Dealing with global economic challenges - a view from the IMF Board[1]

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Tonight I want to talk about the policy challenges facing Asia and the global economy. My aim is to put the subject matter of today's conference – leverage in Asia – in a broader context.

But apart from focusing on specific policy challenges , I want to underscore the policy attitude or approach required to tackle the complex set of issues that face us today. Because these policy challenges are not just ones of calibration within a settled policy paradigm. Instead, we are developing and executing policy in a period of flux when some fundamental tenets of the profession – academic and practical – are being revisited.

So policy making is in some sense 'feeling the stones' as we cross the river, to draw on the well known Chinese allusion.

There are some elements when we are reasonably sure of the directions needed. However, in general, we need to approach domestic policy making with some measure of experimentation, flexibility and agility. As such, we need to apply a more generous amount of humility to our efforts than is often characteristic of our profession.

I will also urge that we need to have an open conversation internationally, with a view to making pragmatic steps to strengthen our international financial architecture.

The goal of course -- is to ensure that international cooperation can complement domestic action to achieve better growth and stability.

Conjunctural and structural factors bearing on policy

Let me briefly go through the key factors bearing on the outlook in Asia and to an extent globally. I will divide them into three baskets – conjunctural, legacy, and structural.

The key **conjunctural factors** are well known to this audience. For brevity, I'll list them.

1) The transition in the Chinese growth model – from export to domestic drivers of growth, from investment to consumption, and with an expanding role for the market particularly in capital markets. As we all know this is overlaid by adjustments associated with an advanced credit cycle and high leverage. An important element of this reform is that it will gradually integrate a large new capital market with global arrangements.
2) Related to this transition is the end of the commodity super cycle – oil price reductions have been the most recent and visible manifestation of this. For hard commodity exporters like Australia, the cycle turned three years ago. Several commodity exporters are facing a sharp economic adjustment.

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[1] The views expressed in this speech are those of the author and do not necessarily represent those of the IMF, the IMF Board or IMF policy. The speech benefited from input from Chris Stewart.

3) The normalization of monetary policy in the US – as we all know this raises strong opportunities if US economic growth and prices continue to strengthen, but it comes with some risks of volatility in international capital flows and asset markets.
4) Leverage and other vulnerabilities in many economies, but particularly so for some large emerging economies.
5) Geopolitical risks – the risk of internal or cross border tensions are present in several regions including our own. In a number of cases these risks coincide with the economic vulnerabilities I've noted.

At the same time policy makers are still dealing with **legacy issues** from the global financial crisis. In particular:

1) Deflationary pressures and a still-large amount of economic slack are characteristics of many economies. Even in the United States – the strongest advanced economy – there is weak price growth. In Japan and the Euro zone we have persistently low inflation and inflation expectations. More generally demand is weak and unemployment remains high in several key economies. And so too, in economies not at the epicenter of the crisis – like my own country Australia and our host country Korea – low prices and lingering economic slack have been notable features of their recent performance.
2) High levels of sovereign debt in many economies, which limit the room to maneuver in responding to these challenges, is another key crisis legacy.

Policy makers also need to contend with important **structural trends** that overlay these challenges, I will choose three:

1) Demographic changes in all advanced economies and some emerging economies, will have important implications for population and economic growth, budgets and capital markets. Refugee flows have added a unique new challenge to this.
2) Slowing trend productivity growth in almost all countries is reducing estimates of potential growth. This is also complicating the assessment of the current cyclical position in some economies.
3) The recent Paris conference has underscored the challenges of climate change. This goes way beyond economics but to this audience I would say this issue will increasingly feature in macroeconomic and financial policy setting frameworks. The test will be to deal with climate both decisively and efficiently to ensure we can achieve both environmental and growth and development imperatives. All the literature suggests this is possible, but it will take some time to develop appropriate policy responses, and finance ministries will need to remain highly engaged on these issues given their systemic importance.

