# MANAGING DIRECTOR'S GLOBAL POLICY AGENDA
# APRIL 2013

***The global economy*** *has avoided the worst, but it is by no means out of the woods, and prospects may be diverging. A three-speed global recovery is emerging. Sentiment has improved, but growth and jobs are still lagging in many places, some old risks remain and could rekindle tail risks, and new risks are arising. Policymakers must, to varying degrees, continue to nurse the recovery, repair systems damaged by the crisis, strengthen defenses against a recurrence, and anticipate new challenges from stronger expansion. In a world of interconnections, lagging policy momentum in some corners will soon affect all.*

*Activity in* ***emerging market and developing countries****, plus some advanced economies, has strengthened, with relatively high growth attracting capital flows.*

- ***Emerging markets*** *face the new risk of avoiding potential financial excesses. They should rebuild macroeconomic policy space and further strengthen financial regulation and supervision. The* ***Fund*** *will advise on how to manage volatile capital flows and limit financial stability risks, including through macroprudential policies.*
- ***Low-income countries*** *should take advantage of their current strong growth to rebuild buffers and invest in the future, including by reforming subsidy regimes, while meeting infrastructure and social needs. The* ***Fund*** *will propose options for these priorities, complemented by capacity building to strengthen policy frameworks and financial deepening.*

*Major* ***advanced economies*** *need to balance supporting activity and grappling with old risks from structural weaknesses that weigh on growth. A slow but fairly steady private sector led recovery is in the making in the U.S., while recovery remains elusive in the euro area and Japan.*

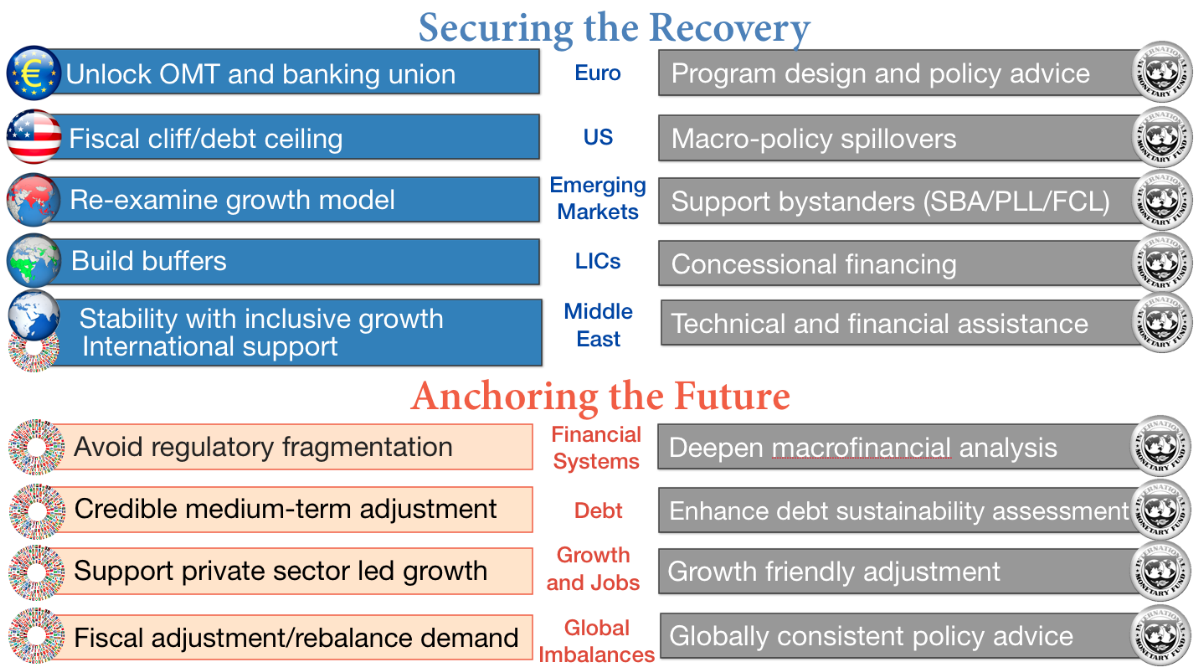
- *While sentiment has improved, the top priority for the* ***U.S.*** *is to raise the debt ceiling in a timely manner and agree on a credible medium-term fiscal roadmap to bring down debt.*
- *In the* ***euro area****, monetary policy should remain accommodative and fiscal consolidation be properly paced. The foundations of monetary union should be made more secure. National authorities should fix frayed banking systems and rebuild competitiveness as required.* ***Japan*** *needs to balance upfront stimulus with more ambitious plans to bring down debt and structural reforms to put growth on a permanently higher plane.*
- *In its advice and analysis, the* ***Fund*** *will seek the right balance between supporting growth (including through monetary easing) and removing the millstone of high private and public debt.*

