

## **20100226 IMF: Reconstructing the World Economy (Speech by John Lipsky, First Deputy Managing Director)**

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Good morning, distinguished guests, and welcome to this conference on reconstructing the world economy. I would like to begin by thanking the Korea Development Institute for co-organizing this event. I would also like to thank the Presidential Committee for the G-20 Summit, the Ministry of Strategy and Economy, the Financial Services Commission, and the Bank of Korea for their support. And, of course, I would like to express my gratitude to my colleagues in the IMF's Research, Monetary and Capital Markets, Fiscal Affairs, and External Relations Departments for their role in preparing this event.

Hopefully, the most severe crisis since the Great Depression is winding down. Nonetheless, policy makers face many new challenges. Some are immediate, such as deciding when and how to exit from crisis support measures. At the same time, the persistence of global imbalances signifies that risks to the recovery remain substantial. Other challenges pertain to establishing strong and sustained growth over the medium term, including by re-evaluating macroeconomic policy frameworks, by redesigning financial regulation and supervision, and by strengthening the international financial architecture.

Our goal for this Conference is to provide a forum for discussing these challenges. The papers prepared by IMF staff that form that basis for today's program are intended to serve as a starting point for our discussions. The content of these presentations do not represent official Fund positions, but rather reflect our internal debate. They are intended, in part, to be provocative. I would like to take a few minutes to present the key ideas in each of these papers.

### *Exit Strategies*

While the financial crisis hit economies around the world at more or less the same time, recovery from the crisis is taking place at different speeds across economic regions. In several advanced economies, the recovery remains vulnerable. High and still rising unemployment, together with weakened household balance sheets, are holding back private consumption, while tighter than normal credit conditions are restraining investment. In many emerging economies, by contrast, the recovery is underway already, reflecting buoyant domestic demand and relatively healthy financial sectors. Overall, the IMF has called for supportive policies to be maintained through 2010 for most of the world's advanced economies, while in many emerging economies—notably some in Asia--the time for stimulus withdrawal has arrived already.

Judging when to exit from macroeconomic stimulus is a difficult challenge: unwinding too early could jeopardize the recovery. In contrast, maintaining support for too long could pose risks to price, financial, and fiscal stability. In response to the IMFC's request for the Fund to advise on the timing, and nature, of exit from crisis-related intervention measures, IMF staff have prepared the paper presented in today's first session.

The paper identifies five basic principles to guide an exit strategy.

First, strategies must be integrated across policy instruments. For example, in countries where restoring fiscal sustainability is critical, fiscal measures should be withdrawn first, while monetary policy can, in most cases, remain supportive for some time.

Second, exit strategies must be able to adjust flexibly to unforeseen developments. Exiting will not involve a single, one-off decision, but will rather comprise a series of evolving steps.

Third, strategies should rely, where possible, on market-based incentives. More generally, policies must aim to restore the role of market forces, especially in the financial sector, where the government has taken on an expansive role in many advanced economies.

Fourth, strategies should be established early and communicated clearly and consistently to reduce uncertainty, anchor expectations, and secure public support.

Fifth, cross-country consultation and coordination on macroeconomic policies -- and consistency across some types of financial and monetary support -- can increase the chance of success.

Of course, laying out broad principles is the relatively easy part—the difficulties emerge when putting them into practice. The IMF is playing an important role in these more practical efforts as well. By reporting on the unwinding process through our surveillance mechanisms, specific additional monitoring, and technical support, we hope to reduce the likelihood of policy inconsistencies across countries.

### *Global Imbalances*

While the issue of exit has often been presented solely in terms of removing crisis-related measures, I would prefer to think of it in the broader question of choosing the sort of global economy we would like to exit into. Most notably, it is necessary to think clearly about where the future sources of growth be found, but also about how we can avoid reinstating the array of policies that produced a record widening of global imbalances and that played an important role in fomenting the current crisis. International policy coherence will represent a necessary condition for achieving the needed global rebalancing in demand growth, that the G-20 identified as critical for securing strong, sustainable, and balanced growth. In this regard, many of you know that the IMF is providing analytical support for the G-20's innovative mutual assessment process, with an initial report to finance ministers due in April.

Even though global imbalances have narrowed considerably since the crisis, there is a significant risk that they may widen again in the absence of policy adjustments. And failure to address the underlying causes of imbalances could result in the world economy getting stuck "in the middle of the stream," threatening the sustainability of the recovery. The principal recommendations of this session's paper includes:

- If global growth is to be put on a more sustainable footing, US net national savings will need to increase. A significant adjustment in private savings out of current income has taken place already in the context of the crisis. Moreover, further adjustment is to be expected in the coming years. In addition, public dis-saving will be reduced through automatic stabilizers as the recovery gains strength. Nonetheless, significant new discretionary measures are going to be required.

