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Panel: "Taking stock: global implications of transatlantic differences"

SPEAKING NOTE (10 minutes)
Version 0

1. The worst of the financial crisis is behind us, but it is too early to celebrate the end of the crisis. Economic and financial situation dominated by positive news:

- GDP growth stabilised in Q2 and should become positive in the EU and the US in Q3 (and Q4)
- Sentiment indicators rebounded: PMI, Commission confidence indicators.
- Stock prices recovered: doubling since March.
- Spreads on money, bond and CDS markets declined, broadly comparable to pre-Lehman time.
- Most banks reported better-than-expected earning figures in Q2.

2. Risks – Possibility of a W-shape recovery. The pace of recovery is still very slow and remains far below pre-crisis levels, and there is an issue about sustainability of current stabilisation.

- The current pick-up is mainly carried by (technical correction) of inventory cycle, rebound in demand in Asia and most importantly heavy government intervention.

- So far in the US the only positive contributions to growth have come from net exports and government spending.
- In the EU consumption was stronger than expected in the second quarter, but, with unemployment rising, not clear whether it will remain resilient.
- Overall, economic and financial conditions remain highly fragile and risks of a reversal of current trends are a significant concern. Therefore, once the stimulus fades, there is the risk of a new slowdown in the EU and US economies.

3. Risks - Financial sector not yet out of the woods. The ultimate resolution of the financial crisis requires removing investors' uncertainty about the quality of banks' balance sheets.

- Economic rebound likely to be sluggish unless viability of financial sector is restored. Evidence by academics and IMF of cyclical developments in financial crisis, lessons from Nordic countries in BIS annual report.
- Banks are still highly leveraged, in particular in the EU, and concerns about the quality of their assets remain. Some of them are in the position to weather the current crisis with limited adjustments in their operations. Others need to undertake in-depth restructuring.
- As it happened in the US, it is vital that EU Member States and industry capitalise on the stress tests that are currently undertaken.
 - Considerable public resources still available for bank support. Take up rate for recapitalisation is 61%, i.e. 137 billion EUR still available.
 - Member States could consider whether certain structural changes are needed for the reconfiguration

of their financial sector. Commission provided guidance on restructuring aid.

3. Regulatory initiatives have a vital role to play in restoring investor confidence. Consistent with efforts at global level, the EU has embarked on an ambitious agenda of regulatory reform. Main initiatives are

- the creation of a European Systemic Risk Board and European Supervisory Agencies;
- the introduction of dynamic provisioning to reduce pro-cyclicality, as well as the introduction of non-risk based metric to increase capital requirements and reduce leverage;
- the introduction of a robust and effective bank stabilisation and resolution framework.
- EU is moving ahead in complementary areas, such as the accounting frameworks, remuneration policies or regulatory coverage of other financial market participants.

4. The US Administration has recently produced a far-reaching blueprint for regulatory reform. G-20 demonstrated broad consensus with US on a wide range of issues, both in terms of diagnoses and therapy.

- Very important points of convergence, for instance
 - a body to look at and deal with systemic risk
 - a regulatory framework for derivatives and other complex structured products.
 - Intention to reduce pro-cyclicality, increase capital requirements and reduce leverage.

- Differences with EU, for instance on remunerations and bonuses (but this did not impede to reach an agreement in the G20).
- Legislation needs to be mutually compatible, and a certain degree of regulatory convergence is warranted.

5. Exit strategy is not about announcing an unconditional timetable

- Exist strategies must be comprehensive and address unprecedented policy intervention in all major policy dimensions, including macro (both monetary and fiscal policy) but also structural and in particular sectoral measures (both in the financial but also in the non-financial sector)
- Exit strategies are a very delicate issue
 - US Administration cautious on the issue of exit strategies. Fear that announcing and implementing them too early would plunge the economy again into recession, as it happened in 1937- 1938.
 - Need to identify the right sequencing and avoid negative spillovers due to untimely moves by one (or more) major player(s). Risk finding ourselves and the global economy in a Japan's trap. This is why this is a key issue in the G20.
 - G20 Finance Ministers agreed to start withdrawal of impetus once recovery is on a 'firm footing'. However, given the nature of this global financial crisis, determining when the recovery is sufficiently robust is not an easy task. Benchmarks from the pre-crisis (e. potential growth; levels of capacity utilisation) may not give the right guidance now.

- There cannot be a clear-cut timetable for all and all policies. Approach to exit must be differentiated across countries, specific to the policy area and well-coordinated.
- **Fiscal policy:**
 - The overall support of government finances to the economy amounts to 5 percentage points in the EU (around 4½ percentage points in the euro area) in 2009 and 2010. [If automatic stabilisers are taken into account, the size of the stimulus in the EU and the US is more or less the same, according to IMF. ECFIN figures show higher fiscal stimulus in USA]
 - Need to ensure effective implementation of agreed measures throughout the rest of the year and 2010 in line with announced plans. At the same time the temporary character of these measures should be confirmed and their validity not extended unless increase of relapse into recession.
 - For macroeconomic policies to be effective, markets need to be reassured that medium-term macroeconomic stability is not compromised. In this context, the projection of debt dynamics at current trends – even after withdrawal of the temporary stimulus measures – is a matter of concern and formulation of credible consolidation strategy is imperative.
 - As agreed by euro-area ministers, this strategy includes (i) ambitious but realistic budgetary targets, (ii) consolidation measures, (ii) a strengthening of the national framework underpinning budgetary discipline, and (iv) implementation of structural reforms.
 - With Treaty and Stability and Growth Pact, the EU has useful rules-based framework in place that provides

orientation for Member States to return to sustainable public finances. Given the formidable consolidation challenges, need for judicious application. In particular, the painful consolidation phase needs to be differentiated according to i) the extent of the gap vis-à-vis a sustainable fiscal position and ii) the availability of fiscal space.

- **Structural/sectoral policies**

- In order to minimise impact of crisis on potential growth, structural reform must be geared towards fostering medium-term supply conditions. Sectoral support measures that have distorting effects or hamper necessary adjustment must be withdrawn with priority.

- Phasing out of **bank support schemes** should be

- linked to the pace of the recovery.
- cost of government support will increase gradually in order to provide banks with sufficient incentives to return to the private markets.

- **Monetary policy** is providing crucial assistance to the financial sector and important stimulus to the economy as a whole. A timely and credible exit strategy for fiscal policy may improve the perspective for price stability and allow a later withdrawal of support from monetary policy.

6. EU-US convergences and divergences. Policies in the pipeline are not "an ocean apart".

- We agree on what the key issues are and on most of the instruments that should be used.
- Need for the EU and the US

- to have even closer exchange of views and coordination,
- to understand better where we diverge in our policy responses and
- to agree solutions that are mutually beneficial for both sides.
- EU suggested to establish such a mechanism
 - In the past the US was not keen about it, since we had already informal contacts as well as the G7/G8.
 - Because of the crisis, these channels are not any longer sufficient
 - we need a forum where we can have an extensive and frank exchange of views and try to find policy convergence.