*The* ***Fund*** *will continue to help develop and monitor well-designed programs.*

*It is critical to make the global economy more resilient. Policymakers should complete* ***financial reforms*** *to limit financial fragmentation and build a system that safely supports the real economy. Durable* ***fiscal adjustment and institutional reform*** *are needed to get to grips with high public and private debt.* ***Job creation and inclusive growth*** *are foundational priorities. Policies also need to support adjustment of* ***global imbalances*** *and take account of cross-border* ***spillovers****. The* ***Fund*** *will continue to help members on these issues via enhanced surveillance and capacity building.*

## I. The Global Context

1. ***Last GPA***. At the time of the last IMFC meeting, the global recovery had suffered renewed setbacks, with output contracting in the euro area and growth decelerating in many other countries, including major emerging markets. At my last IMFC presentation, together, we outlined the policy priorities for the membership and the Fund that were needed to secure the recovery and anchor the future (text chart below).




2. ***Economic developments***. The global economy is in a better place than last fall and increasingly moving at three speeds. Activity has already strengthened in many emerging market and developing countries, which continue to post relatively high growth rates. In the United States, although fiscal withdrawal will weigh on recovery, private demand appears to be gradually reviving. By contrast, the handover from public to private demand and thus economic recovery remains elusive in the euro area and risks of a relapse into crisis persist. Meanwhile, Japan continues to face deflation but will see a stimulus-driven rebound of activity.

3. ***Policy record***. The membership has acted on many of its commitments. Policy implementation has generally been encouraging in emerging market economies and low-income countries, and more mixed in advanced economies and in countries in transition in the Middle East and North Africa (MENA) region.

- Policy action by *euro area* policymakers has reduced tail risks. At the national level, program countries have delivered on difficult reforms, including fiscal adjustment, in a challenging environment. The ESM became operational but has yet to provide direct support to banking systems. Some key elements of a robust banking union were adopted, including agreement on the Single Supervisory Mechanism (SSM). While fiscal governance is being strengthened, a common vision for a full fiscal union remains wanting.