At the same time, growth in the major surplus countries, such as China, will need to be led relatively more by domestic demand, especially by private consumption. Improved social insurance, stronger corporate governance, and increased access to credit for households and SMEs will be needed. Moreover, real exchange rate adjustment almost certainly will play an integral role in achieving better balanced and sustainable growth in global demand.

If oil prices are stable or higher in the medium term -- as currently forecast -- some oil-exporting countries will be able to further boost domestic demand, especially through increased spending on social infrastructure.

The IMF is supporting the rebalancing effort through our policy advice and surveillance activities. Further reform of our lending facilities, building on the Flexible Credit Line (FCL) introduced during the crisis, could promote rebalancing by reducing the demand for precautionary reserves.

Turning to medium-term challenges, the crisis revealed potential flaws in the prevailing macroeconomic policy frameworks, as well as major gaps in financial sector supervision and regulation, and vulnerabilities in the international monetary system. These issues are at the center of the current debate about the future shape of economic and financial policy.

### *Rethinking Macroeconomic Policy*

Before the crisis, macroeconomists and policymakers generally agreed that keeping inflation low and stable -- and keeping public debt sustainable -- were critical elements for attaining economic success. But the crisis showed that vulnerabilities and threats to macro-financial stability may develop even under a seemingly tranquil surface of stable prices, small output gaps, and relatively healthy public finances.

While many tenets of the pre-crisis consensus—notably low inflation and fiscal discipline—remain

valid, others need to be reassessed. In particular, the crisis has raised the issue of whether financial stability – including asset price performance -- should be an explicit goal of policy, and if so, how it should be achieved. In that context, it has been noted that monetary policy is a blunt (and possibly ineffective) tool to deal with these specific additional challenges and that better and more targeted instruments should be developed. For example, regulatory ratios that vary over the cycle are a potential option. Undoubtedly, work is needed urgently on designing a practical macro-prudential framework that could be applied widely.

The crisis also reminded us of lessons we had learned previously, such as the importance of building fiscal space in good times. And it has made a strong case for improving automatic stabilizers, in particular those that allow some transfers or taxes to vary based on the state of the economic cycle.

### *The Future Financial System*

It comes as no surprise that the crisis—with its financial sector origins —has motivated a profound re-evaluation of the global financial system. How policy makers and market participants respond to the recent events will shape the future financial system and its role in the global economy for decades to come.

To limit future crises, we must be better equipped to cope with systemic risks in a globalized system. This will require multiple reforms, including a widening of the perimeter of regulation to include all systemically significant financial institutions. In addition, incentive-compatible regulation will be needed to limit excessive leverage and risk-taking. Of course, efforts to mitigate systemic risks are not costless. For example, excessive regulation could stifle innovation and unduly limit the potential benefits of a globally integrated financial system.

The dramatic recent demonstration of the impact of international linkages has underscored the importance of creating a new regulatory framework that is broadly consistent across countries. This will represent a complex challenge, especially for such issues as the resolution of failing cross-border institutions. The IMF can and will encourage our members to coordinate their reform efforts. And the Fund's detailed knowledge of its members' financial systems and its experience in monitoring global standards and codes should allow the Fund to contribute meaningfully to the efforts currently underway to design a new financial system that serves the global community. Reaching agreement, however, will require serious and sustained political support.

### *Reforming the International Monetary System*

The final session today focuses on how a new international financial architecture -- and in particular a strengthened international monetary system -- can help to address some of the current challenges.

As is recognized generally, key exchange rates have been relatively stable through the crisis. A flight to the US dollar took place in September 2008—contrary to what many had predicted, given concerns about the US economy.

However, the dollar's continued dominance as an international reserve asset means that the global demand for reserve assets can only be satisfied if the reserve issuer runs external deficits. And there is no automatic mechanism that would mitigate an ongoing reserve build-up by surplus countries. This problem has been aggravated in recent years as the demand for reserves rose sharply—reflecting in part the desire of many large emerging markets to self-insure against costly capital account crises. Of course, in many cases the reserve build-up has far exceeded any conceivable insurance function.

How can these tensions best be addressed? On the demand side, alternative insurance arrangements could mitigate the precautionary demand for reserves. On the supply side, alternative reserve assets could strengthen systemic stability and efficiency.

The recent reform in the IMF's lending instruments—in particular the introduction of the Flexible Credit Line (FCL), and the mainstreaming of high-access precautionary arrangements (HAPA)—represents a significant step forward in bolstering the Fund's insurance facilities. However, these instruments cannot serve as full substitutes for reserves, given that countries must qualify for them.

Recent studies by Fund staff, including today's background paper and a paper presented to our Executive Board last summer on "Exchange Rate Regimes and the Stability of the International Monetary System" present a number of proposals to improve the stability of the international monetary systems in light of recent challenges. These proposals eventually could gain traction and practical relevance, if more incremental efforts aimed at strengthening the current system prove insufficient.

As you can see, today's agenda is both broad and deep. I thank you for joining us today, and look forward to useful discussions.

**NovaRes Team**