made a significant financial pledge to contribute to the international effort to increasing the **IMF's resources**. Our financial contribution of up to EUR 125bn will represent 35% of a new and enlarged NAB and is by far the largest. We are also actively looking into how we can mobilise additional resources for the IMF's revised concessional lending framework.

Developing countries will need our continued support to be fully part of a global recovery. While developing countries in general proved to be more resilient to the crisis than initially expected because of good economic fundamentals prior to the crisis, many are significantly constrained in their policy response and strongly dependent on external support to avoid a reversal of recent achievements in poverty reduction. The European Commission is currently implementing a number of EU measures to support developing countries in coping with the crisis. Most importantly, the EU is providing EUR500 million of additional grant money in 2009 and 2010, mainly in Africa in the form of budget support, in order to avoid cuts in social expenditure in the most vulnerable countries.

We fully support advancing the **IMF's governance agenda** and welcome the political support by G20 Leaders for a transfer of 5 percent of quotas to under-represented emerging market and low-income countries. Our ambition should be to align actual quota shares as much as possible with calculated quota shares of all countries. We also need to ensure that the voice of the poorest is safeguarded. But we need to go further. The IMF's reform will be incomplete by focusing squarely on the question of quota and voice. All elements of IMF governance need to be addressed for this reform to become a success. Quota and voice can only address so much of the IMF's legitimacy, while a reform of the IMF's internal governance will address its efficiency but also its legitimacy. Some of the reforms have the potential to advance the voice of emerging and developing countries more effectively than a simple increase in quotas. We therefore will continue to advocate a comprehensive governance reform package, which will include the size of the quota increase, the size of the IMF's Executive Board, the involvement of Ministers and Governors in setting the IMF's strategic agenda and for providing traction to the IMF's surveillance and importantly voting majorities of IMF decisions. Europe will stand ready to play its part and counts on the cooperative spirit of its partners.

Signs that **world trade** is recovering are increasing. However, protectionist pressures could mount in the coming months as unemployment continues to rise in many countries and the room for stimulus through macroeconomic policy becomes more limited. An increase in protectionism could halt the incipient recovery of world trade. This underlines the importance of respecting the stand-still commitments agreed within the G-20 and the importance of concluding the **Doha Development Round.** The Commission, therefore, strongly supports an ambitious and balanced conclusion of Doha in 2010. To support world trade in the nearer future, it is also important to maintain the G-20 trade initiative worth USD 250 billion working through both bilateral and multilateral channels. The EU has been a key contributor to the initiative making available EUR 100 billion over the next two years for trade finance.

Important efforts have to be made by all parties to reach an ambitious agreement at the UN Conference on **climate change** in Copenhagen this December. While contributions by developing countries should largely take the form of mitigation actions embedded in low carbon growth plans, all advanced countries need to soon come forward with ambitious commitments for emission reductions and with proposals for a significant scaling-up of resources to finance mitigation actions in developing countries. The European Commission estimates that the net incremental costs of mitigation and adaptation in developing countries are about EUR 100 billion annually by 2020, to be financed from domestic sources, the carbon market and international public finance. The EU proposes a fair burden-sharing for international public finance on the basis of a country's ability to pay and responsibility for emissions, including also all developing countries except the least developed ones. If Copenhagen is successful, public finance estimated at €5 to 7 billion per year will be needed already from 2010–2012 for adaptation, mitigation, research and capacity building in developing countries.