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Mr. Tharman Shanmugaratnam
Chairman, International Monetary and Financial Committee

Mr. Marek Belka
Chairman, Development Committee

Dear Chairmen:

The Spring Meetings of the International Monetary and Financial Committee (IMFC) and the Developing Committee are taking place at a time when the global economy continues to face significant challenges, despite some recent encouraging signs. Important steps have been taken to address the Euro Area sovereign debt crisis. The successful voluntary debt exchange for Greece, the strengthened adjustment efforts by the peripheral Euro Area countries, and the ECB liquidity support have given a sense of momentum. However, problems still persist and risks remain elevated. Risks continue to emanate from the oil price increases, the deleveraging pressures, and the lingering weaknesses in the US housing market. In addition, the sovereign debt crisis has adversely affected Euro Area growth and poses risks to the global economy through spillover effects on trade flows and international funding conditions, including trade finance.

At the global level, a strengthened framework for international policy coordination among the major countries is sorely needed. Such a framework should emphasize increased accountability and deeper commitment from key economies, as well as a fuller and more active participation of leading emerging markets, such as Brazil, China, and India. Key priorities include the adoption of appropriate policies to address the fiscal imbalances in the United States and other mature economies (through credible medium-term consolidation plans) and the correction of both global and regional imbalances between surplus and deficit countries. A successful strategy should also focus on balancing the competing objectives of regulatory reforms for financial stability and sustaining credit growth in the current environment and avoiding other unintended consequences.

As those issues were dealt with in some detail in the IIF February 2012 Policy Letter to the G-20 Finance Ministers, we focus this letter on addressing the strains in the Euro Area, given the critical role of Europe in the global economy at this stage of the recovery. The IMFC has a strong interest in encouraging policy measures to resolve the Euro Area sovereign debt problems, building on steps already taken. These measures include more a balanced fiscal policy, consistency between economic policy and regulatory policies, and intensified efforts to implement structural reform. Such policies are needed to cushion near-term pressure on growth, restore market confidence, and address over time deep-rooted obstacles to growth. In addition, an appropriate augmentation of the Euro Area financial firewall is important to underpin market sentiment and help facilitate a necessary increase in IMF lending resources to address global risks going forward, including in Europe.

Concrete steps to address the strains in the Euro Area

Euro Area authorities have taken several policy measures to deal with the ongoing sovereign debt crises in peripheral countries:

- The voluntary Greek debt exchange on an unprecedented scale by private investors, in combination with the large additional official financial assistance by the Euro Area and the IMF, provide Greece with the needed breathing space to implement reforms effectively and move toward economic recovery. It will be crucial for the Greek government to take the fullest advantage of this opportunity in the immediate period ahead.

- Many of the actions taken by the other Euro Area countries in difficulty to address their fiscal imbalances and enhance their competitiveness, including the important labor market reforms in Italy and Spain, will have a beneficial effect and serve as a strong basis for further reforms. Ireland and Portugal have kept their programs on track, but recovery is yet to be achieved and large market financing requirements are projected for 2013.

- The continued efforts to strengthen the Euro Area-wide fiscal framework are welcome. The introduction of the fiscal compact is a useful first step, but somewhat narrowly focused on promoting the implementation of rather inflexible fiscal consolidation objectives. The broader efforts to enhance economic governance reforms are important to bolster fiscal discipline and facilitate more effective and coordinated policy implementation across the Euro Area.

- The ECB's injection of liquidity through long-term refinancing operations is the single most important factor in alleviating near-term tensions in regional financial markets.

While the above policy responses are welcome, a more balanced approach is needed to address the existing fundamental problems.

Real GDP and domestic demand growth in the Euro Area slowed down markedly during the second and third quarters of 2011 and turned negative in the fourth quarter and most likely in the first quarter of 2012, with further weakness projected for the next six months. This has resulted in a drag on global growth and, in particular, the demand for exports from emerging markets (Euro Area imports from emerging markets have declined by about 3.5% per quarter since Q2 2011), with a notable adverse effect on the growth of exports by countries such as China and Korea. At the same time, deleveraging by European banks reduced trade financing by 10% to 20% in the fourth quarter of 2011, depending on specific institutions.

