International Monetary and Financial Committee

Twenty-First Meeting
April 24, 2010

Statement by Olli Rehn
Commissioner
European Commission

Statement of Commissioner Olli Rehn

to the International Monetary and Financial Committee

on behalf of the European Commission

Washington, 24 April 2010

The world economic revival is still somewhat fragile and recovery in most advanced economies is dependent on temporary factors in most of the advanced economies. However, it is more robust in many emerging markets, which are injecting much needed momentum to the world economy. In the **short term**, the recent increase in sovereign risk, the need for credible fiscal consolidation and the need to fully repair the financial sector in advanced countries are clear downside risks. Weak credit growth could become a drag on domestic demand despite some recent improvements. In the **medium term**, the lack of co-ordination of exit strategies and the lack of rebalancing between surplus and deficit countries could also weigh on the downside. There is a real risk that we repeat the mistakes of the past, especially if the recovery takes hold and good intentions are forgotten.

In the EU a gradual albeit fragile recovery is ongoing. Massive policy interventions have succeeded in achieving stabilisation of the financial system and are providing support to economic activity. However, the recovery is not yet self-sustained. The easing of GDP growth in the last quarter of 2009 can be partly explained by the inventory cycle and the fact that the effects of some policy measures started to fade, but it also reveals sustained weakness in domestic demand. Fixed investment contracted and private consumption did not accelerate. Only exports continued to expand appreciably, supported by a stronger global recovery.

The economic upturn in Europe seems to have continued in the early months of 2010 and there are reasons to be moderately optimistic about the **near-term outlook**. The outlook for external trade remains encouraging. Industrial production started the year expanding at a solid pace, consistent with a rebound in GDP growth in the first quarter of this year. Firms are signalling an abnormally low level of inventories. The latest business sentiment and consumer confidence readings show improvements compared to last year. However, it is too early to detect clear spill-over effects from a pick-up in manufacturing activity to the rest of the economy. Domestic demand could contract again this year as the high level of excess capacity dampens investment, and as a certain degree of labour hoarding during the recession limits job creation, weighing on consumer spending.

After falling into negative territory in summer 2009, **euro area headline inflation** has turned positive again in November 2009 and has steadily increased to stand at 1.4 percent in March of this year on the back of positive base effects, stemming from past energy price developments, and rising commodity prices. Against the background of subdued economic activity, core inflation has been gradually declining since mid-2008. The weak pace of economic recovery, combined with uncertainties surrounding the economic outlook as well as the effects of gradually phasing-out expansionary economic policies, is expected to contain inflationary pressures over the coming months. With medium-term inflation expectations well-anchored, euro area inflation is thus expected to remain moderate in the period ahead, at a level consistent with price stability. The economic crisis has exposed different short-term adjustment needs that could underpin inflation differentials across euro area Member States and possibly imply spells of negative inflation in some countries.

Looking ahead beyond the near-term, the **robustness of the economic recovery** in the EU is yet to be tested. While the EU is likely to benefit from a stronger global economy, the balance-sheet adjustment across sectors in several countries is not over yet. Concerns about the sustainability of public finances in some EU countries could also have a stronger adverse impact on economic growth than currently assumed. The European Commission Spring 2010 economic forecast will be released on May 5. So far, the economic outlook seems broadly in line with the Commission's Autumn 2009 forecast and the February 2010 interim forecast. However, uncertainty remains rife and the recovery is likely to be largely reliant on global growth in the near-term and held back by weak private demand further out.

Fiscal policy in Europe has provided a very substantial contribution to stabilise the economy. The implementation of the European Economic Recovery Plan (EERP) is still continuing in many Member States. 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 decline in economic activity has been crucial in alleviating the economic and social cost of the crisis and to bolster aggregate demand.

We attach great importance to the proper design, clear communication and timely implementation of a comprehensive **exit strategy**. Such a strategy should entail both the phasing out of short-term temporary crisis-related support measures and the phasing in of structural measures with a longer-term horizon to put public finances on a sustainable footing and to 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, not least within the G-20. It is necessary to begin work on designing such a strategy, so as to provide the markets with sufficient time to adjust to the changes that will eventually have to be made. Timing and implementation, however, should occur only when the necessary conditions for a solid recovery have been well established and will depend on individualized circumstances.

The main legacy of the global economic and financial crisis in the EU and elsewhere has been a widespread and severe deterioration in public finances. Investor concerns about the ability of some Member States to deal decisively with budgetary issues has triggered a sudden and sharp reassessment of their sovereign risk, with the potential to induce a higher risk premium. 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 fully and on time.

