Global Risks Are Rising, but There Is a Path to Recovery

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Listening to the many wise voices here over the last day or so, I am struck by several salient themes. The global economy continues to grow, yet not enough. Some of the main causes of the 2008 crisis have been addressed, yet not adequately. There remains a path to recovery, yet we do not have the luxury of time.

Two years ago, it became clear that resolving the crisis would require two key rebalancing acts—a domestic demand switch from the public to the private sector, and a global demand switch from external deficit to external surplus counties. On the first, the idea was that strengthened private sector finances would allow the engine of growth to switch back from the public to the private sector. On the second, the idea was that higher demand in surplus countries would make up for a lower spending path in deficit countries. But the actual progress on rebalancing has been timid at best, while the downside risks to the global economy are increasing.

Those risks have been aggravated further by a deterioration in confidence and a growing sense that policymakers do not have the conviction, or simply are not willing, to make the decisions that are needed.

Developments this summer have indicated that we are in a dangerous new phase. The stakes are clear: We risk seeing the fragile recovery derailed. So we must act now. It is a matter of vision, courage and timing. Decisive action will bolster the confidence that is required to restore and rebalance global growth.

We are not without options. We know what needs to be done to support growth, reduce debt, and prevent further financial crises. But we need a new approach—based on bold political action, with a comprehensive plan across all policy levers, implemented in a coordinated global way.

The Balance Sheet Problem

As we all know, a major cause of the crisis was too much debt and leverage in key advanced economies. Financial institutions engaged in practices that magnified, disguised and fragmented risk, while households borrowed too much. Experience tells us that these excesses (combining both housing and financial crises) take a long time to work off—and require decisive action. We have made some progress, but not enough to unshackle growth.

I am by no means downplaying what has been done. In 2008, governments took bold action to prevent a calamitous collapse in demand. They offset private contraction with fiscal expansion and used public resources to recapitalize financial institutions. They strengthened financial regulation, and reinforced the capacity and resources of international institutions. And monetary authorities did their part as well.

But today, it is public sector balance sheets themselves that are in the firing line. Today, the headline problems are sovereigns in most advanced economies, banks in Europe, and households in the United States. Adding to this—global growth is also being held back by policies that slow demand in some key emerging market economies while balance sheet risks are increasing in others.

The fundamental problem is that in these advanced economies, 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 policy instruments will lose their ability to sustain the recovery.

The Policy Agenda

What should be done? Clearly, the scope for policy action is much narrower today than in 2008. There are no easy solutions, but that does not mean there are no solutions.

Put simply, while fiscal consolidation remains an imperative, macroeconomic policies must support growth. Fiscal policy must navigate between the twin perils of losing credibility and undercutting recovery. The precise path is different for each country. But to meet the credibility test, each country needs a dual focus: a primary emphasis on durable measures that will deliver savings tomorrow which, in turn, will help to create as much space as possible for supporting growth today—at least by permitting a slower pace of consolidation where possible. For instance—measures that change the rate of growth of entitlements, health or retirement.

Monetary policy also should remain highly accommodative, as the risk of recession outweighs the risk of inflation. This is particularly true as (1) in most advanced economies inflation expectations are well anchored; and (2) pressures from energy and food prices are abating. So policymakers should stand ready, as needed, to dive back into unconventional waters.

Microlevel policy actions to relieve balance sheet pressures—felt by households, banks, and governments—are equally important. We must get to the root of the problem. Without this, we will endure a painful and drawn-out adjustment process. Structural reforms will surely help boost productivity and growth over time, but we should take care not to weaken demand in the short term.

While we can all agree on the broad brushstrokes of what needs to be done, the devil is always in the details. I would like to delve deeper into the different problems of Europe and the United States.

Europe

I'll start with Europe. Here, we need urgent and decisive action to remove the cloud of uncertainty hanging over banks and sovereigns. Financial exposures across the continent are transmitting weakness and spreading fear from market to market, country to country, periphery to core.