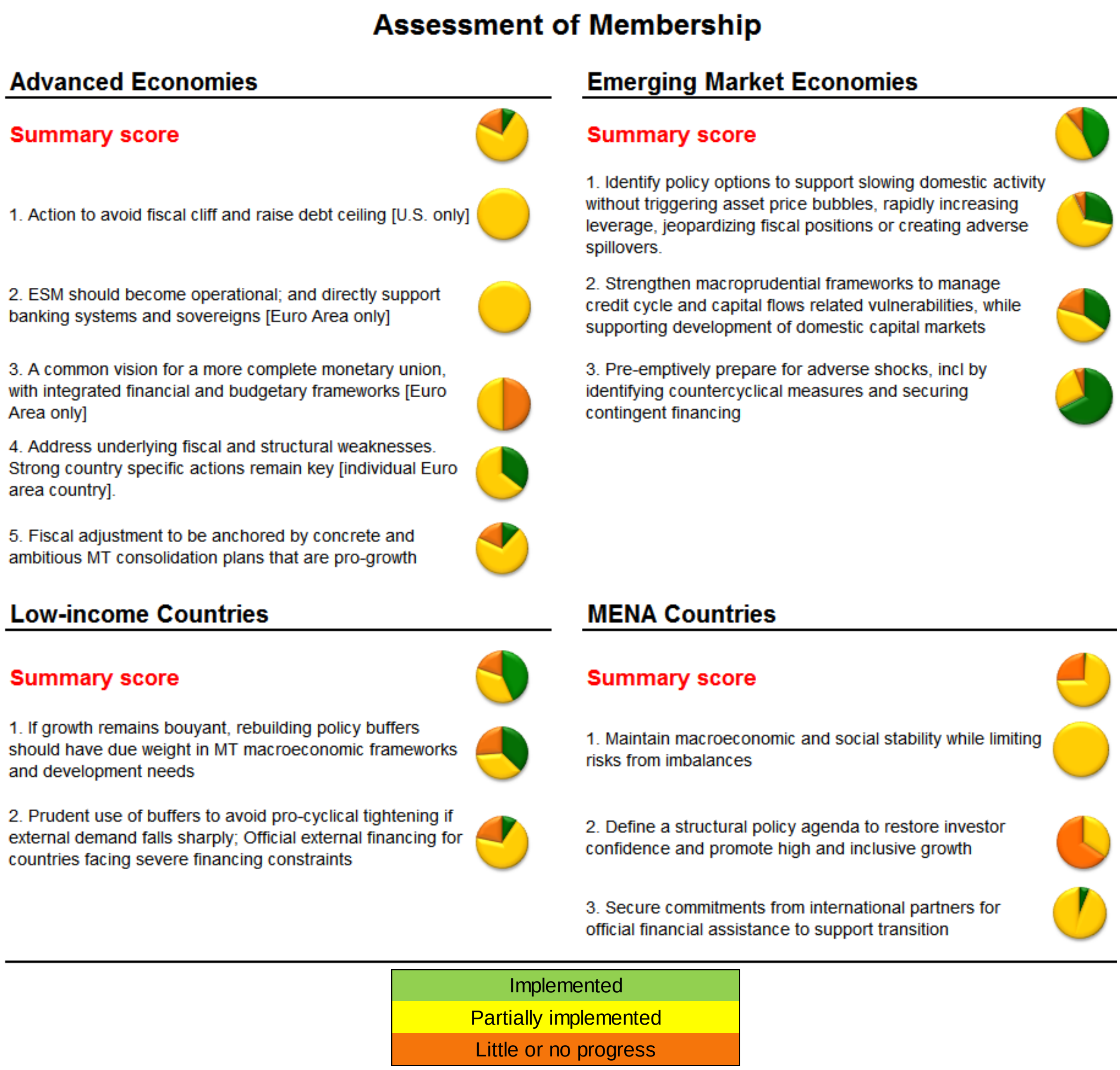
- In the *United States*, a last minute deal averted the tail risk of a fiscal cliff but not the sequester. A comprehensive medium-term plan remains lacking and the debt ceiling needs to be lifted.

- In *Japan*, the commitment to fight against deflation has been dramatically stepped up while the start of the fiscal adjustment was postponed, warranting a stronger medium-term fiscal plan to achieve sustainability.

- Many *emerging market economies* have taken measures to support slowing demand and have averted a hard landing. But in some cases these measures have given rise to new vulnerabilities and stability concerns that need to be addressed. Emerging markets have also continued their efforts to strengthen policy frameworks, including macroprudential, to deal with volatile capital flows and potential financial excesses. Several have renewed their precautionary arrangements with the Fund to prepare for shocks.

