The Managing Director's Statement on the Global Economy and Financial Markets to the IMFC

The recovery remains fragile and uneven. In many advanced economies, activity is still sluggish and unemployment high, while legacy problems in the financial system remain unresolved. Activity is more robust in many emerging and developing economies. However, their prospects also depend on a healthy, broad-based recovery among the advanced economies, owing to deep real and financial linkages. The key policy challenge is to effect a smooth transition from public- to private-sector-led growth in many advanced economies, and from external to domestically driven growth in key emerging economies. While short-term macroeconomic policies are broadly appropriate, completing the two rebalancing acts will require tackling the medium-term fiscal, financial, and structural challenges raised by the crisis. Without such reforms, growth could sputter, with grave economic and social consequences.

The Recovery Is Moving Ahead, but Downside Risks Persist

The economic recovery is proceeding broadly as forecast, notwithstanding the setback to financial stability. Global activity expanded at an annual rate of about 5¼ percent during the first half of 2010, roughly in line with expectations. At the same time, high unemployment remains a major economic and social challenge. More than 210 million people across the globe may be unemployed, an increase of more than 30 million since 2007. Three-fourths of the increase has occurred in advanced economies.

There are important differences in the speed and strength of recovery across economies. Recoveries in most advanced and a few emerging economies are moving at a sluggish pace and unemployment is high, holding back consumption. Improvements in business investment in the hard-hit economies have not translated into substantially lower unemployment. Financial sector weaknesses remain largely unresolved, undermining credit provision. By contrast, many emerging and developing economies, which did not have major financial excesses prior to the Great Recession, are again seeing strong output and employment growth.

A sustained and healthy recovery rests on two rebalancing acts: internal rebalancing, with a strengthening of financial systems and private demand in advanced economies to facilitate a shift away from fiscal support; and external rebalancing, with an increase in net exports from current account deficit countries, such as the United States, and a decrease in net exports from surplus countries, notably emerging Asia. Policies to facilitate the internal rebalancing are central to continued recovery, while those to support external rebalancing are crucial for sustained global growth, free of the tensions that eventually undermined the previous upswing.

The global recovery remains subdued and fragile because these two rebalancing acts are proceeding slowly. According to the latest *World Economic Outlook* (WEO), global activity is forecast to expand by 4.8 in 2010 and 4.2 percent in 2011, broadly in line with earlier IMF staff

projections. In advanced economies, growth is projected at 2.7 percent in 2010 and 2.2 percent in 2011, with some economies slowing noticeably during the second half of 2010 and the first half of 2011. As a result, economic slack will remain substantial and unemployment persistently high for some time. Prospects are better for emerging and developing economies, which are projected to expand at rates of 7.1 percent and 6.4 percent for 2010 and 2011. Inflation is projected to stay generally low, amid continued excess capacity and high unemployment, with a few exceptions among the emerging economies.

Risks to the economic growth forecasts are to the downside, although the probability of a sharp global slowdown, including stagnation or contraction in advanced economies, appears low. A key risk is that low growth undermines financial healing and amplifies fiscal deficits and sovereign debt levels. Alternatively, rising risk aversion could exacerbate sovereign debt problems, undercutting the recovery. And to the extent that adjustment of real exchange rates in response to current account imbalances is insufficient it could hold back global growth even further and raise the specter of protectionism.

The Need for Coordinated Policies

Policy can and must be used to spur a stronger recovery. Specifically, policies need to become more proactive and coordinated to achieve the internal and external rebalancing required for robust real GDP and employment growth. History suggests that, without strong action, financial crises leave deep, permanent economic scars. Households and companies have already scaled back expectations for growth over the next one or two years. Policymakers must avoid paralysis and put in place policies to strengthen medium-term prospects. Otherwise, an indefinite period of lost growth could have severe social and political consequences not only in the advanced economies but also in emerging and developing economies that have relied on exports to achieve high growth.

