Managing Director's Global Policy Agenda
IMFC, October 2012

The global recovery has suffered new setbacks *with uncertainty weighing heavily on confidence and prospects. Output is contracting in the euro area and growth has decelerated in many other advanced economies and major emerging markets.*

Markets have been buoyed by central bank action in the advanced economies *which provides an opportunity to lay the basis for a recovery. Policymakers must detail, and aggressively implement, measures to address the underlying weaknesses—fiscal, financial, and structural. In the* ***Euro area*** *the ESM and the OMT need to be deployed, banking union advanced, and national authorities should implement strong policies to credibly ensure fiscal consolidation over the medium-term and to raise growth and employment. In the* ***U.S.,*** *the immediate priority is to resolve the fiscal cliff and raise the debt ceiling, while developing an appropriately ambitious medium-term fiscal consolidation plan. In the Euro area, the Fund will support members' efforts by assisting in the development and monitoring of well-designed adjustment programs and providing analysis and advice on options for banking and fiscal union. For other advanced economies, the Fund will assess the implications of the underlying policy framework.*

Emerging market economies *face mounting risks from external and domestic vulnerabilities, amid reduced policy buffers. Policymakers should preserve policy flexibility to facilitate a response to adverse shocks and support growth. The Fund will support crisis bystanders with analysis of potential spillovers, including from volatile capital flows, and if needed financial assistance.*

Low-income countries *have been resilient but need to manage weakening external demand and, in some cases, adverse terms of trade shocks. Where growth remains buoyant, countries should rebuild policy buffers. Where growth slows sharply, existing buffers should be used prudently. The Fund will make available its concessional resources in support of strong policy frameworks and continue its capacity building efforts.*

Legacy issues will need to be resolved to anchor future growth*. Many countries face weak financial systems, elevated debt levels, and high unemployment, while global imbalances are likely to re-emerge. The Fund can play a lead role in supporting the membership to address these issues, drawing on its revamped surveillance toolkit.*

Enhancing the Fund's legitimacy is critical*. Ongoing quota and governance reforms need to be completed in a timely manner, and further progress made in enhancing the diversity of the staff.*

I. THE GLOBAL ECONOMY

Developments. *Central bank announcements in early September in Europe, Japan, and the U.S. have buoyed markets, but this comes against the backdrop of a world economy that has slowed further and more widely than anticipated at the time of the last IMFC meeting*.

- Activity in the advanced economies decelerated notably amid intensification of the crisis in the euro area and continued fiscal consolidation and balance sheet repair. Financial conditions in the euro area remain fragile with significant financial fragmentation having taken place.
- Growth in many emerging market economies has also weakened, notably in China, Brazil, and India, reflecting both home-grown and external factors. Low-Income Countries (LICs) have held up relatively well, but face intensified pressures of adverse spillovers—both from the advanced economies as well as from a growth slowdown in the major emerging markets.
- Falling non-food commodity prices as the global economy slows together with spikes in some food prices due to supply shocks add an extra burden to many countries, particularly LICs and some countries in the Middle East.

Policy record. *The pace of policy initiatives has accelerated, including in many of the areas identified at our last meeting*.

- The membership has delivered on many of its commitments. In addition to augmenting Fund resources—both GRA and PRGT—and following through on the 2010 governance reforms, most members have maintained accommodative monetary stances. Less progress has been made in the design and implementation of fiscal consolidation strategies and structural reforms, while only limited support for the Arab Countries in Transition has been provided.

- In the euro area, where risks are concentrated, work is underway to fortify the union: vigorous efforts have been made to stabilize financial markets, including the ECB's Outright Monetary Transactions; the European Stability Mechanism could be allowed to recapitalize banks; work on a banking union has been initiated; EFSF financial assistance to Spain of up to €100bn for recapitalization of banks was approved; and countries in the periphery have undertaken significant fiscal adjustment.
- In the U.S., following on from "Operation Twist" a third round of quantitative easing was launched and low interest rate guidance extended to mid-2015.
- In Japan, the consumption tax rate is being doubled to 10 percent and asset purchases under quantitative easing were increased in size and extended to end-2013.
- In Brazil, several rounds of stimulus measures were unveiled to revive the economy; and in China, banking rates were liberalized to advance financial sector reform and support growth. India also announced policy liberalization to support growth.

- The Fund has made a good deal of progress in strengthening its surveillance toolkit and mobilizing resources to support adjustment, delivering on the key tasks it was entrusted at the last IMFC.