There are three key steps that Europe should take. First, sovereign finances need to be sustainable. Such a strategy means more fiscal action and more financing. It does not necessarily mean drastic upfront belt-tightening—if countries address long-term fiscal risks like rising pension costs or health-care spending, they will have more space in the short run to support growth and jobs. But without a credible financing path, fiscal adjustment will be doomed to fail. After all, deciding on a deficit path is one thing, getting the money to finance it is another. Sufficient financing can come from the private or official sector—including continued support from the ECB, with full backup of the euro area members.

Second, banks need urgent recapitalization. They must be strong enough to withstand the risks of sovereigns and weak growth. This is key to cutting the chains of contagion. If it is not addressed, we could easily see the further spread of economic weakness to core countries, or even a debilitating liquidity crisis. The most efficient solution would be mandatory substantial recapitalization—seeking private resources first, but using public funds if necessary. One option would be to mobilize EFSF or other European wide funding to recapitalize banks directly, which would avoid placing even greater burdens on vulnerable sovereigns.

Third, Europe needs a common vision for its future. The current economic turmoil has exposed some serious flaws in the architecture of the eurozone, flaws that threaten the sustainability of the entire project. In such an atmosphere, there is no room for ambivalence about its future direction. An unclear or confused message will add to market uncertainty and magnify the eurozone's economic tensions. So Europe must recommit credibly to a common vision, and it needs to be built on solid foundations—including, for example, fiscal rules that actually work.

The United States

In the United States, policymakers must strike the right balance between reducing public debt and sustaining the recovery—especially by making a serious dent in long-term unemployment. A fair amount has been done to restore financial sector health, but house price declines continue to weaken household balance sheets. With falling house prices still holding down consumption and creating economic uncertainty, there is simply no room for half-measures or delay.

So the United States needs to move on two specific fronts. First—the nexus of fiscal consolidation and growth. At first blush, these challenges seem contradictory. But they are actually mutually reinforcing. Credible decisions on future consolidation—involving both revenue and expenditure—create space for policies that support growth and jobs today. At the same time, growth is necessary for fiscal credibility—after all, who will believe that commitments to cut spending can survive a lengthy stagnation with prolonged high unemployment and social dissatisfaction?

Second—halting the downward spiral of foreclosures, falling house prices and deteriorating household spending. This could involve more aggressive principal reduction programs for homeowners, stronger intervention by the government housing finance agencies, or steps to help homeowners take advantage of the low interest rate environment.

The Global Dimension

Stepping back to a global perspective, as I said at the outset, rebalancing has not advanced sufficiently, despite the slow growth in deficit countries. In some key emerging economies, policies keep domestic demand growth too slow and currency appreciation too modest, if not blocked outright—even if this is not in their own or the global interest. Some other emerging markets—including those that have allowed their exchange rates to appreciate—are dealing with threats to economic and financial stability from capital inflows.

So the lack of rebalancing hurts everyone, while at the same time, everyone should recognize that decoupling is a myth. If the advanced countries succumb to recession, the emerging markets will not escape.

As we take a global perspective, we should not—and cannot—forget the low-income countries, where populations are especially vulnerable to economic dislocation in the rest of the world. These countries need to focus on protecting themselves from future storms—including by rebuilding policy buffers and investing in social safety nets. The international community, of course, must stand ready to help.

Conclusion—Risks Rising, but Path To Recovery

In sum, risks to the global economy are rising, but there remains a path to recovery. The policy options are narrower than before but there is a way through. There are lingering uncertainties, but resolute action will help to dispel doubts.

I am confident that with the right actions, strong, sustainable, and balanced growth can and will be restored.

As in the first phase of the crisis, we have reached a point where actions by all countries, doing what they can, will add up to much more than actions by a few.

There is a clear implication: we must act now, act boldly, and act together.

I can assure you that for its part, the IMF will continue to do everything in its power to advocate for this outcome, and to lend its material support wherever it is requested and relevant.