Boosting an anemic recovery requires fundamental policy adjustments on many fronts. For the time being, accommodative macroeconomic policies are essential to support demand, keep financial markets functioning smoothly, and prevent more profound economic and social dislocation. However, it would be a mistake to rely solely on macroeconomic policy stimulus. Easy money and fiscal support are no substitutes for repairing and reforming financial sectors, and realigning their incentives to build stronger balance sheets and reduce excessive risk taking. This is essential for a durable recovery in private demand. Another priority is to repair lingering structural failings—such as entitlement systems that are built on shaky financial foundations, tax systems that favor debt and are riddled with loopholes, labor markets that concentrate job losses on vulnerable segments of the labor force, product or services markets that are closed to entry, barriers to research and development, and public services that are inadequate to meet education, health care, and business needs. These shortcomings may have not been among the root causes of the crisis when compared to financial sector problems, but addressing them in a coordinated manner can significantly improve medium-term growth and employment prospects.

Financial Sector Reform

The financial sector remains the Achilles' heel of the recovery. The global crisis was rooted primarily in the financial sector and the failure of policymakers to grasp the depth and breadth of ways in which financial shocks could be amplified across financial institutions and economies. Ensuring that a still-damaged financial sector does not act as a drag on activity requires: restructuring or resolving weak banks; enhancing banks' capital adequacy and liquidity buffers; pursuing orderly and globally consistent regulatory reform; and strengthening supervision and oversight of the financial system. Progress has been primarily in the strengthening of banks capital and liquidity buffers, but not on the more challenging issues of systemic stability. Hence, measures to address risks posed by too-important-to-fail institutions, the design of effective cross-border resolution frameworks, and other methods to mitigate systemic risks are imperative to avoid speculative excesses observed in the recent crisis and to rebuild a more robust global financial system that is able to support sustained, strong, and balanced growth.

The *Global Financial Stability Report* suggests that the financial system remains quite vulnerable. Many banks face a "wall" of maturing debt at a time of large public sector financing needs. This could place some banks under significant refinancing strain and risk an intensification of the fiscal/financial spillovers. The linkage between fiscal and financial stability is a particular concern in the euro area, but is important in other advanced economies as well. Over the short term, central banks and governments in many advanced economies will need to continue to support their weakened financial systems. Some of the mechanisms providing crucial support to banks in recent years—including liquidity facilities, government-guaranteed debt issuance programs, and dollar swap facilities—have been appropriately extended. It may also be necessary to revive and possibly enlarge the use of unconventional monetary policies should downside risks begin to materialize.

While keeping the support to financial systems in place, as needed, the next steps are to continue to enhance the banking system's resilience to shocks and turn it again into an engine for global growth. There is a need to further strengthen the quality and quantity of bank capital, alter business models, and ensure more secure and stable funding sources in many advanced economies. To achieve the latter goal, supervisors should encourage banks to increase the maturity of their liabilities whenever market opportunities arise and to shore up their funding sources. Also, the risks to financial stability from rising sovereign debt burdens and contingent liabilities must be reduced, particularly given the extensive linkages with the financial system. This also raises an urgent need to put in place credible plans for medium-term fiscal adjustment.

More generally, regulatory reforms have focused primarily on improving the prospects of individual institutions and sectors, and need to take a broader and more global view. Regulators need to insist not just on micro-prudential regulation, but also on developing appropriate regulations with a more macro-prudential approach to limit systemic effects of too-important-to-fail institutions, which are now recognized to include non-banks.

In this context, we welcome the recent proposals of the Basel Committee on Banking Supervision (BCBS), which represent a substantial improvement in the quality and quantity of capital in comparison with the pre-crisis situation. In particular, common equity will represent a higher proportion of capital and thus allow for greater loss absorption. Also, the amount of intangibles and qualified assets will be limited to 15 percent.[1] Phase in arrangements have been developed to allow banks to move to these higher standards mainly through retention of earnings.

As the global financial system stabilizes and the world economic recovery is firmly entrenched, phasing out intangibles completely and scaling back the transition period should be considered. This will raise further banking sector resilience to absorb any future shocks that may lie ahead. In our view, it would have been desirable to provide for the eventual exclusion of all intangible assets from capital, and, under the baseline scenario of the WEO, shorter phase-in periods would not have placed undue pressure on the banking system and the economy. The longer financial institutions remain with lower buffers, the higher the burden will be on supervisors.

Countries must be able to look beyond their domestic situations, and aim for a global financial system that serves all countries and people. Regulatory reforms must deliver a credible, coherent and demanding change that both signals a clear intent and announces firm action to strengthen the global financial system.