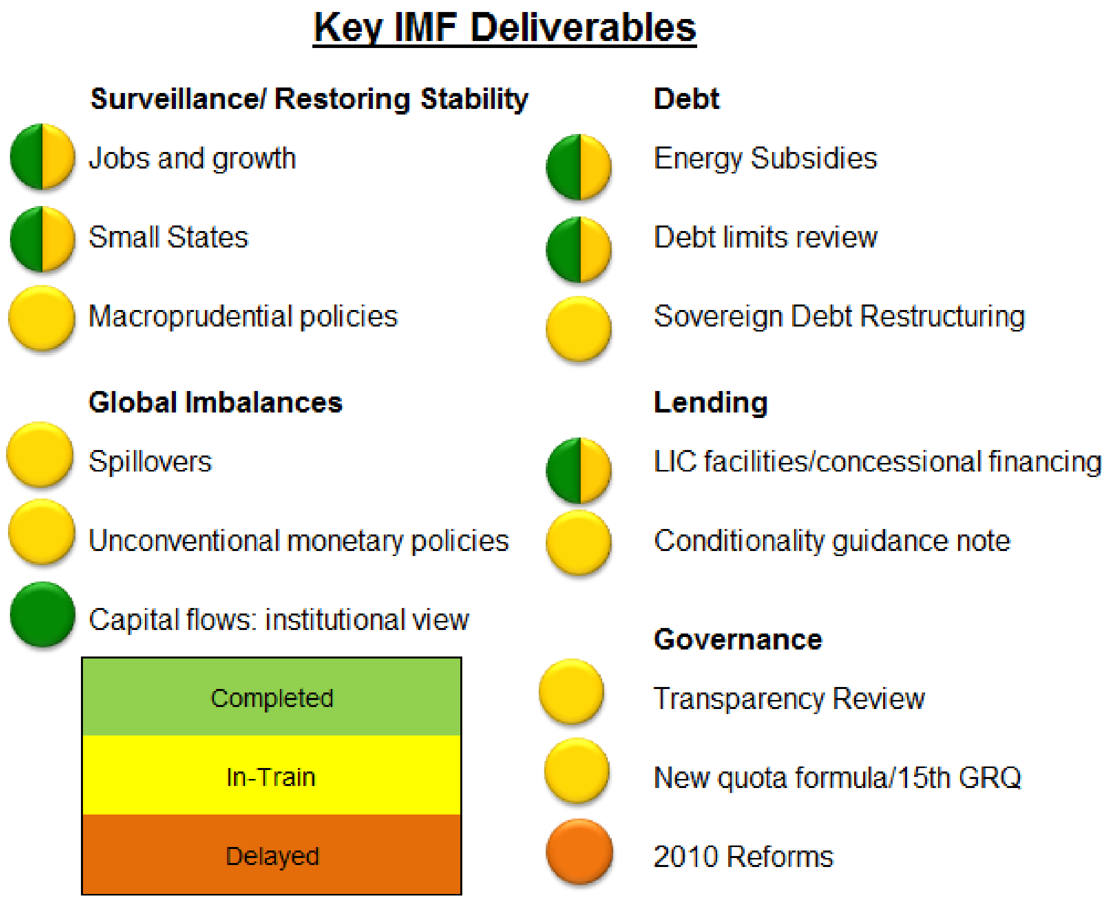
- Policy implementation in many *low-income countries* has been largely in line with commitments, as countries experiencing buoyant growth have made efforts to rebuild policy buffers. However, a few countries facing falling external demand could have made better use of their existing policy buffers.

- Protracted transitions and continued social instability have made it difficult for many *MENA countries* to maintain macroeconomic stability and to implement structural policies needed for restoring confidence and promoting inclusive growth. Despite important financial contributions from key regional partners, there is a need for stepped-up and better-coordinated donor support, including from partners in the Deauville Partnership.




Note: For each income group, members are assessed on progress against the relevant commitments since October 2012 and aggregated using 2012 PPP GDP weights. Assessment of progress on policy commitments is complicated by the differing time scales involved in implementing different types of policies.

- With support from the membership, the *Fund* has also made progress toward its deliverables by strengthening its surveillance framework, through coming on stream of the Integrated Surveillance Decision (ISD), clarifying the institutional view on capital flows, and implementing the Financial Surveillance Strategy. It has also advanced policy and analytical work on a number of topics to support member countries.




Note: Key Fund deliverables completed or in progress since November 2012.

4. ***Risks***. The global economy still faces headwinds, with lingering risks of a prolonged slump. Deep policy concerns and economic brakes are still at work, including from limited progress in post-crisis reforms, and new risks are appearing in the context of the emerging three-speed recovery. Addressing these underlying weaknesses is critical to improve global business sentiment needed to make the recovery stronger and more durable.

