

## **20100303 IMF: Recovering from the Global Crisis - Exit Policies and Challenges Ahead (Speech by Murilo Portugal)**

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Good afternoon, ladies and gentlemen. I am delighted to be with you in Sydney today to address this distinguished gathering. I wish to thank the Australian School of Business for inviting me, and particularly, Prof. Moshirian for organizing this event.

Today, I want to touch on three issues.

First, I want to share the IMF's view on the global and the regional economic outlook. Second, I will highlight the key challenges policymakers are facing in the current environment, in particular the challenges of exiting from extraordinary policy support, of building a stable financial system, and of reducing public debt. And third, I want to conclude with the enhanced role of the G-20 and its agenda to achieve strong, sustainable, and balanced growth.

### **I. Global and Regional Economic Outlook**

Let me begin with the outlook for the world economy. Following the deepest global recession in recent history, the global recovery is off to a stronger start than we had earlier anticipated. We expect global output to rise by 4 percent in 2010. This represents an upward revision of  $\frac{3}{4}$  percentage point from the October 2009 WEO and is the good news. But the recovery is proceeding at different speeds across the various regions and is still heavily dependent on extraordinary policy support.

In most advanced economies, growth is likely to be sluggish. Output is forecast to expand on average by 2 percent in 2010 and 2½ percent in 2011 in these economies, following a sharp decline in output in 2009. The recovery will be slow by past standards, with few signs that private demand is self-sustaining on the back of high unemployment—especially in Europe and the United States.

The outlook is much brighter in emerging market economies. Growth is expected to reach 6 percent in 2010, and pick up further in 2011, although again with significant variation across and within regions, reflecting different initial conditions and policy responses. The recovery is being led by key emerging Asian economies, notably China, India, Indonesia, and Korea thanks to buoyant domestic demand and stimulus measures.

In Asia, growth is likely to reach almost 7 percent in 2010 (1 percentage point higher than our forecast in October), largely driven by buoyant domestic demand, particularly consumption. The outlook for private investment is more mixed. In a few Asian economies, investment is expected to pick up significantly in 2010. In Korea, this reflects a fast return to high levels of capacity utilization; in India, a pickup in credit; and in Indonesia, the beginning of large infrastructure projects. But elsewhere, the investment outlook remains somewhat weak, partly owing to the still large excess capacity in manufacturing sectors, such as in Japan, Malaysia, and Thailand.

The outlook for Asia's exports and industrial production is generally strong, with restocking of inventories in the United States providing a significant boost. However, export volumes remain below pre-crisis levels—with the exception of Korea and China. Domestic inventory rebuilding is also expected to contribute significantly to growth in 2010.

In China, growth is expected to reach 10 percent in 2010, following stronger than expected growth of almost 9 percent in 2009. Activity will continue to be driven by strong domestic demand supported by a large policy stimulus, although there are also signs that the private sector is providing growth momentum.

Australia has been remarkably resilient to the global turmoil. The economy was hit by the global financial crisis. But growth was stronger than in any other advanced economy thanks to a timely and significant policy response, robust demand for commodities from China, a flexible exchange rate, and a healthy banking sector.

For Australia, the IMF forecasts 2½ percent growth in 2010 and 3 percent growth in 2011. This represents an upward revision from the October 2009 WEO. The revision was prompted by an improved global outlook and better-than-expected domestic performance in recent months, especially in the labor market. We expect growth will be led by domestic demand, both private and public.

Strong commodity income prospects are supporting investment in the resource sector in Australia. Some large projects have commenced recently, such as the Gorgon LNG project with investment equivalent to almost 3 percent of Australia's GDP. Other large projects are in the pipeline in Western Australia and North Territory.

In the medium term, Australia will continue to benefit from China's large fiscal stimulus and its demand for commodities. As you know, a large component of China's fiscal package consists of large public investment in its infrastructure, mainly railways and roads. For example, China plans to build about 20,000 miles of railway by 2020. To give you an idea of the scale of these plans, this is the equivalent of building 10 railway lines from Canberra to Perth. While Australia is benefiting from China's demand, this presents some risks. A sharp fall in demand for commodities would hurt the resource sector in Australia, although the likely adjustment in the exchange rate would provide a buffer.

## **II. The exit strategy from supportive policies**

Turning to my second issue, policymakers now face a critical policy challenge. Given the still-fragile nature of the recovery, withdrawing policy support too early may undermine growth momentum, while leaving policy support for too long could lead to overheating and asset bubbles. The key challenge remains to exit at the right time, pace and sequencing.

### *A. Macroeconomic Policies to Ensure an Orderly Exit*

As I said, this is a multi-speed recovery. For this reason, the pace of exit strategies will have to differ among countries. Macroeconomic policy stimulus should be maintained in major advanced countries, but may need to be unwound sooner in key emerging markets.

In advanced economies where the recovery is expected to be weak, central banks should maintain low interest rates in 2010 given that underlying inflation is expected to remain subdued and unemployment is expected to remain high. At the same time, credible strategies for unwinding monetary policy support need to be prepared and communicated clearly to anchor inflation expectations.

