## 20100302 Post-Crisis Challenges (Speech by John Three Lipsky)

**Source: IMF**

*1 March 2010*

**Remarks by John Lipsky, First Deputy Managing Director, International Monetary Fund, at the Seminar in Honor of Mr. Marcel Wormser,Banque de France, Paris.**

Before anything else, I would like to thank the Bank of France and the Wormser family for giving me the opportunity to participate in this wonderful event honoring Marcel Wormser. Marcel not only has contributed to the development of French financial markets, but also to preserving the memory of some important and particularly admirable aspects of modern French history and to strengthening civil society – all while epitomizing standards of courtesy, discretion and thoughtfulness that I am sure all who know him aspire to emulate. So it is not surprising that he has a wide circle of friends and admirers here, but also in America and elsewhere.

To open the proceedings on a positive note, it appears that the most severe crisis since the Great Depression is winding down. While considerable uncertainty persists regarding the strength of the recovery, our most recent World Economic Outlook (or WEO) forecast anticipates global growth of around 4 percent this year, and around 4-1/4 to 4-1/2 percent in 2011.

Even if our forecast is correct, there is no doubt that the crisis is leaving a legacy of profound challenges for policymakers. Some are immediate, such as deciding when and how to exit from crisis support measures. At the same time, the unevenness of the pace of growth between countries and the prospective renewed widening of global imbalances still represent a risk. Other challenges pertain to establishing strong and sustainable 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.

Just last week, the IMF—in partnership with the Korea Development Institute—sponsored a conference on “Reconstructing the World Economy”. The conference addressed all these challenges through a set of very interesting, clear and thought-provoking presentations. These are available on the IMF website (imf.org), and I recommend them highly.

Turning to the substance of my presentation, I would like to briefly address three linked post-crisis challenges—1) the crucial opportunity represented by the G20 Framework for Strong Sustained and Balanced Growth; 2) dealing with the crisis-related surge in public debt; and 3) the potential role for an international lender of last resort.

Over the past weekend, the Group of 20 Finance and Central Bank Deputies met in Incheon, Korea as part of the extensive preparations for the G20 Leaders Summits that will take place this year in June and November. The policy agenda to be addressed by the Leaders is broad and highly relevant. The decisive and coherent anti-crisis actions agreed and implemented by the G20 countries last year no doubt were instrumental in avoiding a much deeper global crisis. Now the test is to maintain the same coherence and focus in propelling the recovery.

### The G20 Framework

An innovative and critical element of the Leaders’ agenda is the implementation of the Framework for Strong, Sustainable and Balanced Growth that was agreed at last year’s Pittsburgh Summit. At the heart of the Framework initiative is a path-breaking mutual assessment process in which alternative medium-term policy programs will be examined and discussed at the highest political level. The goal is to insure that budget, monetary and structural policies across the G20 countries are coherent, consistent and as supportive as possible of restoring and sustaining well-balanced global growth.

Success of the Framework process would boost confidence in the stability and durability of the renewed global expansion. Thus the stakes are high for this unprecedented effort at international policy cooperation. The IMF is providing technical support to the G20 authorities in preparing the analytical bases for the discussions.

### Coping with Rising Public Debt

It is widely agreed that the success of the anti-crisis efforts implemented over the past year in part reflected the positive impact of the unprecedented fiscal stimulus implemented by the G20 countries and others. However, these large-scale efforts have not been costless. To the contrary, even if our WEO forecast is correct, the crisis will leave heavy fiscal scars.

We project general government gross debt in the advanced countries to rise, on average, from about 75 percent of GDP at end-2007 to about 110 percent of GDP at end- 2014, even assuming the expiration of temporary stimulus measures in the years ahead. By 2014, debt ratios will be close to or exceed 85 percent of GDP in all G7 economies except Canada.

Already in 2010, the average debt-to-GDP ratio in advanced countries is projected to have reached the level prevailing in 1950, in the aftermath of World War II. This surge in public debt is occurring at a time when pressures on health and pension spending are starting to accelerate, reflecting the combined effects of aging populations and of rapidly rising health care costs: On the basis of current policies and existing cost trends, we project this spending to increase by an additional 4-5 percentage points of GDP during the next two decades. Thus, it is easy to conclude that public debt ratios in the advanced economies at present are on an unsustainable path.

The situation is more favorable in the emerging market economies, where the average debt ratio, after rising in 2009 and 2010, is expected to begin to decline next year. These countries are not exempt from fiscal risks, however. Our baseline projections are premised on the implementation of announced fiscal tightening plans in several emerging economies, and on the absence of negative spillovers from advanced economies.

The increase in advanced economy debt reflects several factors: Notably, and contrary to widely-held assumptions, discretionary fiscal stimulus and direct crisis-related support to the financial and other sectors accounts for less than one fifth of the projected increase in public debt through 2014. Rather, the bulk is related to revenue losses from the output decline, lower tax payments from the financial sector, underlying spending increases, and, increasingly, higher interest payments as debt rises.