- U.S. public finances remain unsustainable and a comprehensive and backloaded plan involving higher revenues and entitlement reform is urgently needed. In the euro area, without steady progress on reforms critical for a robust banking union—such as the Single Resolution Mechanism and common deposit insurance, supported by a common backstop—the financial system will remain vulnerable, as seen for instance in Cyprus. Short-term fiscal stimulus is raising fiscal risks in Japan, unless it is soon combined with an ambitious fiscal consolidation plan and growth strategy. China faces the challenge of strengthening regulation and supervision of its rapidly expanding financial system to guard against financial excesses.

- Concerns are rising about the spillovers from loose and unconventional monetary policy. While monetary expansion is helping to bolster growth in major advanced economies, the boost from further action is diminishing as financial conditions have stabilized and may impart future stability risks. At the same time, many emerging market economies are concerned about the possible blow to output and financial system if large inflows of capital reverse rapidly. These concerns are partly related to questions about whether the breathing space provided by unconventional monetary expansion is being used by advanced economies to make progress on deeper fiscal, financial, and structural reforms.

- The risk of "adjustment fatigue" is increasing, especially in Europe, with growing tensions over the fairness of adjustment. Policymakers should undertake fiscal consolidation and other necessary reforms with an eye to limiting the impact on activity. They should also ensure a fair distribution of the burden of adjustment across the population.

## II. INVIGORATING A SUSTAINABLE RECOVERY

5. **More action is needed to disperse the clouds still weighing on the global economy and to encourage stronger and sustainable growth**. This will require policymakers to commit to bold medium-term objectives with realistic implementation paths. To be effective, policies should balance the need to support growth with the need to overcome weak fundamentals—fiscal, financial, business, or household. This can help anchor private sector expectations and generate the needed recovery in confidence, jobs, and investment. These tradeoffs and the policy mix will need to be carefully calibrated to country circumstances and shifting risks.

6. ***Advanced economies***. *Monetary policy should remain accommodative (with due regard to cross-border spillovers) and short-term adjustment properly paced. Medium-term fiscal consolidation remains key.*

- The *euro area* has the clearest need to balance supporting growth with needed reform. Monetary policy should remain accommodative, and countries delivering on program commitments should be eligible for OMT. The ESM should provide direct bank recapitalization. At the same time, there needs to be tangible progress toward a single resolution authority and deposit insurance backed by a common fiscal backstop. Fiscal consolidation should continue to be tailored to country needs and anchored in structural targets, complemented by more integrated fiscal frameworks with stronger enforcement provisions at the union level. Countries should press on with needed bank and corporate balance sheet repair to help mend monetary transmission and improve the flow of credit to SMEs, as well as implementing structural reforms to rebuild competitiveness and widen the tax base.

- In *Japan*, the recently adopted higher inflation target has been supported by bold new quantitative and qualitative monetary easing. More ambitious medium-term fiscal adjustment plans are needed to achieve sustainable public finances given the recent stimulus and structural reforms are needed to support future growth.

- The top priority for the *United States* is to agree on a credible medium-term fiscal roadmap to deliver high quality fiscal adjustment and to raise the debt ceiling in a timely manner. This will mitigate the risk of excessive near-term consolidation, support confidence and private demand, and ease the burden placed on monetary policy.

- *Many other advanced economies* need to enhance resilience by rebuilding policy space eroded by the crisis and strengthening their financial systems.

*The **Fund's** role:*

- Discuss and propose policies that balance the need to support growth with the need to reduce deep fiscal, financial, and private balance sheet risks in advanced economies.

- Continue to analyze the global benefits and risks of prolonged monetary easing in advanced economies and associated exit strategies.

- Continue to help develop and monitor well-designed programs for countries impacted by the crisis.

- Further technical assistance to Europe on fiscal issues and on financial sector repair and reform.

7. ***Emerging market economies***. *Accommodative policies have helped strengthen activity in emerging market economies, but resilience needs to be enhanced*.

