International Monetary and Financial Committee

Twenty-Ninth Meeting
April 12, 2014

Statement by Siim Kallas,
Vice-President of the European Commission

On behalf of the European Commission

Statement of Vice-President Siim Kallas to the International Monetary and Financial Committee on behalf of the European Commission

Washington, 12 April, 2014

1. The recovery in the European Union is gaining ground and spreading across countries, although it remains modest. Short-term indicators suggest a continued economic expansion in the coming quarters. Looking ahead, GDP is expected to grow by 1.5% in the EU and 1.2% in the euro area this year, before speeding up more markedly in 2015 to 2.0% and 1.8% respectively. Economic activity has also started to strengthen in the vulnerable countries, who also managed to make significant progress in rebalancing their external accounts. We believe that this adjustment is largely non-cyclical and will stay even after the recovery takes a firmer hold. Growth is expected to be increasingly driven by stronger domestic demand, as the burden of excessive debt and financial fragmentation is fading, and confidence is improving. Unemployment rates have stopped increasing since mid-2013 in most of the EU. Some Member States (e.g. Ireland, Latvia, and Portugal), have, supported by strong reform efforts, already achieved substantial declines in their unemployment rates as well as falls in long-term unemployment. Over the forecast horizon, we expect labour-market improvements to become visible in more Member States. Confidence has also been strengthening in financial markets, which is reinforcing the turnaround. Financial fragmentation has considerably receded in the sovereign and corporate debt markets. Bond spreads of vulnerable Member States are continuing to narrow, thanks to investor confidence in the success of the fiscal adjustment and economic reform process. The main challenge now is to stay on the path of consolidation and reform.

2. Inflation has recently fallen faster than anticipated. The disinflationary pressures in the EU have been driven by both external and domestic factors. Falling commodity price inflation and the substantial appreciation of the euro since mid-2012 as well as the abating impact of short-term factors (taxes, administered prices, food) and weak demand all played a role. Looking ahead, only a muted increase in prices is expected throughout the forecast horizon on the back of decreasing unemployment and excess capacity. The European Commission's Winter Forecast projects an average EU-inflation rate of 1.2% for 2014 and 1.5% for 2015 (1.0% and 1.3% for the euro area, respectively). The risk of outright deflation, in the sense of a generalised and self-enforcing fall in prices across countries, exists but seems low. For deflation to materialise, a strong shock to the assumptions of our forecast would be required to drive underlying inflation to unprecedented low levels and to de-anchor inflation expectations. This seems unlikely at the current juncture.

3. The framework for economic and budgetary coordination for the EU as a whole and for the euro area in particular has been improved and strengthened since the crises. As part of the enhanced macroeconomic surveillance, the European Commission has carried out in-depth reviews of the economies of 17 Member States. Overall, the analysis shows that macroeconomic imbalances, which have been built up over many years, are gradually receding. However, in some cases, new concerns have arisen, which require closer attention. Consequently, we concluded that 14 Member States are experiencing imbalances. The drivers of imbalances and the risks they raise are different from one economy to another, but some issues are common to a number of countries. High levels of external indebtedness continue to

weigh on countries with previously high current account deficits, while persistent large current account surpluses reflect subdued domestic demand in a few other countries. Further improvements in competitiveness are key to stimulate the reallocation of resources and promote export performance, particularly in countries experiencing large losses in export market shares. The progress in deleveraging will have a crucial impact on the ability of the private sector to boost consumption and investment. The policy responses to these challenges also need to consider the euro area dimension of imbalances. The Commission will put forward country specific recommendations by early June 2013, for consideration by the European Council.

4. We stand by Ukraine and are committed to provide strong financial backing. The European Commission has proposed new macro-financial assistance (MFA) to Ukraine of up to EUR 1 billion in medium-term loans, which is to be added to an already approved (but not yet disbursed) MFA operation for Ukraine in the amount of EUR 610 million and to a budgetary support operation in the amount of EUR 355 million financed under the EU's regular cooperation assistance. This rapid-disbursement assistance is part of the EUR 11 billion assistance package for Ukraine endorsed by the European Council last month. The disbursement of the intended MFA would be conditional on the successful implementation of a financing arrangement that the Ukrainian authorities are expected to conclude with the IMF and on specific economic policy conditions that the Commission and the Government of Ukraine will agree on. The policies that the Commission considers important to support through the proposed assistance comprise urgent fiscal consolidation and external stabilisation measures, as well as structural reforms aimed at improving overall macroeconomic management, strengthening economic governance and transparency and improving conditions for sustainable growth.