The mere unwinding of discretionary policies therefore will be very far from sufficient to bring deficits and debt ratios back to more moderate levels. In other words, the magnitude of the anti-crisis fiscal measures of the past year or so has served to bring into high relief a profound fiscal policy challenge that previously was mainly seen as a prospective one.

Thus, the moment for real engagement with this issue has arrived, and the G20 Framework will provide a potential venue for such engagement. In the near term, there is a risk that concerns about fiscal sustainability could undermine confidence in the economic recovery. In the medium term, high public debt in the absence of remedial measures could usher in a period of high real interest rates and slower growth.

Of course, there is general agreement that the rise in government debt ratios will need to be curbed. There is, however, less agreement about the level at which debt ratios should be stabilized. The key choices will range from accepting a sustained increase in debt ratios, to stabilizing debt at the post-crisis ratio (at more than 100 percent of GDP in many cases) or lowering it, perhaps even back to where it was before the crisis began (or even lower for countries that started with high debt).

Just stabilizing debt ratios at post-crisis levels will not be easy. Without substantial policy action to control spending growth for pensions and health care, most advanced G20 countries simply would suffer ever-rising public spending burdens, outpacing either economic growth or any prospect for revenue increases under current tax laws. Attempting to push public debt back below expected post-crisis ratios would be even more difficult. Nonetheless, it is worth asking what benefits might be reaped by such a strategy, or viewed another way, what benefits would be sacrificed by a policy of only stabilizing post-crisis debt ratios.

First, simply allowing the crisis to have "permanently" ratcheted debt ratios higher likely would reduce the prospective room for a flexible fiscal response in the event of future downturns. Indeed, in some countries—such as Italy—the response to the current crisis already was constrained explicitly by the existing large stock of outstanding government debt and the absence of fiscal space. Moreover, experience suggests that high debt levels would be associated with greater vulnerability to crises, especially in those countries where debt ratios already are relatively high.

Second, in a high public debt world, real interest rates likely would be higher—other things equal—than in the pre-crisis environment, with adverse consequences for private sector activity. Recent analysis by IMF staff suggests that long-term interest rates rise by five basis points for each percentage point increase in the debt/GDP ratio. The effect can be even larger when debt ratios are high. There also is evidence that the effect of weaker fiscal accounts on interest rates is greater when fiscal deteriorations take place in many countries at the same time, as the terms of access to foreign financing of budget deficits likely will be tightened.

Third, higher debt ratios seem to be associated with slower growth. Preliminary analysis by our staff for a sample of advanced and emerging economies suggests a negative impact of government debt on per capita GDP gains: Specifically, a 10 percentage point increase in the debt ratio appears to lead to a slowdown in annual growth by 0.2 percentage points, with a somewhat smaller impact in the advanced economies. And, if high public debt is associated with higher interest rates and slower growth, a larger primary surplus would be needed to ensure debt stabilization.

Therefore, despite the greater near-term fiscal effort that would be required, it might be deemed preferable to attempt to lower debt ratios from their expected lofty post-crisis perch before trying to stabilize them. Naturally, debt targets should reflect country-specific circumstances, including the initial level of debt and its composition, and the depth of financial markets.

How could such an outcome be achieved? There will always be a temptation to look for an easy—or at least easier—way out. Thus, some have suggested that higher inflation may be a reasonable price to pay to reduce the real value of debt. There are two ways that higher inflation could help. First, even fully anticipated inflation raises the real value of seigniorage that can be used to pay down debt. Second, an unexpected rise in the inflation rate would reduce the real value of government debt directly.

However, the first channel is modest in advanced economies, because base money is relatively small. The second channel is larger, but it is temporary, as maturing debt will have to be rolled over at higher interest rates. Altogether, we have computed that increasing inflation in the OECD countries from, say 2 percent (the current WEO forecast) to 6 percent over the next five years would erode less than one-quarter of the projected baseline increase in the debt ratio over that period.

But that isn't the whole story. It goes without saying that a transition to faster inflation itself creates major costs and risks. In most advanced economies, inflation goals and targets—as well as inflation expectations—have tended over the past few decades to coalesce to around 2 percent per annum.

This result has not been coincidental. Rather, analysis has suggested that existing consumer price indexes tend to under-adjust for quality changes—and we are in a period of substantial product innovation. Thus, the argument goes, inflation at about a two percent annual pace according to current CPI measures is roughly equivalent to "true" price stability. Moving to a higher inflation rate therefore would represent abandoning price stability, rather than just exchanging one positive (and arbitrarily chosen) inflation rate for another.

In contrast to a theoretical world—where indexing can be perfect and inflation can be stabilized indifferently at any arbitrarily chosen rate—actual inflation gives rise to distortions in resource allocation, reduces economic growth, hurts the poor, and tends to exacerbate social and political stress. Moreover, given current low inflation rates and generally well-anchored inflation expectations in most advanced economies, the welfare costs of a transition to faster inflation likely would not be trivial.