- Many emerging market economies should begin to recalibrate policies to guard against financial excesses, to rebuild macroeconomic policy space, and to make their financial systems more resilient against the eventual policy tightening in advanced economies. Country circumstances, including the need to rebalance demand and the adequacy of policy buffers, will determine the pace of fiscal consolidation and monetary policy tightening.

- Tighter regulation and supervision, including macroprudential measures and capital flow measures when appropriate, will help avoid potential financial stability risks from rapid credit growth, large capital inflows, high asset prices, and rising corporate leverage and foreign exchange exposure.

*The **Fund's** role:*

- Advise on the appropriate policy mix as well as the pace of recalibration.

- Assist with monitoring and developing policies to tackle volatile capital flows and limit financial stability risks, including by deepening understanding of the effectiveness and appropriate use of macroprudential policies.

- Continue to assist crisis bystanders through well-designed programs, building on the revamped lending toolkit and increased Fund's general resources.

- Focus capacity building on strengthening policy frameworks and financial sector oversight, as well as on capital market deepening.

- Advance on the analytic, capacity building, and outreach agenda for small states. Program design will also reflect their special needs, particularly capacity constraints and challenges to growth, given their limited economic diversification.

8. ***Low-income countries**. Robust growth in low-income countries (LICs) should be used to build more resilient frameworks while also meeting infrastructure and social needs.*

- Countries should begin reforming poorly-targeted subsidy regimes that leave budgets too dependent on commodity prices. In a similar vein, commodity exporters should move toward budget frameworks that smooth the impact of volatile commodity prices. These reforms would enable countries to replenish depleted fiscal buffers, provide better-targeted support to the poorest, and build the physical infrastructure needed to further bolster future prosperity and jobs.

- It is also important that progress on financial sector deepening and improvements in regulation and supervision move forward in parallel to guard against financial stresses down the road.

*The **Fund's** role:*

- Engage on policy options to rebuild policy buffers and improve priority spending.

- Target capacity building to strengthen policy frameworks, mobilize revenue, improve spending efficiency, and deepen the financial sector.

- Further improve the tailoring and flexibility of Fund support, building on recent refinements to the LIC facilities; continue efforts to raise adequate financing from members to establish a self-sustained Poverty Reduction and Growth Trust (PRGT).

9. ***Middle East and North Africa***. *The MENA region faces particularly difficult policy challenges. Many countries face protracted transitions and some need to re-establish macroeconomic stability.*

- Further fiscal consolidation remains a priority. In this regard, reforming inefficient and poorly-targeted subsidies and instead providing cash transfers for the poor can support consolidation and free up resources for more productive investments, such as infrastructure, needed to generate growth and employment.

- Donors should promptly provide stepped-up external official financing and improved trade access to countries embarking on difficult reforms.

- At the same time, greater exchange rate flexibility would help protect international reserves while supporting exports and activity by boosting competitiveness.

*The **Fund's** role:*

- Analyze and advise on policies to achieve macroeconomic stability and lay the basis for sustainable growth

- Continue to provide financial support where appropriate.

- Target capacity building efforts to build strong institutions, promote equitable fiscal policies, and strengthen statistics to support informed decision making and accountability.

## III. Restoring Resilience

10. **Restoring the world economy's resilience requires decisively addressing medium-term structural issues**. Progress so far has been uneven and lagging in some areas, and the associated uncertainty is undermining the recovery. Policy measures discussed at the last IMFC meeting remain relevant. There are, however, a few areas where urgent collective action is warranted.

### *Financial system reform*

11. **Despite some progress on regulatory reform, it is critical that policymakers commit to completing these reforms to limit uncertainty, arbitrage, and financial fragmentation**. The good news is that enhanced capital rules and G-SIFI surcharges are largely agreed. The major remaining priorities include: addressing the "too big to fail" problem (where competing plans risk regulatory arbitrage); reforming over-the-counter derivatives trading; and agreeing on consistent accounting standards and shadow banking regulations. Once these reforms are completed, consistent implementation will be essential for the regulations to be effective.

