

IMF EXECUTIVE BOARD DISCUSSION OF THE OUTLOOK, MARCH 2014

The following remarks were made by the Acting Chair at the conclusion of the Executive Board's discussion of the World Economic Outlook, Global Financial Stability Report, and Fiscal Monitor on March 21, 2014.

Executive Directors welcomed the strengthening of global activity in the second half 2013. They observed that much of the impetus has come from advanced economies, but inflation in these economies continues to undershoot projections, reflecting still-large output gaps. While remaining fairly robust, growth activity in emerging market and developing economies slowed in 2013, in an environment of increased capital flow volatility and worsening external financing conditions. Directors underscored that, despite improved growth prospects, the global recovery is still fragile and significant downside risks, including geopolitical, remain.

Directors agreed that global growth will continue to improve this year and next, on the back of slower fiscal tightening and still highly accommodative monetary conditions in advanced economies. In emerging market and developing economies, growth will pick up gradually, with stronger external demand being partly offset by the dampening impact of tighter financial conditions.

Directors acknowledged that successfully transitioning from liquidity-driven to growth-driven markets will require overcoming key challenges, including strengthening policy coordination. In advanced economies, a sustained rise in corporate investment and continued efforts to strengthen bank balance sheets will be necessary, especially in the euro area. Risks to emerging market economies have increased with rising public and corporate sector leverage and greater foreign borrowing. Directors noted that the recent increase in financial volatility likely reflected renewed market concern about fundamentals, against the backdrop of early steps toward monetary policy normalization in some advanced economies. In view of possible capital flow reversals from emerging markets, Directors considered the risks related to sizable external funding needs and disorderly currency depreciations and welcomed the recent tightening of macroeconomic policies, which

appears to have shored up confidence. Regarding the financial sector, Directors noted that, despite the progress made in reducing global financial vulnerabilities, the too-important-to-fail issue still remains largely unresolved.

Most Directors recommended closer monitoring of the risks to activity associated with low inflation in advanced economies, especially in the euro area. Longer-term inflation expectations could drift down, leading to higher real interest rates, an increase in private and public debt burdens, and a further slowdown in demand and output. Directors noted, however, that continued low nominal interest rates in advanced economies could also pose financial stability risks and have already led to pockets of increased leverage, sometimes accompanied by a weakening of underwriting standards.

Against this backdrop, Directors called for more policy efforts to fully restore confidence, lower downside risks, and ensure robust and sustainable global growth. In an environment of continued fiscal consolidation, still-large output gaps, and very low inflation, monetary policy should remain accommodative. Many Directors argued that in the euro area, further monetary easing, including unconventional measures, would help to sustain activity and limit the risk of very low inflation or deflation. A number of Directors thought that current monetary conditions in the euro area are already accommodative and further easing would not be justified. Some Directors also called for a more comprehensive analysis of exchange rates and global imbalances in the *World Economic Outlook*.

Directors recommended designing and implementing clear and credible medium-term fiscal consolidation plans to help mitigate fiscal risks and address the debt overhang in advanced economies, including the United States and Japan. They welcomed the expected shift from tax to expenditure consolidation measures, particularly in those advanced economies where rais-

ing tax burdens could hamper growth. Moreover, they agreed that a new impulse to structural reforms is needed to lift investment and growth prospects in advanced economies.

Directors welcomed the progress made in strengthening the banking sector in the euro area, but noted that more needs to be done to address financial fragmentation, repair bank and corporate sector balance sheets following a credible comprehensive assessment, and recapitalize weak banks in order to enhance confidence and revive credit. While acknowledging the EU Council's recent agreement on a Single Resolution Mechanism (SRM), Directors underscored the importance of completing the banking union, including through functional independence of the SRM with the capacity to undertake timely bank resolution and common backstops to sever the link between sovereigns and banks.

Directors noted that the appropriate policy measures will differ across emerging market economies, but observed that there are some common priorities. Exchange rates should be allowed to respond to changing fundamentals and facilitate external adjustment. Where international reserves are adequate, foreign exchange interventions can be used to smooth volatility and avoid financial disruption. In economies where inflationary pressures are still high, further monetary policy tightening may be necessary. If warranted, macroprudential measures can help contain the growth of corporate leverage, particularly in foreign currency. Strengthening the transparency and consistency of policy frameworks would contribute to building policy credibility.

Directors underscored the need for emerging market and low-income economies to rebuild fiscal buffers and rein in fiscal deficits (including by containing public sector contingent liabilities), particularly in the context of elevated public debt and financing vulnerabilities. Fiscal consolidation plans should be country specific and properly calibrated between tax and expenditure measures to support equitable, sustained growth. Priority social spending should be safeguarded, and the efficiency of public spending improved, through better targeting of social expenditures, rationalizing the public sector wage bill, and enhancing public investment project appraisal, selection, and audit processes.

Directors agreed that emerging market economies could enhance their resilience to global financial shocks through a deepening of their domestic financial markets and the development of a local investor base. They supported tightening prudential and regulatory oversight, including over nonbank institutions in China, removing implicit guarantees, and enhancing the role of market forces in the nonbank sector in order to mitigate financial stability risks and any negative cross-border spillovers.

Directors concurred that many emerging market and developing economies should implement other key structural reforms, designed to boost employment and prospects for diversified and sustained growth, while also promoting global rebalancing. Reforms should, among other things, encompass the removal of barriers to entry in product and services markets, improve the business climate and address key supply-side bottlenecks, and in China, support sustainable and balanced growth, including the shift from investment toward consumption.