Remaining Agenda: *But the policy record remains mixed, as key actions called for at our last meeting have not yet materialized.*

- In the euro area, despite the many policy steps noted above, policy implementation remains insufficient to achieve the strong and balanced growth needed to secure debt sustainability and facilitate rebalancing within the monetary union. In the advanced economies, despite progress in reducing deficits, debt ratios and risks remain elevated. In particular, the US fiscal cliff and debt ceiling remain unresolved.
- The larger emerging markets have introduced structural reforms that could support domestic sources of growth and contribute to global rebalancing, but more could be done. Arab countries in transition need adequate support for appropriate policy frameworks.
- While financial regulatory reform is proceeding, implementation is patchy and the reforms have yet to produce a safer set of financial structures.
- Regarding the Fund, additional actions are needed to complete the augmented safety net—by finalizing all bilateral borrowing arrangements and obtaining the needed approvals for the use of the windfall profits from gold sales to put the PRGT onto a sustainable footing. The 2010 quota and governance reform needs to be completed.

Assessment. *A lot has been done, but—with limited progress in addressing legacy issues such as debt overhangs and weak financial systems and continued uncertainty on key policies—confidence still has yet to be restored*.

- Projections for global activity in 2012 and 2013 are weaker than forecast in the April WEO. Downside risks—renewed euro area strains, the U.S. fiscal cliff and debt ceiling, and the slowdown in large emerging market economies—loom large, implying greater risks of broad contagion to bystanders.
- The intensification of fragmentation of financial systems in the euro area implies that the costs to the financial sector and real economy—for both the core and the periphery—will increase unless policymakers act more proactively.
- Decisive action is thus needed to put the global recovery firmly back on track and to strengthen policy and institutional frameworks to address the legacy issues and provide a sounder foundation for inclusive growth.
- For the Fund, just as for the membership, the key now is to act**—**the new program and surveillance toolkit should be employed, as appropriate, to support the membership to implement immediate policy responses and strengthen the global architecture.

II. Securing the Recovery

Global vulnerabilities in an increasingly interlinked world make a collective response an international, as well as domestic, priority. The specter of a protracted stagnation remains. Concerted action is needed, including policies to restore growth, address known vulnerabilities, and better position crisis bystanders to deal with adverse spillovers.

Advanced Economies. *Removing uncertainty by reaching a common understanding over the future policy path and rapid implementation of key measures is critical to restoring confidence and diffusing tail risks*.

- In the euro area, the ECB's actions have provided relief but need to be supported by actions to attenuate sovereign-bank feedback loops, facilitate market borrowing by sovereigns at sustainable interest rates, and address underlying fiscal and structural weaknesses. The ESM should quickly become operational and be used to directly support banking systems and sovereigns. More broadly, a common vision for a more complete monetary union, with integrated financial and budgetary frameworks, would help reverse financial fragmentation. Strong country specific actions remain key.
- In the U.S., early action is needed to avoid the fiscal cliff and raise the debt ceiling.
- In the U.S., Japan, and some other advanced economies, fiscal adjustment needs to be anchored by concrete and ambitious medium-term consolidation plans that are designed in a pro-growth manner.

*The **Fund's** role*:

- Assisting in the development and monitoring of well-designed and credible adjustment programs, including through the use of Fund resources, and a strengthened framework for debt sustainability analysis aimed at maintaining market access or paving the way for market re-entry;
- Helping to forge a common understanding through analysis and advice on options for achieving a euro area-wide banking and fiscal union; and
- Continuing to analyze the effectiveness of unconventional monetary policy, potential risks, possible spillovers, and potential exit strategies once the crisis abates.

Emerging Market Economies. *Many EMEs are facing slowing growth, mounting external risks, and reduced policy space*.

- The priority is to identify policy options to respond to slowing domestic activity without triggering asset price bubbles, rapidly increasing leverage, jeopardizing fiscal positions, or creating adverse spillovers. Policy responses will depend on national circumstances, but where there is scope additional support should be provided to domestic demand if growth continues to disappoint.
- Macroprudential frameworks should be strengthened to manage credit cycle and capital flows related vulnerabilities, while supporting the development of domestic capital markets.
- Countries should pre-emptively prepare for adverse shocks, including by identifying countercyclical measures and securing contingent financing. Vulnerable countries and crisis bystanders should seek assistance before they lose market access, to allow greater policy room for maneuver.