Fiscal Consolidation and Structural Reform

Fiscal policies must increasingly address medium-term requirements. One of the most urgent challenges facing advanced economies is the need to put in place medium-term plans to help achieve sustainable fiscal positions. This task has been made more pressing by the need to rebuild room for fiscal policy maneuver in the wake of the turmoil in sovereign debt markets during the past six months. Such plans must address rapidly growing spending programs, notably entitlements; tax reforms to favor investment rather than consumption; and subsidies and tax exemptions that favor some consumers or producers over others.

Importantly, as part of these plans, fiscal consolidation should start in 2011. To the extent that the medium-term fiscal consolidation plans are credible and growth-friendly, this would help mitigate any short-term dampening impact on private demand. Also, the type and speed of adjustment should reflect different circumstances in different countries, especially in terms of the pace of recovery and risks to fiscal credibility. On the whole, country consolidation plans for 2011 strike an appropriate balance between progress toward stabilizing public debt and continuing to support the recovery. However, if growth threatens to slow

[1] These include deferred tax assets, mortgage servicing rights, significant investments in common shares of financial institutions, and other intangible assets.

appreciably more than expected in the WEO, countries with fiscal room could postpone some of the planned consolidation.

At the same time, labor market reforms in a number of economies could not only enhance growth but also spur job creation and reduce current high unemployment levels. Specific reforms include: measures to eliminate two-tier labor markets by lowering protection afforded to workers on permanent contracts, while raising protection available to those with temporary contracts; measures to facilitate job searching, skills matching, and labor mobility; better access to training and education to support ongoing sectoral changes; and well-designed employment subsidies for vulnerable groups (the long-term unemployed or the young) to help accelerate their reintegration into the labor market. Complementary reforms to product and services markets could strengthen these employment effects by boosting both labor demand and real wages through greater competition and lower markups.

The actions described above can promote the internal rebalancing needed in many advanced economies. What are the priorities in the emerging economies? In a number of these economies, private demand is already fairly well established. This testifies to the growing resiliency of these economies, which is a fruit of strong policies implemented over the past decade. In these economies, macroeconomic policy normalization can gradually proceed. In economies with excessive external surpluses and low public debt, fiscal tightening should take a backseat to monetary tightening and exchange rate flexibility. In other economies, fiscal tightening can start immediately, either because domestic demand is already recovering well or because public debt is relatively high. In some, rising inflation or high credit growth also signal a need for further monetary tightening.

Future growth in many emerging economies will depend vitally on a greater contribution from domestic demand. This is desirable not only to offset a loss of exports to advanced economies but also to address high domestic consumption and investment needs. Capital inflows and exchange rate appreciation can be very helpful in achieving the required re-allocation of demand and resources. Macro-prudential or other measures can help contain speculative excesses and thereby bolster financial stability.

Many emerging and developing economies have successfully implemented first-round reforms to improve the macroeconomic policy framework and thereby strengthen their resilience to macroeconomic shocks. However, more could be done to boost potential growth and job creation in these economies. Reforms could include simplifying regulation, raising human capital, and building critical infrastructure. In emerging economies with large external surpluses, it would be helpful to remove distortions that drive high household or corporate saving and deter domestically-oriented investment. This could be achieved through further reform of the financial sector, stronger corporate governance, and better social safety nets. Such structural reforms would also contribute to putting capital inflows to productive use.

International Policy Coordination

Policy coordination will enable economies to achieve the twin goals of internal and external rebalancing with minimum disruption. Such coordination was the basis for the progress attained in alleviating liquidity strains and rebuilding confidence in spring 2009, and averting more serious instability during the turmoil in European sovereign debt markets this past spring. Beyond such emergency measures, the challenge ahead is for policymakers to implement more fundamental adjustments in a coordinated manner. In the midst of the crisis, policy was responding to very similar requirements across countries—to stabilize demand with accommodative macroeconomic policies and support a weakened financial sector. Now, however, different countries need to pursue quite different macroeconomic, structural, and financial policies.

Internal and external rebalancing vigorously pursued in advancing and emerging and developing economies through the types of macroeconomic and structural policies sketched out here—including significant adjustments in real exchange rates—could significantly benefit the entire global economy. Not least, as outlined in recent G20 reports, global GDP could be elevated by 2½ percent over five years, which could potentially create 30 million jobs. Global policy coordination thus has a crucial role to play in creating more growth and more jobs.