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Transcript

Challenges for the Global Economy

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Christine Lagarde:

Good morning. It's a pleasure to be here with you today, at this beautiful and historic venue. About six weeks ago, I spoke at a similar early morning event in New York, at the Council on Foreign Relations. These two sister organizations – founded in the wake of the Great War – have a common goal of fostering the ideas and dialogue needed to build a prosperous and secure world for all. Given the precarious state of the global economy, such dialogue is clearly essential. I wish to thank Chatham House for organizing this event, and thank my friend, Chancellor Osborne, for inviting me to speak. I look forward to hearing his views, as well as those of the eminent economists joining us at this roundtable.

The key message I wish to convey today is that countries must act now – and act boldly – to steer their economies through this dangerous new phase of the recovery. The world is collectively suffering from a crisis of confidence, in the face of a deteriorating economic outlook and rising concerns about the health of sovereigns and banks. All this is happening at a time when the scope for policy action is considerably narrower than when the crisis first erupted. But while the policy options may be fewer, there is a path to recovery.

Challenges for the global economy

Let me set out the principal economic challenges. The bottom line is that global activity has slowed, and downside risks have increased. At the same time, the global rebalancing of demand needed for sustainable global growth has stalled.

In key advanced economies, the necessary hand-off from public to private demand is not taking place. The fundamental problem is that weak growth and weak balance sheets – of governments, financial institutions, and households – are feeding negatively on each other. If growth continues to lose momentum, balance sheet problems will worsen, fiscal sustainability will be threatened, and the scope for policies to salvage the recovery will disappear.

In the emerging economies, performance has been considerably better. But in some countries, growth may be too fast, and policies are needed to contain overheating risks. Another issue is that in many of the key surplus economies, there has been little progress in shifting from external to domestic demand. In these economies, significant currency appreciation and structural reforms can help bring about the rebalancing needed to support strong, stable and sustainable global growth.

The picture I have painted is not a rosy one. But although the tools have become fewer, policymakers do still have options to support the recovery. The key, however, is for policymakers to act with conviction and urgency in tackling today's challenges – while at the same time being nimble, should circumstances change.

The time to act is now

For the advanced economies, there is no question that fiscal sustainability must be restored through credible consolidation plans. But we also know that consolidating too quickly will hurt the recovery and worsen job prospects. So the challenge is to find the pace of adjustment that is neither too fast, nor too slow.

The precise path of fiscal consolidation will differ by country. Those that are facing considerable market pressure, or could face it in the absence of upfront adjustment, must press ahead with fiscal consolidation now. But in others, there is scope for a slower pace of consolidation, combined with policies to support growth. The key is to clarify a credible medium-term strategy to first stabilize, and then lower debt ratios. Within this strategy, fiscal measures that reliably deliver savings tomorrow will help create space for supporting growth today – by permitting a slower pace of consolidation.

Monetary policy also has a role to play in the advanced economies. Broadly speaking, it should remain highly accommodative, as the risk of recession outweighs the risk of inflation. This is particularly true since inflation expectations are well anchored in most economies, and commodity price pressures are waning. So policymakers should stand ready, as needed, to take more action to support the recovery – including through unconventional measures.

I'd like to focus briefly on some of the key policy priorities for the United States, the Eurozone, and the United Kingdom.

First, the United States. Recent economic performance has disappointed, and downside risks to growth have increased. At the same time, agreeing on the policies needed to secure the required fiscal adjustment – while at the same time sustaining economic growth – has proven more difficult than expected.

Credible decisions on fiscal consolidation – involving future entitlement spending, but also other revenue and expenditure measures – would create some space for policies that support growth and jobs today.

We welcome the proposals announced by President Obama last night, which focus on supporting growth and job creation in the short term. As the

President also emphasized, it remains critical for the United States to clarify its medium term plan to put public debt on a more sustainable path, and we look forward to the proposed consolidation plan to be announced in the coming days.

Second, the Eurozone. Policymakers face two major and related challenges to the recovery: sovereign risks and banking risks. Because these two challenges are deeply intertwined, they must both be solved to clear the way to a sustainable recovery.

To address sovereign risks, many in the Eurozone need more fiscal action and more clarity about the availability of sovereign financing. Fiscal adjustment is critical for the long-term sustainability of public finances in many economies – not just in the program countries. And with regards to financing, it is essential that Eurozone leaders implement their groundbreaking July 21 commitments as soon as possible.

As this process unfolds, we should see a decline in sovereign risk – which should go a long way in removing some of the uncertainty weighing on European banks. As I have said before, this will take time. In view of the heightened risks and uncertainties – and the need to convince markets – some banks need additional capital. We must not underestimate the risks of a further spread of economic weakness, or even a debilitating liquidity crisis. That is why action is needed so urgently so that banks can return to the business of financing economic activity.

Third, in the United Kingdom strong fiscal consolidation is essential to restore debt sustainability, given the UK's very high structural budget deficit and large financial sector relative to GDP – which, as we've seen, can pose contingent liabilities for the government sector. The IMF's annual Article IV consultation with the UK authorities, which took place over the summer, supported the government's plans to move decisively on the fiscal front. But we also cautioned that there are downside risks and that policymakers should be nimble.

As we all know, the policy path was premised on a greater role for private sector demand – especially a robust recovery in exports – to take over as the public sector retrenches. But since the summer, the outlook has become more subdued – including in the rest of Europe and the United States, the UK's major trading partners. So risk levels are rising. The policy stance remains appropriate, but this heightened risk means a heightened readiness to respond – particularly if it looks like the economy is headed for a prolonged period of weak growth and high unemployment.

On the fiscal side, the free operation of automatic stabilizers – which are government tax and spending programs that automatically ease the pace of deficit reduction as GDP growth slows – provides an important cushion. And on the monetary side, there is room for additional easing if the outlook does not improve soon.

Before I close, I would like to say a few words also about the financial sector in the UK. One of the key findings of our analysis of spillovers between economies was that UK financial stability is a global public good, requiring the highest quality regulation and supervision. Recognizing this, the UK authorities' approach to stringent capital and liquidity regulations, including the emphasis on building buffers ahead of Basel III requirements, and intensive supervision is hence both commendable and essential.

But the stability of the UK financial sector also depends on a stronger international framework for oversight of cross-border financial institutions. Coordinated multilateral frameworks for crisis management need to be developed with clear principles to guide information exchange and cross-border bank resolutions. Making progress on this critical issue will require difficult policy decisions and increased cooperation from all stakeholders involved.

In just a few hours, I will be traveling to Marseille, to join the meeting of G-7 central bank governors and ministers of finance. I look forward to a discussion of the outlook and the balance of risks at this pivotal time for the global economy, and what this means for their policies.

We will also be focusing on the challenges facing the Middle East and North Africa. The region is experiencing a historic transformation, which also has significant economic and financial consequences. Clearly, the countries themselves must take the lead in charting their forward course, to building stronger and more open economies. But they will have a strong partner in the international community – including the IMF. More broadly, the IMF will continue to support its members as they seek the best policies to deal with the challenges they face today – be they advanced, emerging, or developing economies.

In two weeks, our members will come to Washington for the IMF Annual Meetings. Together, we will discuss the critical challenges facing the global economy. The road ahead may be rocky, but a way forward exists – if we act now. With each country playing their part, we can identify the actions needed to achieve strong, sustainable and balanced growth.

Thank you.