5. EU Member States are making progress in addressing their economic challenges. We would like to highlight some of the key elements from our comprehensive strategy going forward:

- Sound public finances are a prerequisite of long-term sustainable growth. The EU fiscal strategy focuses on headline (nominal) and structural balances, and is differentiated according to the Member States’ fiscal and economic situation. The EU pays particular attention to the need for a growth-friendly fiscal consolidation, which includes an adequate mix of growth-friendly expenditure and revenue measures, accompanied by structural reforms to enhance the economic growth potential. The European Commission forecast shows that the fiscal stance in the EU as a whole is expected to be broadly neutral in 2014, which should support the nascent recovery, while debt ratios are projected to stabilise at 90% of GDP. The large consolidation efforts implemented over the last couple of years have led to visible results and the average headline deficit in the EU is now forecast to decline below 3% of GDP this year. This achievement has allowed reducing the pace of fiscal consolidation overall, even though large differences across EU countries remain. However, large debt levels and sustainability concerns imply that consolidation has to continue in the majority of the countries to reach sustainable medium-term budgetary positions.

- It is important to support the ongoing economic recovery by continuing to step-up structural reforms that promote growth and job creation on a sustainable basis. The European Council in December 2013 endorsed the five broad policy priorities for the European Union and its Member States in 2014: pursuing differentiated, growth-friendly fiscal consolidation; restoring normal lending to the economy; promoting growth and competitiveness; tackling unemployment and the social consequences of the crisis; and modernising public administration. To provide a steer to the EU Member States for the National Reform Programmes under the European Semester which they will present in April, the European Council in March 2014 put particular emphasis on policies enhancing competitiveness, supporting job creation and fighting unemployment, particularly youth unemployment, and on the follow-up to reforms to improve the functioning of labour markets. The European Union is also approaching the halfway point of its Europe 2020 growth strategy. The crisis has slowed down progress towards many of the key goals of the strategy and the long-term challenges affecting growth in Europe. As the recovery is gaining ground and the legislation adopted over that last few years has been fully integrated in the economic governance framework, this is a good moment to discuss policies that can move us decisively beyond the crisis. The European Commission therefore considers it necessary to launch an EU-wide public consultation to gather the views of all interested parties on the first years of implementation of the Europe 2020 Strategy and on the elements to take into consideration in the further development of the strategy. The consultation will start later this spring and conclude in the autumn. Following the consultation, the Commission will present the mid-term review to the European Council in 2015.

- The EU has made further important progress towards the completion of Banking Union. The preparations for the Single Supervisory Mechanism (SSM) are well on track. The Supervisory Board has been established, most senior management has been appointed and progress is underway in recruiting about 800 supervisors to be operational as of November this year. In addition, the European Central Bank has also made good progress regarding the comprehensive assessment of the banking system which involves 128 banking groups. This exercise consists of an asset quality review, aiming to identify remaining unaddressed vulnerabilities, and a EU-wide stress test coordinated by the European Banking Authority. We consider that the comprehensive assessment is crucial to reinforcing confidence in the European financial system and supporting financial stability. In this respect, it should be noted that European banks have already considerably reinforced their capital base sine the onset of the crisis. We would like to underscore that steps are also being taken to ensure the availability of national backstops, as a last resort and after appropriate burden-sharing with private investors. In cases whereby national backstops are not sufficient, EU/Euro area level instruments would be available. Significant progress was also achieved on the second pillar of the Banking Union, namely the Single Resolution Mechanism (SRM). On 20 March, the European Council and the European Parliament reached a political agreement on a Single Resolution Mechanism, including a Single Resolution Fund, to complement the Single Supervisory Mechanism. This represents a major step towards the alignment of both banking supervision and banking resolution at a central level, whilst involving all relevant national authorities. This will facilitate an orderly resolution process, in particular in cross-border cases and help reduce adverse bank-sovereign links. It will strengthen confidence and stability in the financial markets and support lending to the economy. The EU is also working towards promptly reaching an agreement on the operational framework of the European Stability Mechanism direct recapitalisation instrument.