On the fiscal front, due to the still-fragile nature of the recovery, policies need to remain supportive of economic activity in the near term and the stimulus planned for 2010 should be implemented. However, countries facing growing concerns about fiscal sustainability need credible medium-term consolidation plans. There is also a need to start implementing measures that do not have a negative impact on aggregate demand now, for example by increasing the retirement age for public pensions and strengthening budget policies.

In some major emerging economies in Asia and Latin America, output gaps are rapidly closing and policy makers will need to guard against the risk of overheating. If low interest rates persist for too long, they could lead to inflationary pressures and asset price bubbles. This suggests that an earlier exit is needed in these countries than elsewhere. In India, where the output gap is closing and inflationary pressures have emerged, the authorities have started to tighten monetary conditions. In China, given that the recovery is increasingly well established, we agree with the government that it is time to withdraw some monetary stimulus, given the risks it poses to credit quality and asset price inflation.

Australia entered the global turmoil on a solid footing, and thus the exit strategy appears less challenging here than elsewhere. Indeed the early recovery, compared to other advanced

countries, has allowed the Reserve Bank of Australia to begin the process of normalizing interest rates. On the fiscal front, the Government has already begun to unwind its fiscal stimulus, as originally planned. However, the still fragile nature of the global recovery suggests that withdrawal of policy stimulus should continue to proceed gradually. In the medium term, even though public debt is projected to remain low by advanced economy standards, an early return to budget surpluses would be prudent for a number of reasons. It would put Australia on a firmer footing to deal with future shocks and contain the debt servicing costs associated with the private sector's relatively high external debt. It would also help the budget face longer term challenges from population aging.

### *B. Financial Sector Reform*

As you know, financial markets have recovered strongly since the peak of the crisis, thanks to improving economic fundamentals and policy support. Risk appetite has returned, equity markets have improved, corporate bond issuance has reached record levels, and capital markets have reopened. As a result, systemic risk receded somewhat. All this is good news.

However financial stability remains fragile. Continued deleveraging pressure on banks suggests that bank credit will remain weak for some time. And corporate bond issuance has been insufficient to offset the decline in bank financing, particularly for small and medium enterprises.

New risks are emerging as a result of the extraordinary policy support. Concerns over sustainability and political uncertainty have led to a widening of the sovereign spreads in some small countries in Europe. There is a risk that public debt issuance in the coming years could crowd out private sector credit growth, gradually raising interest rates for private and public borrowers and putting a drag on the economic recovery.

There has been a resurgence in portfolio flows to emerging markets, with Asia receiving a large part. This surge has been driven primarily by rapidly improving growth prospects, a rise in risk appetite, and large interest rate differentials. The return of capital to emerging markets is good news. However, the strength of these flows may complicate economic policy management.

Policies to manage a surge in capital inflows depend on circumstances. Options include macro-prudential policies aimed at limiting the emergence of new asset price bubbles, some buildup of reserves, and greater exchange rate flexibility. Some capital controls on inflows, especially if the surge in capital flows is expected to be temporary, can be part of the appropriate response. However, capital controls are costly and may not be effective in the long run. Of course, the right policy mix depends on each country's circumstances. We need to be pragmatic and open-minded.

Australia's banking system has proved resilient to the global crisis and recovery has been much quicker. The Australian government's decision to remove the guarantee on large deposits and wholesale funding from end-March 2010 is an important sign of the improvement in bank funding conditions. Continued stress-testing of banks in Australia and close supervision will be key to avoid the emergence of problems.

But in other countries much work is still needed to repair damage to the financial system from the crisis. In many advanced countries and some hard-hit emerging market countries, banking systems are still stressed and unable to play a proper role in channeling credit to worthy borrowers. In most advanced economies, policymakers still have to address an overhang of bad loans.

Moreover, bank restructuring needs to gain pace, including through liquidation of nonviable financial institutions. The absorption of failed financial institutions has led to an exacerbation of the "too-important-to-fail" problem and the associated moral hazard. The shortening of bank funding maturities is raising the need to address a rapidly advancing "wall of maturities".

Over the medium term, countries should adopt policies that solidify financial stability. Public sector risks will need to be reduced through credible fiscal consolidation, while risks emanating from private financial activities should be addressed by the adoption of a new regulatory framework.

This leads me to my next topic—regulatory reform. Major failures of regulation and supervision created dangerous financial fragilities that led to the current crisis. The international community has recognized the importance of regulatory reform and has strengthened supervision of banks and other financial institutions, to prevent future financial crisis. They mandated the Financial Stability Board (FSB) to coordinate and monitor progress in strengthening financial regulation and

supervision.

The major regulatory reform proposals are centered on strengthening bank capital and liquidity. Some enhancements to the Basel II capital framework were announced in July 2009, to be implemented by end 2010. These include significantly higher capital requirements for banks' trading book exposures and increased capital requirements for certain securitizations. These measures would significantly increase the capital required to be held against market risk. Other proposals announced in December 2009 are aimed at improving the quality and transparency of bank capital and introducing a minimum global standard for funding liquidity.

