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Statement by the Managing Director to the International Monetary and Financial Committee on the Global Economy and Financial Markets

The recovery is solidifying. However, old policy challenges still need to be fully addressed and new challenges are arising, especially on account of rising commodities prices. In many advanced economies the handoff from public to private demand is proceeding. But unemployment remains high and weak public balance sheets and still vulnerable financial sectors mean that the recovery is subject to downside risks. In many emerging market economies, overheating and financial imbalances present growing policy concerns. Monetary policy should stay accommodative in advanced economies, but needs further tightening in a number of emerging and developing economies to rein in inflationary pressure and rapid credit growth. Additionally, in emerging surplus economies, real exchange rate appreciation is needed to help contain inflation and support global demand rebalancing. In most economies, the time has come to begin fiscal adjustment by implementing measures to steadily reduce debt ratios toward more prudent levels. Moreover, financial sector repair and reform need to accelerate. Absent major progress on all these fronts, the recovery will remain vulnerable and job creation will continue to fall short of requirements in many parts of the world.

The Recovery is Gaining Traction, but Downside Risks Persist

As the global inventory cycle came to a close, world growth moderated to about 3¾ percent in the second half of 2010. But signs are increasing that the recovery has become more self-sustaining, and the global economy seems set to accelerate again. In advanced countries, the hand-off from public to private demand is advancing, reducing concerns that diminishing fiscal policy support might cause a "double dip" recession. Financial conditions have continued to improve, although they remain unusually fragile. In emerging and developing economies growth is robust, buoyed by well-entrenched private demand.

World real GDP growth is forecast at about 4½ percent in 2011 and 2012, down modestly from 5 percent in 2010. Real GDP in advanced economies is projected to expand by around 2½ percent as investment recovers, supported by low interest rates, easing financing conditions, and generally healthy corporate balance sheets and profitability. Consumption will also be helped by reduced job layoffs and the gradual recovery of employment. Real GDP in emerging and developing economies is projected to expand by 6½ percent. Activity in these economies is being boosted by accommodative macroeconomic policies and easy financial conditions, including capital inflows.

Downside risks continue to outweigh upside risks. In advanced economies, weak sovereign balance sheets (especially in certain euro area economies) and still-vulnerable real estate markets continue to present major concerns. Financial risks are also to the downside as a result of the high funding requirements of banks and sovereigns. New risks are building on account of commodity prices, notably oil supply disruptions, as well as overheating and booming asset markets in some emerging market economies. On the upside, surprises to near-term growth may emanate from strong corporate balance sheets in advanced economies and more buoyant-than-expected demand in emerging and developing economies.

Advanced Economies Need to Repair Public and Financial Balance Sheets

Many old policy challenges remain unaddressed even as new ones come to the fore. Addressing these challenges forcefully holds the key to durably improving growth prospects with a view to lowering unemployment, especially among the young, who have been hit particularly hard by the crisis-related layoffs.

In most advanced economies, the still-modest pace of economic recovery calls for continued monetary accommodation and structural reforms to boost productivity and job creation. However, fiscal positions need to urgently be placed on sustainable medium-term paths, lest they pose growing risks for global bond and currency markets and curtail room for policy maneuver. This will require implementing adjustment plans, and specifying further fiscal consolidation and entitlement reforms, supported by stronger fiscal rules and institutions. This is particularly important in the United States, where the recent agreement to trim discretionary spending needs to be complemented with timely fundamental entitlement and tax reforms, with plans adopted this year. In Japan, the immediate fiscal priority is to respond to the humanitarian and reconstruction needs following the recent earthquake. Once reconstruction efforts are underway and the size of the damage is better understood, attention should turn to linking reconstruction spending to a clear fiscal strategy for bringing down the public debt ratio over the medium-term.

