José De Gregorio: IMF challenges and policies for the global economy

Statement by Mr José De Gregorio, Governor of the Central Bank of Chile, speaking on behalf of the Southern Cone Countries of Latin America International Monetary and Financial Committee Meeting, Washington DC, 24 September 2011.

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In the past few months, the near-term prospects for the global economy have worsened significantly and financial risks have increased. What some time ago was a modest, albeit unbalanced recovery, risks turning into a new economic downturn, particularly in major Advanced Economies (AEs). This new scenario poses urgent challenges to the IMF and to the membership in terms of decisive political and policy responses to solve fundamental weaknesses and mitigate the negative impact of this new downturn. Against this backdrop, the Fund's surveillance capacities, and a well-functioning International Monetary System (IMS), are being and will again be put to the test only a couple of years after the 2008–2009 Great Recession and financial crisis.

I. The immediate challenges ahead and the fund's policy advice

Two forces are influencing each other and weighing down on economic prospects in major advanced economies. On the one hand, uncertainty and volatility have increased to their highest levels since October 2008, constraining credit and leading to more cautious behavior by households and financial institutions. On the other hand, fully credible medium-term fiscal consolidation in those economies with high debt burdens is still lacking, prompting even higher sovereign spreads and more calls for short-term fiscal retrenchment when private demand has yet to recover to its pre-crisis levels. The policy debate surrounding the appropriate fiscal and monetary policy mix, as well as the assessment of public debt sustainability, have become muddled. It would be paradoxical that only a few years after witnessing an example of successful global policy coordination and sound financial policies, which staved off another Great Depression, the lessons learned were to be ignored. The Fund can provide guidance and leadership on a number of issues, and the membership should heed its advice. In particular, we would like to note that:

- The political will to achieve meaningful short-term fiscal adjustment is more present in those core AEs where public sector financing conditions are benefiting the most from flight to quality, whereas in cases of more acute solvency concerns, and thus higher spreads, adjustment fatigue is dangerously settling in.
- The negative growth implications of further short-term fiscal retrenchment have not been given proper regard by the global community. The bulk of the evidence, and appropriate risk considerations in the weak economic environment of today, suggest much caution should be exercised when implementing short-term fiscal consolidation measures, especially in those cases where the long-term sustainability of public finances is not threatened.
- Structural reform fatigue is settling in, with electorates weary in both creditor and debtor countries to pursue tough measures to ensure medium-term fiscal consolidation and containment of the sovereign crisis in Europe. Moreover, financial markets remain jittery as the final outcomes of agreed commitments are not a foregone conclusion.
- The risk of disorderly outcomes is high, and balance sheet repair, especially of those banks most exposed to the European periphery, should be bolstered. Hoping for the best is no substitute for preparing for the worst, and the markets are well

aware of that. More extreme measures on debt restructuring might be unavoidable if fiscal transfers are ruled out and fatigue settles in debtor countries.

- In an environment of financial uncertainty and fiscal retrenchment, monetary policy should remain supportive.

Emerging Market Economies (EMEs) and smaller, financially stable AEs, are threading carefully in this uncertain environment, and as we saw a few years ago, it is unlikely that full decoupling will occur under most scenarios. The Fund's advice should properly recognize that the rebalancing challenges are not the same across this heterogeneous group of economies; thus, an adequate level of differentiation in terms of policy advice is called for. In this regard, we would like to note that:

- If the external scenario should worsen significantly, many EMEs with flexible exchange rates and inflation-targeting regimes would have scope to adjust monetary policy, thanks to a timely process of raising interest rates to contain overheating risks. Going forward, these economies will be able to react flexibly to changing global circumstances in a context of anchored inflationary expectations.
- Other EMEs have limited room for maneuver, as their economies have expanded beyond their potential output, with widening fiscal and external deficits, and thus today face the risk that external shocks might unhinge inflationary expectations and force pro-cyclical monetary and fiscal policy adjustments.
- A third group of EMEs has maintained structurally high national saving rates throughout the expansion phase of the global cycle and might be subject to a natural deceleration as the global economy cools down. In these cases, undertaking reforms to boost domestic demand would help sustain both medium-term global rebalancing and short-term policy accommodation.
- Economies that are being affected by high commodity prices, particularly Low-Income Countries (LICs), should strive to develop targeted policies to the most vulnerable groups through efficient cash transfers, instead of across-the-board subsidies. The international community should strive to support these efforts through similar measures, as demand subsidies or export constraints in non-LIC economies exacerbate commodity price pressures.

Policy advice by the Fund should be tailored to these different groups of economies. Policy recommendations that are appropriate for some economies are not necessarily suitable for other economies. One salient theme, however, is that fiscal policy space is more limited across the spectrum than it was in the run up to the 2008–2009 financial crisis. Moving from broad policy recommendations to concrete messages on policy implementation is required to draw the policy-makers' attention and establish a constructive dialogue. The Consolidated Multilateral Surveillance Report is a positive step in that direction.

II. The medium-term challenges and the fund's action plan

Under the current circumstances, the Fund should focus on its short-term policy challenges. Indeed, one of the main issues that the Fund is tackling right now, namely the Triennial Surveillance Review, will be shaped directly by the lessons that the practice and traction of surveillance reveal in the current uncertain environment. Such surveillance practices will be the basis on which to revamp the surveillance framework, for instance, through an integrated surveillance decision that encompasses both its bilateral and multilateral aspects.

The Fund's resource adequacy is, in our view, directly linked to the functioning of Regional Financial Arrangements (RFA) and the existence of bilateral central bank swap lines. It is welcome that major central banks are currently cooperating in this area. A reasonable question is whether current Fund resources, plus those available through RFAs and bilateral swap lines, are sufficient to deal with a significant major financial dislocation.

Assessing these resource needs is critical to evaluate whether, for instance, the New Arrangements to Borrow will have to remain active, even if the quota increase is fully implemented by next year. Moreover, the discussion of resources would have to be linked to a broader rethinking of the need for alternative lending instruments to bolster the global safety net.

This topic should be given higher priority at the current juncture and not, as in our previous IMFC meeting, simply as part of a broader agenda for IMS reform. The activation and deactivation, and the criteria for conditionality, for the Flexible Credit Line or similar instruments could be reviewed, towards making them closer substitutes to bilateral swap lines that have been implemented by major central banks. This would help reduce the stigma associated with the Fund's toolkit, and would contribute to ensure adequate liquidity provision in times of market stress.