The impact on the Australian banks of these new proposals may be less than in many other advanced countries. This is because Australian regulators adopted a conservative approach in the implementation of Basel II capital requirements. Moreover, Australian banks had a lower share of securitized assets than many other banks in advanced countries, so may not be so affected by new rules on securitization.

### **How should a new financial system look?**

As you know, the IMF is working with the Financial Stability Board and other international agencies to craft a more stable and secure financial system.

The new regulatory framework should put more weight on financial stability. But avoiding excessive regulation that could stifle innovation and the benefits of a more globally integrated financial system is important. The increased regulatory burden imposed by higher capital and liquidity requirements is likely to lower returns, increase the cost of capital, and restrain risk-taking.

The perimeter of regulation will need to be extended to better take into account the risks in the non-banking financial sector and avoid cross-sectoral arbitrage. Moreover, the regulatory framework will need to be consistent across countries in order to ensure a level playing field. Regulation needs to be adjusted in some way to the economic cycle, to limit the risk that credit standards weaken because of excessive optimism during economic upswings.

The IMF has a role in helping countries transition to a healthier financial system, and in ensuring a level playing field. The G-20 has asked the IMF to review options on how the financial sector could make "a fair and substantial" contribution to paying for government interventions to repair the banking system.

We are taking a broad perspective on this issue, including the trade-offs between taxes and regulation of the financial sector. We will present our initial analysis at our Spring Meetings in April, and in a final report to the G-20 Leaders Summit in June.

One point is clear. We cannot return to the financial system of yesterday. We must move forward to set up a financial system where macro and micro regulations complement each other and help to reduce systemic risks.

### **III. Policies for strong, sustainable and balanced growth: The G-20 agenda**

To tackle all these challenges, international policy collaboration will need to be more effective. The G-20—in which Australia is playing a major role—has emerged as a key forum for the world's major economies to discuss policy priorities. As you know, the G-20 leaders launched a framework for strong, sustainable and balanced global growth.

What does this mean in practice?

- Growth is strong if it can create enough jobs to return to full employment and close output gaps.
- Growth is sustainable if it is driven by private demand rather than the public sector and the inventory cycle. And is consistent with the underlying potential of the economy.
- Growth is balanced if it is broad-based across regions and does not involve excessive global imbalances, such as persistent and large current account deficits or surpluses that stem from domestic or international distortions, and asset price booms.

Global external current account balances declined sharply in the aftermath of the crisis, due to painful adjustments. But imbalances are projected to widen over the medium term based on current policies, though not to pre-crisis levels.

Going forward, rebalancing growth is essential. This will require shifting toward internal demand in economies with large and persistent current account surpluses and shifting toward external demand in economies with large and persistent current account deficits.

Over the medium term, the key challenge for Asian policymakers remains to strengthen domestic sources of growth. For China, there is a need for financial reforms to improve credit availability for smaller enterprises and to establish broader social protection to help reduce precautionary households' saving. The government's plan for public healthcare is an important step in this direction. Raising productivity in the service sector through structural reforms could enhance domestic growth prospects in Korea and Japan. For many ASEAN economies improving the environment for private investment will be key in boosting private domestic demand. This can be achieved through easier access to credit especially for small and medium enterprises and by removing red tape. In the United States and some countries in Europe that have traditionally run large current account deficits there is a need to shift resources toward the tradable sector.

Greater exchange rate flexibility in major emerging market surplus countries would help rebalancing. Allowing currencies to strengthen in key emerging market surplus countries would raise households' purchasing power and shift resources from tradable to non tradable sectors. Depreciating currencies in major deficit countries would facilitate adjustment away from overstretched domestic demand.

Strengthening the availability of foreign exchange liquidity could also help promote greater exchange rate flexibility, by limiting the precautionary incentives to hold excessive foreign exchange reserves. The IMF has already taken an important step in this direction, by introducing the Flexible Credit Line. We are looking into ways to further boost the availability of precautionary and crisis financing, through further reform of our financing facilities, and also by exploring the possibility of collaborating with regional reserve pools.

To achieve strong, sustainable, and balanced global growth will require collaborative policy efforts by both advanced and emerging economies. The G-20 has asked the IMF to assist countries by developing an analysis of the consistency of individual country policy frameworks. In this way, the world's largest economies will be accountable to each other for adopting policies needed to ensure strong, stable and sustainable growth.

#### **IV. Concluding Remarks**

Let me conclude by saying that we stand at a major turning point in global governance and in economic development.

We all need to adapt to the new challenges presented by the current environment. To achieve this, all countries need to play their part. Close policy cooperation amongst the major countries was critical to overcome the most acute period of the crisis. It will continue to be important to ensure a sustained, stronger and balanced recovery. While the path ahead will not be easy, the unprecedented international commitment to find shared solutions to common challenges makes me very confident that we will be able to build a more stable and prosperous world economy.

It has been a pleasure speaking to you this afternoon. Thank you.

**NovaRes Team**