I will discuss policy in detail in a moment, but it is worth noting that this brief list of issues would suggest a fairly clear policy prescription were it not for the legacy of the crisis. Advanced credit cycle dynamics domestically and the prospect of externally generated financial instability would all push monetary policy in the direction of prudence. Similarly demographics, legacy debt and the need to adjust to climate change, would suggest a consolidation bias in fiscal policy, which would be reinforced by precautionary motives. Indeed for many countries,

particularly emerging economies, that is the right policy prescription with the main feature being calibration against the backdrop of a slowing economy.

The presence of deflation and persistent economic slack, however, works against these policy instincts. It is the tension between these factors that is the key source complicating international policy making at present, and the different weightings of various policy objectives are the key source of international policy debate. Often one side of this debate does not seem to recognize the structural and debt aspects, while another appears to ignore the salience of legacy economic weakness. I am suspicious of policy prescriptions that do not deal with the entire range of factors I've outlined in a comprehensive and coherent way.

Policy making paradigms

I want to talk about the main themes emerging from what I've sketched out on the policy landscape for domestic policy choices and international cooperation. But before I do, let's step back and think about where we are right now in the international policy debate.

The period before the crisis was marked by a so-called Washington consensus. The elements of this consensus are well known, and consisted of open product, factor and capital markets, prudent fiscal policy, and with monetary policy focused on price stability and bearing the main work of counter-cyclical policy. At the same time there were several models extant in emerging economies that challenged this. Some were not so successful, including the state-led import substitution models of Latin America and much of the subcontinent. Others were relatively successful including the East Asian models, with a stronger role of the state particularly in capital allocation, though the strong provision of public goods like education no doubt played a role.

The crisis has had a huge impact on international policy paradigms. I think it is fair to say that the consensus has moved from Washington, but it is not clear it has moved to any other capital.

It is perhaps hovering somewhere in the middle of the Pacific.

The new emerging consensus consists of an amalgam of features included in previous models, and indeed reaches back into some previous strands of thought. It largely borrows from the Washington consensus a belief that relatively open product and labor markets are the best way to structure a modern economy. Again it considers flexibility in the exchange rate is generally a useful buffer, though with less attachment to free floats in emerging economies.

However it also borrows the skepticism of unfettered capital markets that has always been in Asian models of development, bolstered of course by the searing experience of the Asian Financial Crisis. The crisis taught us how important the underlying foundations in the financial sector are – they were part of the previous consensus but perhaps not emphasized enough, and with a bent toward reliance on market discipline. The key area where the consensus has shifted Westward from Washington is in the area of capital flow management with the development of a framework for that. While serving a different policy goal, there is a related focus on macroprudential policies as a regular part of cyclical policy consideration.

There are other important changes in the consensus. Views on the role of the state are in some flux. There is still basically a 'market failure' approach to the role of government, but we have just seen that the market fails in a few more areas than we hitherto had assumed. So there is more emphasis on the importance of public investment and more willingness for the state to be part of the financing process for private investment.[2]

On monetary and fiscal policy the framework has not yet settled, and I will return to this later.

Domestic policy considerations

Turning to domestic policy responses, there are some areas where a solid consensus is emerging.

Ensuring the basic micro-prudential foundations of the financial system are sound would appear a good place to start. While there are transitional issues for some economies, strong capital and liquidity arrangements, and effective supervision and crisis response mechanisms, seem close to a 'no-brainer' policy response when faced with the set of factors I've laid out.

The above diagnosis would also emphasize strong structural policy as the key – to lift potential growth, reduce demography pressures on budgets through lifting growth (acting on the denominator), and to validate elevated asset prices by opening up profitable investment opportunities. This involves ensuring labor and product markets are open and working effectively, and that tax systems are efficient.

The possibility of strong international monetary and confidence shocks call for a deliberate approach to handling capital flows. In some economies such as Australia, deep capital markets suggest a "hands-off" approach will work, though even here, extraordinary measures to guarantee bank borrowings were implemented in the depths of the crisis. Other economies will complement external buffers with careful capital flow management.