- The EU is taking a number of important initiatives in order to underpin sustainable economic growth by enhancing the long-term financing of the economy. On 27 March, the European Commission presented a communication on Long-Term Financing of the European Economy and adopted a strong package of measures to stimulate new and different ways of unlocking long-term financing and support Europe's return to sustainable economic growth. Actions to be undertaken in the EU can be grouped into six main areas: (i) mobilising private sources of long term financing; (ii) making better use of public funding; (iii) developing European capital markets; (iv) improving SMEs' access to financing; (v) attracting private finance to infrastructure; and (vi) enhancing the wider framework for sustainable finance. At international level, discussions on financial regulation should also take into account potential effects, in particular any unintended consequences, for the financing of the economy and for long term investments.

6. The EU has largely completed the implementation of the core financial reforms set out by the G20 in response to the global financial crisis especially with the implementation of Basel III, of the derivatives reform, of strong compensation rules, of strict requirements for rating agencies and for hedge funds. Progresses also bring achieved on a new EU framework for the prevention, management and resolution of banks in line with the FSB Key Attributes. On international coordination aspects, the priority for us is that regulation needs to achieve the right balance between, on the one hand, comprehensive cover of global financial markets and, on the other hand, avoidance of conflicts, inconsistencies and duplication. Regulatory cooperation is therefore essential in this context. G20 members should have the possibility to defer to each other’s regulatory regimes, when justified by the quality of their respective regulatory and enforcement regimes and where they achieve equivalent outcome. This approach was already agreed for OTC derivatives by the G20 in St. Petersburg. EU and US regulators made significant steps forward in addressing cross-border issues in the OTC derivatives field. We consider that further structured international cooperation in the financial regulatory areas is necessary, and we remain committed to working with our international partners in this respect.

7. The International Monetary Fund is a key pillar of the International Monetary System. It is important that we continue our efforts to ensure the Fund's capability to address the challenges of today's international monetary and financial system.

8. Our priority continues to be for all IMF members to ratify the 2010 Quota and Governance Reform as soon as possible. We attach high importance to securing this objective. All 28 EU Member States have already fully ratified it. We encourage all IMF member countries that have not yet ratified it to do so expeditiously. The implementation of the IMF 2010 Quota and Governance Reform is key to the Fund's legitimacy and will result in a governance structure that better reflects the realities of the world economy. EU Member States reconfirmed that they remain committed to continue constructive discussions on the quota formula and the 15th General Review of Quotas. It is most important that discussions on the quota formula and the 15th review continue to be treated as an integrated package, as reiterated in the January 2014 report from the Executive Board to the Board of Governors. This implies that no decision can be taken in isolation. An agreement will need to take into account the interests of the entire membership and it should be fully anchored in the relevant IMF bodies, where all IMF members are represented. The main variables of the quota formula should remain both GDP and openness which best capture the role and mandate of the IMF.

9. The European Commission welcomes the improvements in Fund surveillance in recent years, including the adoption of the Integrated Surveillance Decision and an institutional view on capital flows. The EU has significantly improved its surveillance framework in order to enhance the surveillance of the macroeconomic policies of EU Member States as an important layer of our comprehensive crisis response. In regard of the IMF surveillance framework, we would like to emphasize the need and importance of an effective and comprehensive

surveillance of monetary unions as these call for a different set of rules and policy advice than individual countries outside of a currency union. IMF surveillance should in this regard take proper account of the respective competences at EU Member States' and European Union level, as well as of internal and external interconnectedness. Looking ahead, a thorough evaluation of the Fund's surveillance experience in connection with the new institutional view on capital flows as well as macro-prudential policy measures will remain key. We look forward to the 2014 Triennial Surveillance Review with the envisaged objective of assessing effective implementation.

10. The European Commission supports the regular conduct of Financial Sector Assessment Programs and Article IV consultations, as well as mandatory and timely publication of annual Article IV reviews. Systemically important countries/regions should lead by example. We call on all IMF members with overdue Article IV consultations and deficiencies in the provision of data to the Fund to fully cooperate with the IMF in line with their membership obligations. The availability and quality of economic data is essential to the proper conduct of IMF surveillance.