- *Membership*: (i) make further progress on the global reform agenda, including greater international cooperation on remaining issues; (ii) avoid the proliferation of uncoordinated national initiatives that may hamper, rather than enhance, the effectiveness of the reforms; and (iii) monitor credit and asset market developments closely to ensure emerging excesses can be addressed early, including through macroprudential policies.

- *Fund*: in line with the Financial Surveillance Strategy, (i) help identify, and advise on an action plan to remove obstacles and bottlenecks to completing the global reform agenda; (ii) continue to monitor, with the Financial Stability Board (FSB), any unintended consequences of regulatory reforms on emerging market and developing countries, and highlight any emerging inconsistencies across national initiatives; (iii) analyze and monitor closely emerging financial stability risks given continued monetary easing in key advanced economies; (iv) undertake analysis of structural constraints on banks; and (v) continue to support the implementation of the G20 Data Gaps Initiative with FSB.

***High deficit and debt***

12. **Lingering concerns over the future trajectory of public and private debt highlight the importance of durable fiscal adjustment and institutional reform**. Many advanced economies have steadily lowered their fiscal deficits and some are close to achieving primary surpluses that stabilize debt ratios. However, this is only a first step. Even if stable, large deficits and high public and private debt reduce potential growth and leave economies vulnerable to shocks. Many emerging markets and low-income countries are also running primary deficits and have work to do to restore policy buffers to their pre-crisis levels.

- *Membership*: (i) ambitious medium-term fiscal consolidation plans remain critical in many countries, involving subsidy and tax subsidy reforms, broadening the tax base, and, particularly in some advanced countries, entitlement reforms; (ii) the overhang of private debt needs to be reduced to complement the clean-up of bank balance sheets; and (iii) where debt is unsustainable, ways to reduce the debt burden will need to be considered.

- *Fund*: (i) continue to assist countries to identify risks to fiscal sustainability, including from contingent liabilities, using our revamped tools for debt sustainability in emerging and advanced economies; (ii) continue to assist countries to manage their debt portfolios by supporting the design of effective medium-term debt management strategies and strengthening debt management institutions; (iii) draw and apply lessons from previous episodes of unsustainable debt ; (iv) analyze the links between financial sector characteristics and public debt accumulation; (v) strengthen the design of debt limits policy in Fund-supported programs; (vi) strengthen the tools to assess fiscal transparency and improve fiscal institutions; and (vii) continue to advise on employment friendly fiscal policies.

### *Jobs and growth*

13. **Job creation and inclusive growth are imperatives that resonate in the entire membership**. For some countries, the priority is to address the huge increase in unemployment since the onset of the crisis. Others will need to deal with demographic trends (aging populations or large increases in working age populations) in the face of globalization and technological change. The agendas of growth, job creation and inclusion are interlinked, but countries should tailor policies to address differing challenges and differing growth constraints.

- *Membership*: (i) In advanced economies, active labor market policies can help prevent further disengagement from the labor market. Euro area periphery economies need to rebuild competitiveness. This requires policies to boost productivity growth and foster job-friendly wage setting so as to achieve sustained gains in export market shares. (ii) For emerging market economies, it is imperative to identify and address the most binding constraints to growth. An important element of any growth strategy is the use of labor market policies that provide adequate protection to workers without impeding resource reallocation. (iii) For LICs, the priority is to generate employment growth sufficient to absorb labor increasingly released from subsistence agriculture. (iv) MENA countries in transition need to follow through on setting out and implementing economic transformation agendas that will foster inclusive growth and create jobs.

- *Fund*: building on recommendations in the *Jobs and Growth* paper, the Fund will: (i) provide more systematic and tailored analysis of growth and employment challenges in member countries, and help countries identify their most binding constraints on growth; (ii) enhance advice on reform of tax and expenditure policies to create conditions to encourage more labor force participation, robust job creation, and equity in income distribution; and (iii) enhance advice on labor market policies based on current empirical evidence and greater collaboration with international institutions such as the World Bank, OECD, and ILO to assess the impact of these policies on growth, productivity, job creation, and inclusion.