But in many other areas we are 'feeling the stones' domestically. We don't quite know the impact of monetary policy, particularly when it is near or breaches the zero lower bound. We are also not sure of the impact of protracted easy monetary policy. And we have not worked through all the implications of recent experience for our monetary policy frameworks.

We have discovered that fiscal policy is more powerful in both directions when monetary policy has become constrained. And precisely because of this, and the ZLB becoming a more common possibility, fiscal policy will likely need to bear more of the counter-cyclical burden. However, all the old issues associated with fiscal activism still remain – implementation lags, risks of 'one way ratchets' and associated problems with anchors, and the potential for Ricardian impacts in

[2] This is related to the extended poor performance of financial sectors in some advanced economies, and a wider sense that public investment is both underprovided under previous policies and has potential to improve both demand and supply conditions.

some circumstances. And fiscal policy will continue to be affected by its starting position (in terms of legacy debt levels), and external vulnerabilities. We have not yet, however, brought all of this together in a new operating model.

Furthermore, we don't yet know how effective macro-prudential policies are in practice, and whether we have the appropriate toolbox to meet the range of macro-financial tests that may emerge. We are in very early days with this experience.

Even in structural policies we are perhaps reaching the limits of the approach to 'getting the prices right.' That can still get you a long way, for example in the southern European economies where labor and product rigidities are still prevalent, and in many emerging economies where government is heavily distorting some key markets without compelling policy rationale.

And we can all point to areas in our own economies where "correct" prices are lacking – in infrastructure use for example, and the remaining sheltered industries. But it is not clear to me we have a handle on the policies needed to lift productivity and particularly innovation.

So we need to proceed with an attitude of careful experimentation. Evidence based policy means being alert to international experience. We need to ensure policy is not being set to 'fight the last battle,' but we also need to make sure the last battle is actually won! In the post GFC period it is arguable that policy was too focused in some major economies on the risks of reemerging inflation, and that fiscal policy reverted too quickly to a medium term orientation.

We need to now be alert, particularly as economies eventually appear to function more or less "normally," to when our GFC instincts are no longer useful. But we are by no means there yet.

Overall, we need to be humble about the state of our profession's knowledge and understanding of these experiences. The events of the last several years have challenged basic thinking. This uncertainty lends itself well to a new culture of openness, and to debate within policy circles which is now more critical than ever.

International cooperation

In the area of international cooperation, a similar attitude is warranted.

The Washington consensus suggested countries operating with sound policies were largely safe. For those that strayed, or were 'innocent victims' of external spillovers, there was a safety net to buffer the consequences of balance of payments crises or other financial panics. The safety net was sized to handle essentially non-systemic economies facing idiosyncratic capital flow problems, usually domestically sourced. The Asian Financial Crisis started to shift this thinking but not a great deal. Indeed the Fund was in the process of being downsized as the crisis hit.

This is not the world we are in today. The world is characterized by large gross capital flows, movements are not predictable, and not always based on country fundamentals. It appears that risks associated with volatile capital flows will continue to grow as markets respond to inevitable 'risk off' and 'risk on' events. And it is a fair bet this issue is likely to magnify as the

world develops a more multipolar system of capital source countries. Much will depend on China's success in sequencing its liberalization, but even in the most careful of scenarios, events are unpredictable. The outsized reactions seen in recent years seem to demonstrate this – whether taper tantrums or the responses to a reasonably minor change in RMB exchange rate setting mechanisms. Consequently, there is a concern in some emerging markets that they will suffer collateral damage from market events, regardless of the soundness of their policy settings.

At the same time there has been important progress. International cooperative architecture has improved with the emergence of the G20 providing a regular and more inclusive 'economic steering committee' function. Progress has been made in a number of key areas, including important understandings surrounding the conduct of macroeconomic policies[3], a consensus on the growth challenge and building financial regulatory and tax cooperation. While progress on IMF Governance is disappointing, the inclusiveness of policy discussions has also improved. Likewise, the recent decision on the inclusion of the RMB in the SDR basket is a tangible step in broadening representation in international financial arrangements.

