International Monetary Fund

“Global Challenges, Global Solutions” – an Address at George Washington University

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As Prepared for Delivery

Good afternoon, neighbors. It’s a great pleasure to be here today. I want to thank President Knapp for his kind invitation and to Danny Leipziger for organizing this event. I always enjoy speaking to students, and have done so all over the world. After all, you are the leaders of tomorrow, the people who will shape the future.

At the end of next week, the IMF will be having its Spring Meetings. This is the time of year when the finance ministers and central bank governors to whom we are accountable come to Washington to discuss the global economy. And this year, they will have a lot to talk about.

We are living in a very unique moment in history, a period of great upheaval. As you all know, the global financial crisis devastated the global economy and caused incalculable hardship and suffering all over the world. But it did more than this—it also devastated the intellectual foundations of the global economic order of the last quarter century.

Before the crisis, we thought we knew how to manage economies pretty well. This “Washington consensus” had a number of basic mantras. Simple rules for monetary and fiscal policy would guarantee stability. Deregulation and privatization would unleash growth and prosperity. Financial markets would channel resources to the most productive areas and police themselves effectively. And the rising tide of globalization would lift all boats.

This all came crashing down with the crisis. The Washington consensus is now behind us. The task before us is to rebuild the foundations of stability, to make them stand the test of time, and to make the next phase of globalization work for all. This rebuilding has three core areas—a new approach to economic policies, a new approach to social cohesion, and a new approach to cooperation and multilateralism.

Outlook

Let me begin with the economic situation. The global economy continues to recover, but the recovery is unbalanced *between* countries and *within* countries. Growth in advanced economies, the ground zero of the financial crisis, is still too low and unemployment is still too high. At the same time, the emerging market economies—especially in Asia and Latin America—are powering ahead, and dealing with overheating. The low-income countries proved remarkably resilient, but are now being hit by high food and fuel prices.

Great uncertainty still prevails. Indeed, numerous black swans are now swimming in the global economic lake.

After the great tragedy in Japan, the immediate priority is to alleviate human suffering and rebuild what has been destroyed. We are all impressed by the resilience of the Japanese people.

In Europe, some countries are at a crossroads—they have taken difficult steps, but need to do more. Ultimately, Europe needs a comprehensive solution—based on pan-European solidarity—to deal with lingering financial sector and sovereign debt problems. Progress has been partial and piecemeal so far, and this is a key risk for the crisis countries as well as for overall recovery in Europe.

The Middle East is going through a historic transformation. Citizens are seeking greater freedom, and a fairer distribution of economic opportunities and resources. Responding to these aspirations will require far reaching changes in political, economic, and social institutions. This will be a drawn-out process—institutional change on this scale takes time and effort. The immediate challenge is to preserve social cohesion without undermining macroeconomic stability. At a time of social unrest, nearly all governments in the region have tried—quite understandably—to cushion the impact of higher food and fuel price increases by absorbing them partly in government budgets. Of course, this extra spending will strain public finances in the period ahead. Political instability is also lowering tourism and FDI, and raising borrowing costs. This could derail further efforts to move toward a socially-inclusive growth model and create jobs to absorb the growing labor force. The international community must stand ready to help, now and in the years to come.

So, overall, the economic situation is still fragile and uneven, beset by great uncertainty.

A new approach to macroeconomic policy

Under the old paradigm, all monetary policy cared about was inflation and growth. But this was too simple. Before the crisis, great dangers lurked behind the facade of low inflation and strong growth—soaring asset prices, booming credit growth, investment biased toward housing, a financial crucible of toxic assets, and large current account imbalances.

In the old days, the financial sector was too often ignored. Financial regulation and supervision looked narrowly at individual institutions and markets, without paying much attention to broader issues of financial and macroeconomic stability. But a key lesson is that local events can have global repercussions.

Clearly, monetary policy must go beyond price stability, and look to financial stability. But this does not mean that the main tool of monetary policy, the policy rate, must expand its reach. Luckily, we have other instruments at our disposal—macro-prudential instruments like capital ratios, liquidity ratios, and loan-to-value ratios. We need to learn how to design and use these tools more effectively.

What about fiscal policy? Under the old paradigm, fiscal policy was definitely the *neglected child* of the policy family. Its role was limited to automatic stabilizers—letting budget deficits move up and down with the cycle—and discretionary policy was regarded with deep suspicion. But fiscal policy had a *Sleeping Beauty* moment during the crisis—with monetary policy running out of steam, and with the financial system on its knees, the forgotten tool arrived to prop up aggregate demand and save the world from an economic freefall. We need to rethink fiscal policy.

At the same time, the financial sector needs some major regulatory surgery. The crisis originated in a culture of reckless risk-taking, a culture that is unfortunately still alive and kicking.