In contrast, accelerating potential growth—especially if this occurs in combination with expenditure moderation—can make a major contribution to lowering debt ratios. Faster growth raises revenues and, if these are not spent, the effect on debt dynamics can be powerful. For example, a one percentage point increase in annual growth, sustained for 10 years—holding real spending constant and assuming a 40 percent tax rate—lowers government debt by almost 30 percentage points of GDP. Therefore, growth-enhancing reforms, such as increasing competition in goods markets, or removing labor market and tax distortions, can and should be pursued vigorously. Parenthetically these remain key elements of the EU's structural reform agenda.

However, the considerable uncertainties that surrounds both the magnitude and timing of the

effect of structural reforms on potential growth cautions against building a fiscal adjustment strategy primarily around an assumed optimistic growth path. Fiscal authorities should base their plans on conservative growth projections, and hope for growth and revenue "windfalls" to speed the process of alleviating debt burdens.

These considerations suggest that to reduce debt ratios inevitably will require major efforts to improve fiscal primary balances. The implied challenge is even greater than it may appear, as the increase in the primary surplus will need to be achieved despite the current projected increase in aging-related entitlement spending.

**Alternatives to Reserve Accumulation**

Turning to the issue of an international lender of last resort, it is clear that one of the weaknesses of the existing international monetary system has been reflected in the accumulation of record official international reserve holdings, at least in part in an effort at self-insurance against a sudden stop in capital flows or international financial market illiquidity. It is generally agreed that reserve holdings represent a relatively costly form of crisis insurance, while at the same time the buildup of such reserves potentially could make it more difficult for the country or countries providing reserve assets to achieve fiscal and external balance.

A clear risk of the current conjuncture is that many emerging market economy authorities and others could conclude from the recent crisis that new increases in reserve holdings are justified. There is little doubt that a simultaneous move to acquire new reserves would complicate the effort to restore strong and sustained global growth. Instead, borrowing from a global lender of last resort could provide a systemically efficient alternative to the current situation.

The test of any alternative to reserve accumulation would be the ability to provide resources reliably, rapidly, in an adequate scale and at a favorable cost relative to reserve holdings. To some extent, this function was filled in a very ad hoc and partial manner during the recent crisis by central bank swap lines.

The creation in 2008 of the IMF's Short Term Credit Facility (SCF) represented a partial advance toward a multilateral lender of last resort-type crisis prevention instrument, in that it established the possibility of prequalification for Fund facilities. However, the potential usefulness of the SCF was severely blunted by its lack of a conditional or precautionary feature.

Thus, the 2009 establishment of the Flexible Credit Line (FCL) created for the first time a prequalified, high access precautionary Fund facility. In practice, the FCL successfully bolstered investor confidence in the countries that have accessed the facility so far. However, since a drawing under the FCL can be repaid as a medium-term facility, safeguard considerations inevitably will limit the number of qualifying countries.

Looking forward, it is not clear that central bank swap lines would be available on a timely or adequately sized basis in any future period of international market strain. Thus, the Fund will be exploring whether acceptable multilateral swap-like facilities could be developed that would limit members' perceived need for additional reserves. At the same time, avenues for making the FCL more useful will be examined.

Other forms of providing effective and efficient reserve substitutes also will be pursued. These include enhanced backstopping of regional reserve pooling arrangements, such as the Chiang Mai Initiative. More innovative methods of providing reserve substitutes also have been suggested, such as modifying the terms under which the Fund's Special Drawing Rights could be made more useful as a crisis prevention instrument. Even more radical proposals have been developed, including providing public support for crisis insurance schemes, but these seem rather more distant possibilities.

Of course, there also are other motives for reserve holdings, such as attempts to limit exchange rate appreciation, or to compensate for prospective depletion of natural resources. However, the former issue is best dealt with in the context of broad, multilateral economic policy discussions, such as the G20 Framework process. The latter issue seems more appropriate for a sovereign wealth fund or other means of explicitly coping with intergenerational equity challenges, rather than through conventional international reserves.

For its part, the IMF is poised to play a key supportive role in the post-crisis world. We will provide

independent, state-of-the-art analysis and policy advice—as well as direct support of adjustment efforts when required. In particular, the G20 has asked the IMF to provide guidance with regard to exit strategies from crisis-related stimulus, and to monitor their implementation. In this context, our new Fiscal Monitor quarterly publication—available on our website—provides a unique source of information and analysis on the emerging fiscal policy challenges.

More broadly, we are working with the G20 in support of its concrete policy goals, and well as with our global membership, in order to help produce strong, sustainable and balanced growth for the benefit of all.

Clearly, success is going to require serious engagement and effort. Business as usual will not suffice, and changes are going to be needed all around. This of course includes the Fund. I highly recommend to you the Managing Director’s recent address on “The Fund in the 21st Century” for a broad exposition on how we anticipate doing our part to meet the challenges we all share.

Thank you for your attention

**NovaRes Team**