And there are existing elements of international architecture in already place that can assist in responding to the capital flows mentioned. The IMF's balance sheet has expanded in response to the crisis. New tools have been introduced including precautionary vehicles that have clearly provided some countries with additional international firewalls. These tools remain limited by country choice, and it appears stigma still plays a large role.

There is also a variety of new additional resources that could potentially assist in some circumstances. RFAs provide the reality of additional support in Europe and the potential in the Asian region (CMIM) and among the BRICS (CRA). There are also response mechanisms in our region, including a contingent loan arrangement with Indonesia.[4]

Bilateral swap arrangements are growing though these are primarily aimed at dealing with temporary liquidity issues particularly in the form of bilateral foreign exchange markets. In that respect, perhaps they should not be regarded as part of the global safety net. Lack of liquidity in particular foreign exchange markets can of course be associated with crisis, and the network of regional swaps therefore provides some basis for cooperation in certain episodes of market stress. However, swap arrangements face a range of practical constraints as generalized crisis response tools even in those arrangements that allow for such support.[5]

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[3] Key examples include understandings around growth strategies, the objectives of exchange rate management, the importance of clear communication in macroeconomics

[4] This involves resources committed from the Australian Government, JBIC, World Bank and ADB. The arrangement is based on responding to debt market stress.

[5] Some swaps appear to have elements of broader balance of payment support, and indeed the CMI and NRA arrangements rely on swap arrangements rather than independently resourced lending facilities (like the IMF, ERM or bilateral contingent loan arrangements or swaps). Issues surround the willingness to 'lend' foreign exchange reserves in regional crises, and how this fits with the mandate of reserve managers. This suggests that swaps provide less certainty as a back stop than more

Nevertheless, there is a nagging question as to whether this architecture is fit for purpose given the pressures faced by the global economy. Notably, is there more scope to cooperate on arrangements to deal adequately with volatility in capital flows?

There are limits to greater practical cooperation on direct monetary policy settings, both conceptually and in practice. There would however appear more scope to cooperate on capital flow management tools and macroprudential policies at least in enhancing stable flows and reducing structural vulnerabilities.[6]

One further area to enhance cooperation is in the more traditional area of ensuring the adequacy of international firewalls and buffers to deal with hot capital flows. Given these issues will be in front of the IMF's Board in the year ahead, I do not want to get too much into detail on it, and even less into desirable responses. But now is a good time to progress discussion about this within international policy circles.

As such, it is worth laying out some questions to be addressed. Discussion will need to begin by examining ways to improve the take-up of existing tools in appropriate circumstances. It will also need to assess what amount of resources will be appropriate given possible shocks, and to compare this with resources available to elements of that safety net. A realistic review of those questions will focus our minds on how elements of the safety net can better fit together. The principles covering cooperation between the IMF and regional arrangements are reasonably established though there is more experience now to draw on, particularly in the European context.

In this regard, new questions may include: How will cooperation occur in practice between different types of global and regional safety net arrangements (committed resources versus swap based arrangements)? Are there mechanisms that can bring greater consistency between bilateral and multilateral elements? Are there developments in the multilateral system (eg types of enhanced surveillance) that can make countries more confident in building bilateral arrangements, or expanding them in a crisis?

We need to be careful in this area. This is well worn territory, there have been many attempts to bring about reform, and indeed existing reforms are yet to be fully tested. But there are new facets of the current conjuncture that warrant us updating our thinking, particularly in the area of the changing nature of international capital markets and the proliferation of arrangements outside of the IMF.

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established elements of the safety net which have committed resourcing, with established response protocols and arrangements.

[6] This is not to say there is not great advantage to be had from the more intensive exchange of views on monetary policies afforded by international fora like the G20, FSB and IMFC. There is also likely to be limited scope to cooperate in real time to impact on the policy tools bearing on capital flows in response to particular events.

These are big questions which again require humility, an open dialogue and engagement. We need to avoid the temptation to drag old models off the shelf, and focus on taking pragmatic incremental steps rather than contemplating untried (and in some cases more risky) grand systems. As with domestic policy, we will similarly need to 'feel the stones'.

Thank you for your attention.