### *Global imbalances and spillovers*

14. **Global external imbalances have continued to narrow, but policy action needs to contribute more to the adjustment**. Most of the adjustment took place during the Great Recession of 2008–09, reflecting negative global growth and the correction of past financial excesses. The adjustment in real exchange rates since 2007 also facilitated some narrowing of global imbalances. Additional fiscal and structural policy actions are needed to ensure that the imbalances continue to narrow.

15. **Worries over currency valuations and competitive depreciation are on the rise**. Exceptionally accommodative monetary policy in key advanced economies can have side effects through exchange rates and capital flows, including high asset prices in recipient countries and associated misallocation of resources that should be monitored. Over time, unconventional monetary policies are likely to have their largest impact through their effects on underlying market conditions. To the extent that unconventional monetary policies help lower tail risks, they can reduce underlying volatility. If, however, they delay more fundamental reforms, they are likely to prolong financial uncertainty and ultimately put pressure on other economies.

- *Membership*: (i) large surplus economies should continue to raise consumption (China) and investment (Germany), and major deficit countries should boost national savings through fiscal and structural reforms, including entitlement reforms (U.S.); and (ii) major economies need to factor in cross-border implications of their policies when weighing alternative policy options.

- *Fund*: (i) to highlight the interconnectedness of policy measures, the upcoming *Spillover Report* will examine the impact of unconventional monetary policy, highlight risks of negative spillovers, and analyze cross-border impacts of policies being undertaken to restore growth; (ii) a revamped *External Sector Report* will focus more on capital flows and enhance the methodology of External Balance Assessment, incorporating feedback on last year's pilot report; and (iii) the ISD, in effect since January, will strengthen analysis of interconnectedness and spillovers in bilateral Article IV consultations. These discussions are supported by global risk assessment matrices (G-RAMs), which are now produced regularly as a tool to inform risk analysis and spillovers across countries and regions. Cluster-based surveillance in Article IV reports and regional reports should also improve our assessment of risks from common shocks and allow for consistent examination of policy responses.

## IV. Adapting to the Future

16. **It is imperative that the 2010 reform package be adopted by the membership without delay**. The package marks an important milestone in the quota and governance reform that started in 2006. We have fulfilled two of the three conditions needed for the 2010 reform to take effect. The remaining condition is to secure the 85 percent of the total voting power needed for the Board Reform Amendment to enter into force. As regards composition of the Executive Board, the election of a new Board was completed in October 2012, resulting in further progress in consolidating advanced European constituencies.

17. **Continued reform of our quota and governance structure is key to the Fund's legitimacy and effectiveness**. The Fund needs adequate resources to fulfill its role as the guardian of global stability. The 15th General Review of Quotas will offer an opportunity to review the adequacy and composition of Fund's resources over the medium term, as well as

the distribution of quota shares. The quota formula review was completed at end-January 2013 and the membership agreed that work on a new quota formula should be integrated with work of the 15$^{th}$ General Review of Quotas. In the coming months, the membership will need to coalesce around a reform package that can garner the broadest possible support. The Fund should also make further progress promoting the diversity of staff, a key component of the Fund's legitimacy.

18. **The second external evaluation of the Independent Evaluation Office (IEO) was discussed at the Board in March 2013**. There was wide acknowledgement that the IEO has played an important role in supporting the Fund's governance and transparency, and enhancing its learning culture. Many of the external evaluators' recommendations to further enhance the effectiveness of the IEO—including on evaluation topics and the process of following up on recommendations—were strongly endorsed. Specific follow up actions on implementing these recommendations are being prepared for discussion by the Evaluation Committee and the Board.

19. **Long term trends will continue to shape the landscape of the global economy**. Securing the recovery and dealing with legacy issues have rightly occupied us in recent years. However, we must not lose sight of the broader canvass. The growing clout of emerging market economies is setting the stage for an increasingly multi-polar world. Debt overhangs in advanced economies and continued rapid growth of financial sectors in emerging market economies and developing countries are likely to raise the risk and cost of future crises. Growing output and populations in some countries will also put pressure on the environment and, while all countries will bear the cost, low-income countries are the most vulnerable to climate change. We will need to explore the consequence of these trends for the Fund and incorporate them in our strategic planning.