*The **Fund's** role*:

- Engage on policy options to deal with key macroeconomic challenges presented by volatile capital flows, and on the appropriate calibration of policies to support growth and employment while avoiding over-stimulating the economy;
- Assist crisis bystanders to develop strong policy frameworks that could be supported through precautionary or disbursing arrangements—SBAs or FCL/PLL—as appropriate. Reviews of recent Fund programs suggest that the Fund was able to better support adjustment programs during the crisis by providing large upfront financing, streamlined conditionality, and increased flexibility in program design;
- Consider options for strengthening Fund engagement with small states, taking account of the particular challenges they face; and
- Enhance the global financial safety net by clarifying relations—including arrangements for collaboration—with regional financing arrangements (RFAs), with the aim of safeguarding global stability.

Low-income countries. *Weakening external demand and adverse terms of trade movements for most countries have heightened vulnerabilities. In many countries, countercyclical fiscal policy space is more constrained than in 2008 due to weaker fiscal and reserve positions.*

- As long as growth remains buoyant, rebuilding policy buffers should have due weight in countries' medium-term macroeconomic frameworks and development needs.
- If external demand falls sharply, existing buffers will need to be utilized prudently to avoid pro-cyclical policy tightening. Official external financing would likely be needed for those countries facing severe financing constraints.

*The **Fund's** role:*

- Sustain intensive policy support and, where appropriate, financing to help LICs weather the adverse external environment and avoid a new crisis; and
- Enhance capacity building support for LICs, including in advice on natural resource management, sustainable financial deepening, and efficient strategies to support inclusive growth and lower debt vulnerabilities.

Middle East and North Africa. *The Fund, and the broader membership, must assist Arab countries in managing their historic transitions*.

Challenges:

- Social instability and political uncertainties remain substantial; fiscal and reserve buffers have been depleted over the past year leaving little policy space; weaker terms of trade, extensive food and petroleum subsidies, lower remittances, as well as the economic fallout from conflicts in the region, are adding to financing pressures.

Policy priorities:

- Maintain macroeconomic and social stability while limiting risks from imbalances.
- Define a structural policy agenda to restore investor confidence and promote high and inclusive growth.
- Secure commitments from international partners for official financial assistance to support the transitions.

*The **Fund's** role*.

- *Current*. Financial support to Jordan, Morocco and Yemen, ongoing discussions with Egypt, and additional capacity building programs in Libya and Tunisia.
- *Ongoing*. Sustain engagement via financing, policy advice, and capacity building.
- *Future*. Advise on structural reforms to promote inclusive growth to tackle high unemployment in the region and to design efficient policy options to achieve social objectives rather than reliance on untargeted and inefficient subsidies.

III. ANCHORING THE FUTURE

Credible policy frameworks need to be articulated now to support the recovery by removing the pall of uncertainty over the future.

- *The world economy looks very different from a few years ago. Many countries have very high levels of debt that could circumscribe policy space for many years to come. Financial sector incentives and regulation may need to be rethought, and existing growth models refined to deliver sufficient new employment opportunities.*
- *The **Fund's** revamped toolkit provides sufficient flexibility for it to play a lead role in addressing many of these issues. The focus now is on advancing this broad agenda to support the membership in providing a more secure basis for future growth*.

Strengthening financial systems. *The global crisis has exposed significant gaps not only in the financial regulatory framework but also more fundamentally in our knowledge of macro-financial interactions and basic data on financial systems*. Priorities include:

- Full, timely, and consistent implementation of the regulatory reform agenda by national authorities to avoid the risk of fragmentation within unified frameworks, as happened under Basel II. It is also critical to make progress with implementing an effective cross-border resolution regime.
- Progress on closing data gaps must also continue. Implementing data reporting and sharing for G-SIFIs with the official sector is needed to facilitate risk detection.
- Promoting financial deepening, including in emerging market and LICs, to improve their ability to cope with external financial and real shocks and support development.

The **Fund's** *Financial Surveillance Strategy* can assist by:

- Upgrading and integrating the instruments and products of financial surveillance to facilitate early identification and response to systemic risk, including across borders, and making bank funding models more robust;
- Closing gaps in policy analysis on macro-financial issues, such as understanding the feedback loops between finance and real economy and the sovereign, and the design of macroprudential tools;
- Working to fill data gaps, such as through the G-20/IMFC Data Gaps Initiative;
- Supporting members diagnose and address financial sector challenges, risks, and contagion mechanisms via bilateral consultations and the Financial Sector Assessment Program; and
- Engaging more actively with stakeholders, including serving as a global facilitator on macroprudential policy and in contributing to the design of the global regulatory reform agenda and to ensuring evenhanded, consistent, and full implementation.