Much work remains to be done to restore confidence in the banking systems of many advanced economies. This holds the key to more lending for small and medium-sized enterprises, which account for a large share of employment. In the euro area, some banking sector fragilities continue to interact adversely with the sovereign risks. In order to restore market confidence and reduce excessive reliance on central bank funding, rigorous, comprehensive, and transparent stress tests are needed, together with measures to strengthen, restructure, or close banks. This should be supported with credible assurances that multilateral backstops are sufficiently flexible and endowed to facilitate an orderly deleveraging without triggering further fiscal or bank funding strains. In the United States, there is a need to address legacy mortgage problems to relieve pressure on banks from a backlog of foreclosures, and to repair and reform housing finance. Larger bank capital buffers and strengthened balance sheets will also be necessary as countries transition to a new and more demanding supervisory and regulatory regime. This regime will need to address the major challenges posed by shadow banking systems and “too-important-to-fail” institutions, including cross-border finance. Without these longer-term financial sector reforms, short-term funding difficulties may escalate into another systemic liquidity event. Strong macroeconomic policies and financial sector repair are key to restarting robust employment growth in advanced economies. However, some specific measures targeted at the labor market may also be desirable to alleviate the pains related to high unemployment and induce a more job-intensive recovery.

Emerging and Developing Economies Need to Guard Against Overheating and Credit Booms

The challenge for many emerging and some developing economies is to ensure that present buoyant conditions do not develop into overheating or financial vulnerabilities over the coming years. Inflation pressure is likely to build further as growing production comes up against capacity constraints, with large food and energy price increases, which weigh heavily in consumption baskets, stoking demands for higher wages. Real interest rates are still low and fiscal policies appreciably more accommodative than before the crisis in many economies. Many developing economies that demonstrated remarkable resilience during the crisis, thanks to improved policy frameworks, now need to rebuild the policy room to prepare for new risks. Appropriate action differs across economies, depending on their cyclical and external conditions. However, a tightening of macroeconomic policies is needed in many emerging and developing economies.

- For external surplus countries, many of which manage their currencies and do not face fiscal problems, removal of monetary accommodation and appreciation of the exchange rate are necessary to maintain internal balance—reining in inflation pressure and excessive credit growth. This will also assist in global demand rebalancing.

- Many external deficit countries need to tighten fiscal and monetary policies, possibly tolerating some overshooting of the exchange rate, in line with their cyclical position.

- Emerging and developing economies will need to ensure that the gains from trade and financial integration are widely shared. Given the high level and volatility of food prices, they should also stand ready to deploy targeted support for the poor as food prices remain high or food inventories low.

Capital flows to emerging market economies resumed remarkably quickly after the crisis but have slowed down again lately. As policy rates in advanced economies rise from their unusually low levels, volatile flows may again exit the emerging market economies. Depending on country-specific circumstances, and assuming appropriate macroeconomic and prudential policies are in place, measures designed to curb capital inflows can play a role in dampening the impact of their excessive volatility on the real economy. However, such measures are not a substitute for needed macroeconomic adjustments.

Greater progress in advancing global demand rebalancing is essential to put the recovery on a stronger footing over the medium run. This will require action by many, notably fiscal adjustment in key external deficit countries and structural reforms that eliminate distortions that boost savings in key surplus economies.

Strong and Balanced Growth Will Require a Global Effort

There is broad agreement on the contours of the policy responses sketched here. However, with the peak of the crisis now past, the imperative for action and willingness to cooperate among policymakers is diminishing. It would be a mistake for advanced economies to postpone fiscal adjustment in the face of a difficult political economy at home. Additionally, while the removal of distortions that boost saving in key external surplus economies would help achieve fiscal consolidation in key advanced economies, insufficient progress on one front should not serve as an excuse for inaction on the other front. It would be a mistake for emerging surplus economies to delay exchange rate adjustment in the face of rising inflationary pressure. Furthermore, many emerging market economies cannot afford to delay additional policy tightening until the advanced economies undertake such tightening themselves. The task facing policymakers is to convince their national constituencies that these policy responses are in their best economic interests. Importantly, acting together would facilitate more ambitious policy adjustment, helping deliver stronger and more balanced and inclusive growth.