

IMF EXECUTIVE BOARD DISCUSSION OF THE OUTLOOK, SEPTEMBER 2014

The following remarks were made by the Chair at the conclusion of the Executive Board's discussion of the World Economic Outlook, Global Financial Stability Report, and Fiscal Monitor on September 25, 2014.

Executive Directors noted that an uneven global recovery continues, notwithstanding setbacks in the first half of the year. However, the pace of recovery remains weak as the legacies of the crisis continue to cast a shadow. Investment has not picked up solidly in many advanced economies, and emerging market economies are adjusting to lower rates of economic growth than those reached during the immediate postcrisis recovery. Moreover, activity in some regions is being negatively affected by ongoing geopolitical tensions. Directors also observed that some problems that predate the global financial crisis—including the effects of an aging population on labor force growth, weak productivity growth, and infrastructure gaps—are coming back to the fore and affecting the pace of recovery through lower potential growth in a number of economies.

Directors noted that global growth should increase as growth in major advanced economies picks up on accommodative monetary policies, supportive financial market conditions, and the more gradual pace of fiscal consolidation (except in a few countries, including Japan). Growth in emerging market and developing economies should also increase with a gradual improvement in structural factors affecting activity in some economies and further strengthening in external demand as advanced economies' growth recovers.

Notwithstanding this expected pickup in growth, Directors underscored that the recovery remains fragile and subject to significant downside risks. If geopolitical tensions persist it could have negative effects on confidence and contribute to increases in oil prices and declines in asset prices. In some advanced economies, risks also arise from the effects of protracted low inflation or deflation on activity or on public debt dynamics.

Directors underscored concerns about increased financial risk taking arising from the prolonged period of low interest rates, resulting in asset price appreciation, spread compression, and record-low volatility across a broad range of asset classes. They also noted that asset holdings are now concentrated in a small number of large managers. These increased market and liquidity risks could spill over to global markets, potentially triggered by heightened geopolitical risks or volatility associated with monetary policy normalization. Directors noted that the largest banks have strengthened their balance sheets in response to tighter regulation, but low profitability at some banks has created the need for an overhaul of business models, potentially creating headwinds for the economic recovery. Moreover, credit intermediation has been migrating to the shadow banking sector, creating new challenges for supervision and regulation. Against this backdrop, Directors observed that a tighter financing environment could adversely affect the sovereign debt dynamics of many emerging market and developing economies, particularly if coupled with lower growth.

Directors also remained concerned about medium-term risks to the global recovery. Growth in advanced economies could continue to disappoint over a longer period because of lower potential growth or because of a sustained weakness in demand. Directors noted that absent structural reforms, potential growth may be lower than currently projected.

Directors called for greater efforts in most economies to restore growth. They considered that premature normalization in monetary policy should be avoided, given the absence of robust demand growth in advanced economies. Some Directors also

saw a need for additional actions by the European Central Bank, while a few Directors cautioned that more time is needed to gauge the effectiveness of policies already introduced. A few other Directors saw little or no scope for further unconventional monetary accommodation in the euro area, as it may not be effective in promoting demand and sustainable growth, and cautioned against maintaining such accommodation longer than necessary, in view of the financial stability risks.

Directors highlighted the need to restructure weak banks and resolve nonviable institutions and to enhance the transmission of monetary policy through balance sheet repair. Moreover, adequate data to monitor the buildup of risks and a mandate for authorities to limit these risks, particularly in the shadow banking sector, are required. Directors broadly supported the use of macroprudential policies to improve the trade-off between financial and economic risk taking as well as regulate and supervise the shadow banking sector, although a number of Directors noted the limited experience regarding the effectiveness of such measures. To ensure adequate incentives for risk taking in the banking sector, some Directors underscored the importance of governance and executive compensation reforms.

Directors stressed that fiscal adjustment in advanced economies needs to be attuned, in pace and composition, to support the immediate recovery as well as lay the ground for medium-term plans (especially in the United States and Japan). More generally, debt and deficit reduction should be designed to minimize their adverse effects on jobs and growth. Directors broadly agreed that for countries with clearly identified infrastructure needs and in which efficient public investment processes exist, an increase in public infrastructure investment could provide a boost to demand as well as raise potential output in the medium term. Directors also broadly noted that in some cases a more supportive fiscal stance could help to bring forward the growth benefits of structural reforms, provided that there is enough fiscal room and that the costs and benefits of the reforms, as well as their implementation prospects, are sufficiently certain. In some countries, fiscal conditions put a premium on structural reforms that can be implemented without budgetary costs.

Directors noted that emerging markets' efforts to rebalance growth toward domestic sources have supported global growth, although this rebalancing, combined with lower-than-expected growth, has also reduced policy space and raised vulnerabilities for some countries. In this context, the scope for macroeconomic policies to support growth, should downside risks materialize, is limited for economies with weak fiscal or external current account positions or high or increasing inflation levels or those facing financial system risks from a sustained period of credit expansion. Directors underscored the importance of reducing these vulnerabilities, including by rebuilding fiscal buffers. They also stressed that continued strong growth in low-income countries calls for greater progress in strengthening policies—by boosting fiscal positions with stronger revenues and rationalizing public spending, achieving greater monetary policy independence, and strengthening public financial management. Directors emphasized the importance for emerging markets to continue managing external financial shocks with exchange rate flexibility, complemented with other measures to limit excessive exchange rate volatility.

Directors underscored the importance of structural reforms to raise potential growth in both advanced and emerging market and developing economies. Within the euro area, these include active labor market policies and better-targeted training programs. Higher public investment in some creditor economies, complemented by policies to encourage private investment, could boost demand in the short term while raising potential output over the medium term. More forceful structural reforms in Japan are also needed to increase labor supply and raise productivity in some sectors through deregulation. Other advanced economies could also raise potential growth with measures to augment human and physical capital and increase labor force participation. Among emerging market and developing economies, the priorities vary. These include removing infrastructure bottlenecks; reforms to education, labor, and product markets; and better government services delivery. While the current account surplus in China has decreased markedly, further progress to gradually shift its growth toward domestic consumption and reduce reliance on credit

and investment would help forestall medium-term risks of financial disruption or a sharp slowdown. Joint efforts by both surplus and deficit economies are needed to contribute to a further narrowing of

global external imbalances. Further diversification and structural transformation remains a key priority for low-income countries.