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.

As to **fiscal exit**, the European Council of October 2009 set out the principles of such a strategy, namely, (a) the exit strategy should be coordinated across countries in the framework of consistent implementation of the Stability and Growth Pact; (b) there is a need for 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. Specificities of country situations should be taken into account, and a number of countries need to consolidate before then; (c) in view of the challenges, 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; and (d) important flanking policies to the fiscal exit will include strengthened national budgetary frameworks for underpinning the credibility of consolidation strategies and measures to support long-term fiscal sustainability, as emphasised by the SGP. 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 non-specification of consolidating measures.

The **timely yet balanced exit from financial support measures will also be crucial**. The objective will be to achieve a gradual coordinated exit from public support measures to financial institutions, which safeguards financial stability while promoting a return to normal market functioning. The ECB has already started to implement a gradual withdrawal of some of its non-standard monetary policy measures amid ongoing improvement in financial market conditions, though taking into account challenges posed by the Greek crisis. At the same time, it has reiterated its determination to counter any risk to price stability over the policy relevant horizon.

The macro-financial outlook has improved further in recent months, but remains subject to significant risk. While the risk of a systemic banking crisis has receded in a context of extensive policy support, progress in balance sheet repair has been uneven across banks and Member States. Even if the economic recovery proceeds as expected, estimates indicate that significant losses remain to be absorbed. Such losses would be even higher, if the pace of economic recovery were to stall. Meanwhile, important financial-market segments – notably for securitisation – remain largely closed, and the functioning of the key interbank markets is not yet fully restored. Against this background, the potential for adverse feedback between developments in the real and financial sectors of the economy remains high.

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 will be a crucial year to implement the agreed financial reform commitments and to continue to deliver on future 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. 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) is already in an advanced phase of the legislative process. The bodies that will be created 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, as well as work to determine the financial sector's potential contributions to the cost of the crisis.

Global imbalances remain a medium-term challenge for global macroeconomics and financial stability. A significant part of the recent narrowing in global current account imbalances is possibly due to temporary factors. As their impact will gradually vanish, imbalances are expected to widen again. Accordingly, significant efforts are needed in all major regions in the world in order to improve global macroeconomic management and to reduce the risks of further crises. Increased exchange rate flexibility in some countries with pegged exchange rates and large surpluses would contribute to stability by reducing current account imbalances. In this respect, the Chinese authorities are encouraged to implement soon a more flexible exchange rate regime for the renminbi.

Changes in risk aversion and the relative outlook for growth have remained the most important determinants for **exchange rates** in recent months. Concerns about sovereign debt have also weighed on risk taking behaviour and led to a depreciation of the euro against the dollar and the yen. The euro has also weakened in real effective terms and is currently close to its 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.

We fully support advancing the **IMF's governance agenda as set out by the IMFC in Istanbul**. 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 alone 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 go so far in providing the necessary increase in 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 involvement of Ministers and Governors in setting the IMF's strategic agenda and for providing traction to the IMF's. Europe will stand ready to play its part in the reform and counts on the cooperative spirit of its partners.

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 of trading partners remaining fully committed to the stand-still commitments agreed within the G-20 and the importance of concluding the **Doha Development Round.** We strongly support an urgent, ambitious and balanced conclusion of Doha, and counts on the G20 Leaders to continue to show strong commitment to the Round so that the remaining divergences can soon be clarified, with a view to an early conclusion.

A global and comprehensive legal agreement remains the only effective way to reach the agreed objective of staying below a 2°C increase in global temperatures compared to pre-industrial levels. A stepwise approach should be followed, building on the Copenhagen Accord, which should be swiftly implemented. Developed countries have committed themselves to providing resources approaching USD 30 billion in the period 2010-2012. This fast-start funding should be urgently mobilised and deployed to address the need for immediate adaptation and mitigation action, lay the foundations for effective and efficient action in the medium and longer term, and avoid delay of ambitious action.

In the context of meaningful mitigation actions of developing countries and transparency on implementation, developed countries have committed to a goal of mobilising jointly USD 100 billion a year by 2020, coming from a wide variety of both public and private sources, to assist developing countries in fighting climate change. We welcome the establishment by the United Nations Secretary General of an Advisory Group on Climate Change Financing to develop practical proposals on how to significantly scale up long-term financing towards meeting this goal. We underline that the potential of innovative sources of finance and of market-based instruments in particular, including carbon markets, as well as leverage of private finance through public finance should be taken into account.