High debt. *Debt levels have risen to levels typically only seen in war times and many countries face long-term pressures from entitlement spending and large contingent liabilities stemming from financial systems*. Priorities include:

- Credible medium-term fiscal strategies for many countries to gradually bring down debt ratios—public and private—and associated vulnerabilities need to be articulated and enacted and supported by measures to strengthen fiscal institutions.
- Where financing conditions allow, fiscal adjustment should occur at a steady underlying pace that avoids front-loading.

The **Fund** can assist by:

- Developing fiscal policy options to achieve the medium-term fiscal objectives, including by underlining their growth and distributional implications and the challenges imposed by ageing populations;
- Strengthening public and private debt sustainability analysis to help better identify vulnerabilities, while improving understanding of the links between financial sector risk and sovereign risk;
- Advising on effective and sustainable options for reducing subsidies; and
- Assisting in strengthening fiscal institutions to ensure better decision-making and more efficient use of resources.

Growth and jobs. *Unemployment rates, particularly among the youth, are very high in many countries, especially in Europe and the Middle East. A rebound in global growth will help, but even then the pace of job creation will need to accelerate very rapidly to absorb both the existing unemployed and new entrants coming onto the labor market.* Key steps include:

- Foster an enabling environment for private sector growth, including through action in factor and product markets.
- Design clear medium-term policy strategies to emerge from the legacy issues to remove policy uncertainty and support potential growth.

The **Fund** can assist by:

- Advise on growth-friendly adjustment strategies to minimize the employment impact in countries undergoing a period of fiscal consolidation, for example by better targeting social support and reforming taxes; and
- Deeper analysis, in collaboration with the World Bank and other relevant institutions, of the growth and employment consequences of policy actions.

Global imbalances and spillovers. *Global external imbalances have shrunk considerably, but largely on slumping demand in deficit economies. Imbalances are likely to widen again as the recovery takes hold unless major global players address underlying causes and mitigate the risk of outward spillovers*. Priorities include:

- In deficit countries, fiscal positions, which are distorting current accounts in many countries around the world, need to durably improve.
- But the world cannot devalue its way out of its problems. It is therefore equally important that policies to strengthen domestic sources of growth are decisively implemented in surplus countries.

The **Fund** can assist by:

- Analyzing policy spillovers and the multilateral consistency of national policies to allow a better discussion of the pros and cons of alternative policy options;
- Using the *Pilot External Sector Report* to examine global policy consistency as well as external sustainability;
- Using the *Integrated Surveillance Decision* to engage members during bilateral consultations on the impact of their policies on other countries, through interconnected financial and trade systems; and
- Continuing work on improving the functioning of the international monetary system to facilitate adjustment and support for countries suffering adverse shocks.

IV. Addressing the Governance Deficit

Quota and governance reform. *This ongoing process is essential to ensure the legitimacy of the Fund. Since the start of the reforms in 2006, the aim has been to realign quotas to better reflect members' relative positions in the global economy while preserving the voice and representation of the poorest members.*

Agreed reforms. *The 2010 quota and governance reforms included a doubling in quota resources, a substantial shift in quota shares, and accelerating the next stage in governance reforms*.

- Once effective, the quota share of dynamic emerging and developing countries will have increased by 9 percentage points, and a shift of quotas from over- to under-represented countries by 8.5 percentage points, compared to when the reform process began. The voice and representation of the poorest members has been protected.
- The reforms included a historic Board Reform Amendment that will make the Fund the first international financial institution to have an all-elected Executive Board. The number of advanced European chairs will also be reduced by two.
- To better align quotas with members' relative positions in the global economy, a comprehensive review of the quota formula is to be completed by January 2013 and the timetable for the 15th General Review of Quotas brought forward to January 2014.

Implementation status: *Very good progress has been made towards implementing the 2010 quota and governance reforms.*

- The required consents to the quota increase have been received, but the increase will only become effective once the Board Reform Amendment has been accepted.
- Acceptances of the Board Reform Amendment have been received from the required number of members, but approval remains short of the required voting power.
- Progress is also being made on changes in constituency composition, which will help realign the Board, even ahead of the passage of the Board Reform Amendment.

Agenda. *Expeditious implementation of the 2010 quota and governance reform is critical*.

- Discussions are also underway on a comprehensive quota formula review, with progress in some areas but divergent views in several important ones. Compromises will be needed if the January 2013 deadline is to be met.

Diversity. Promoting the diversity of IMF staff is a key component of enhancing the Fund's legitimacy. Good progress is being made, including increasing staff from under-represented regions—reflecting the senior staff Diversity Hiring Initiative and stepped up recruitment efforts. Various dimensions of diversity are monitored in an annual Diversity Report.