The ECB liquidity injections have temporarily eased the tensions in the Euro Area bank funding and, to a lesser extent, sovereign debt markets, thus allowing precious time for more comprehensive policies to be put in place. Nevertheless, the liquidity measures are insufficient and similar injections in the period ahead are neither feasible nor desirable. Measures are needed to address the underlying weaknesses in the interbank market, the national segmentation of bank funding, and the existing negative feedback loop between sovereign debt and bank problems, and thus unblock the monetary transmission mechanism.

Policy adjustments in three broad areas need to be considered:

1. A more balanced fiscal policy approach

The emphasis so far on fiscal austerity, while to a degree necessary for the countries facing market funding difficulties, is excessive when carried out across the board, and has already contributed to a steep contraction in domestic demand in the Euro Area as a whole. ***It is important to move beyond just fiscal discipline, shift the policy focus from nominal to structural budget balances, and embark on a more gradual and differentiated fiscal consolidation by the weak***

member countries, surplus countries such as Germany and the other countries with fiscal space, so as to avoid the risk of an austerity overload.

Moving towards mutualization of the fiscal burden would help weaker Euro Area members cope with the needed adjustment and structural reform and give an impetus to regional growth and thus reduce regional imbalances—these imbalances have been a key factor leading to the present debt crisis. A lasting solution should involve concrete steps toward an eventual, more centralized fiscal authority, with appropriate consideration given to how fiscal risk and resource sharing among Euro Area countries could operate.

These efforts should be combined with intensified implementation of concrete labor market and other growth-enhancing structural reforms.

2. Avoid inconsistencies between ECB and regulatory authority actions—due regard needs to be paid to supporting short-term economic recovery

We recognize the challenges facing the Euro Area monetary and regulatory authorities in addressing the impact of weak sovereign debt markets on banks, while ensuring at the same time that banks are adequately capitalized. Clear progress in solving the Euro Area sovereign debt crisis would alleviate these challenges.

The substantial exposure of European banks to sovereign debt has weakened bank share prices and undermined the banks' access to short-term funding and capital raising markets. At the same time, the tightening of the regulatory capital requirements for European banks to provide a buffer to the market value of their holdings of sovereign debt, over and above the Basel III current requirements, has accentuated the deleveraging process and undermined credit expansion and output growth. The monetary transmission mechanism has been severely impaired, more so than has been the case in the US and other mature economies.

The ECB's liquidity injections have partly eased the funding pressures, but they have yet to be reflected in credit expansion–the growth in bank lending to the private sector in the Euro Area declined to 0.7% in the year to February 2012 from 2.6% a year earlier, remaining at a significantly slower pace than in the US. ***To allow the benefit of an easier ECB monetary policy stance to feed through and support aggregate demand, it is essential to stabilize regulatory capital requirements, eschew any further surcharges on bank capital, and address the identified deficiencies in the proposed Basel III liquidity rules.***

Down the line, a mutualization of fiscal burdens and, more broadly, a centralization of the fiscal authority would facilitate the introduction of a Euro Area-wide resolution regime and of a common bank deposit insurance scheme. Such steps would help enhance regional financial stability.

3. Increase and strengthen the financial firewall

Over the past two years, the Euro Area has made significant progress in putting in place the building blocks for an effective financial firewall. ***The Euro Area needs to increase in the period immediately ahead the resources of its firewall and enhance the flexibility and timeliness of the deployment of these resources to make them effective in times of crises.*** These actions are essential for reassuring markets that the Euro Area has the resources and commitment to assist member countries facing contagion risks and difficulties in accessing capital markets. In this context, it is disappointing that the Eurogroup decided at its recent meeting in Copenhagen to keep the fresh lending capacity of the support vehicles at €500 billion—€300 billion of the €800 billion firewall has already been committed to the three program countries. We believe that a significant expansion of the European Stability Mechanism (ESM) resources is needed, especially in view of the outstanding commitment of the Euro Area to continue supporting members under financial assistance programs until they regain market access, provided their programs are kept on track.

It is very important for the Euro Area to be seen to contribute adequate resources to solve its sovereign debt crisis. A significant expansion of the Euro Area financial firewall is important to facilitate the desired increase in IMF lending resources. A timely and transparent deployment of the expanded IMF resources would help safeguard global financial stability.

Lessons from the voluntary Greek debt exchange

The successful conclusion of the voluntary debt exchange for Greece, with a very high private creditor participation, will provide major benefits to Greece and the broader financial community. These benefits include an upfront nominal debt reduction of about €106 billion or almost 50% of Greece's GDP and major cash flow savings in potential interest payments and the financing of the maturing privately held Greek debt in the period to 2020. More broadly, the support by the Eurogroup and the IMF of the voluntary debt exchange agreement reached through negotiations with private creditors demonstrated and underscored the validity and usefulness of resolving even the most difficult sovereign debt problems in a manner consistent with the cooperative, market-based guidelines established by the *Principles for Stable Capital Flows and Fair Debt Restructuring*.

Nonetheless, the experience with the protracted negotiations and the scope of the Greek debt exchange have given rise to a number of issues that could usefully be discussed in the period ahead. Such a reflection would help sovereign debtors and their private creditors formulate appropriate additional guidelines for more effective ways to both prevent and, if necessary, resolve future sovereign debt crises. The issues raised include:

- **Weaknesses in sovereign debt crisis prevention:** The combined effects of policies and the regulatory environment that encouraged "convergence" carry trade, risk management weaknesses and other factors have contributed to the disconnect between the increasing sovereign debt burdens in several mature market countries and the market pricing of sovereign risk observed in the period prior to the Euro Area sovereign debt crisis. The underlying weaknesses in crisis prevention and risk management are multifaceted and need to be fully addressed.

- **Subordination of private investor claims:** The carving out from the debt exchange of the Greek bond holdings by the ECB, the Euro Area central banks, and the European Investment Bank has resulted in a de facto subordination of private investor claims relative to claims by official sector bodies. Notwithstanding the rationale for such action, questions arise about the implications this or similar actions in the future might have on the perceived credit risk of sovereign debt, the relative ranking of private investor claims, and the incentives of private investors to increase their exposure to sovereign debt. It has also raised questions about the efficacy of market supporting interventions by the ECB or the European Financial Stability Facility (EFSF)/ESM.

- **Use of Collective Action Clauses (CACs):** The Greek debt crisis has demonstrated the useful role that appropriate CACs could play in facilitating sovereign debt crisis resolution. This is in fact recognized by Euro Area countries, as the ESM envisages the introduction of CACs in all future issues of Euro Area sovereign debt. We urge other major countries to consider adopting a similar policy in their sovereign debt issuance, as this would enhance the functioning of sovereign debt markets. However, the retroactive introduction of CACs just prior to the debt exchange in the Greek government bonds issued under Greek law, notwithstanding the private creditor eventual consent to activate these CACs and thus facilitate the success of the debt exchange, has raised a number of concerns and questions. Such retroactive actions could encourage investors to prefer international law bonds instead of domestic law bonds issued by weak countries to minimize sovereign risk.

- **Opaque setting of macroeconomic framework for the debt exchange negotiations:** The rather opaque and non-consultative way the Greek medium-term growth projections and reform objectives were prepared and frequently changed by the official sector, including in the debt sustainability analysis, did not facilitate an open and productive dialogue with private creditors. This raises questions about the proper role of official entities, including the IMF, in the sovereign debt restructuring process, and the best ways to encourage a more open and timely dialogue and greater data and policy transparency with private creditors.

In this context, we are pleased to announce the formation of a joint public-private sector committee, endorsed by the Co-Chairs of the Group of Trustees of the *Principles*, to explore these lessons and we look forward to constructive discussions with the public sector on how to enhance existing practices in sovereign debt crisis prevention and resolution.

In conclusion, we strongly encourage the IMFC to strengthen global policy coordination to facilitate and support the global growth rebalancing that seems to be underway. We also encourage the IMFC to lend its support to the stepped-up policy efforts that are needed in the Euro Area. We reiterate our view that a more balanced and differentiated fiscal policy response and significant augmentation of the Euro Area financial firewall are essential to better deal with the region's sovereign debt crises and reverse its drag on global growth.

Sincerely,