There have been some positive steps, but these are only first steps. The Basel III accord on banking regulation should improve the quality and quantity of bank capital. But we need to extend regulation to the "shadow banking system". We need better supervision as even the best rules are worthless without proper implementation. We need better resolution mechanisms to end the scourge of *too-big* or *too-important* to fail—including along the critical cross-border dimension. We need a tax on financial activities to force this sector to bear some of the social costs of its risk-taking behavior.

Overall, I would say there are two broad conclusions. In designing a new macroeconomic framework for a new world, the pendulum will swing—at least a little—from the market to the state, and from the relatively simple to the relatively more complex.

A new approach to social inclusion

The new global governance must also pay more heed to social cohesion. Don't get me wrong—the old pattern of globalization delivered a lot, lifting hundreds of millions out of poverty. But this globalization had a dark side—a large and growing chasm between rich and poor. While trade globalization is associated with lower inequality, financial globalization—the big story of recent years—increased it.

The tendency was to downplay inequality, to see it is a necessary evil on the road to riches. But the crisis and aftermath have fundamentally altered our perceptions. The lethal cocktail of prolonged high unemployment and high inequality can strain social cohesion and political stability, which in turn affects macroeconomic stability.

Inequality might have been one of the “silent” causes of the crisis. On the eve of the crisis, inequality in the United States was back to its pre-Great Depression levels. Like the Great Depression before it, the Great Recession was preceded by an increase in the income share of the rich and a growing financial sector. In these circumstances, borrowing could have acted as a safety value for ordinary people to increase living standards—but on borrowed time.

Over the longer term, sustainable growth is associated with a more equal income distribution. There are many reasons for this. Inequality can hinder access to finance. It can make countries more prone to adverse shocks. It can reduce trust in institutions and encourage instability. And without a solid middle class, domestic demand is unlikely to take off.

We need a new form of globalization, a fairer form of globalization, a globalization with a more human face. The benefits of growth must be broadly shared, not just captured by a privileged few. While the market must stay center stage, the invisible hand must not become the invisible fist.

A new approach to multilateralism

The crisis taught us many lessons, but the greatest lesson is that cooperation is non-negotiable for stability. Without the cooperation spearheaded by the G20, we would probably have seen a second Great Depression. Today, this cooperation cannot simply fade away. The global economy is simply too interconnected to allow narrow national interests to prevail. I worry that this cooperation will not be sustained.

For the great challenges of today all require a collective solution. Think about rebalancing global growth. Countries that ran external deficits must rely more on external demand. Surplus countries must go in the opposite direction, shifting from external to domestic demand. This means putting global interests first, which is ultimately in the national interest.

Globalization must be seen as a common endeavor. Countries should not use currencies or trade restrictions for short-term gain. They should resist the temptation to entice business by easing financial sector regulations or undermining social protections.

In such a world, multilateral institutions—as forums of global cooperation—will become even more important. But they must stay relevant. They must adapt to the new globalization.

I am pleased to note that the IMF is playing its part. We played a key role in the crisis, drawing a line in the sand with our lending programs—including agreements with some advanced economies that few could have foreseen. Looking ahead, we are striving to better understand the complex interconnections running through the global economy. We want to strengthen our ability to prevent crises, not only manage them.

We have made many changes. We have a new early warning exercise. We have new spillover reports that look at how domestic policies in five key systemic economies affect the rest of the world. We have made our Financial Sector Assessment Programs mandatory for systemic countries. We are improving global monitoring of capital flows. We are working with the G20 to seek a cooperative path to higher growth. We are strengthening the global financial safety net to protect countries from sudden financial reversals of fortune.

But we must have legitimacy. We must reflect the economic reality of the 21st century. This is why the recent IMF governance reforms are so important. Last year, our members agreed to shift voting shares to the emerging market and developing countries by more than 6 percent—on top of a 2.7 percent shift in 2008. Brazil, China, India, and Russia are now among our top ten shareholders. This makes us better placed to fulfill our mandate, a mandate for macroeconomic stability that is more relevant today than ever before.

Conclusion

The challenge we face today is not new. Back in 1933, John Maynard Keynes—one of the founding fathers of the IMF—wrote the following: "*The decadent international but individualistic capitalism in the hands of which we found ourselves after the war is not a success. It is not intelligent. It is not beautiful. It is not just. It is not virtuous. And it doesn't deliver the goods. In short we dislike it, and we are beginning to despise it. But when we wonder what to put in its place, we are extremely perplexed*."

Today, we face eerily similar challenges. We are rebuilding after eerily similar circumstances, with eerily similar roots. And yet the post-war institutions proved enduring, leading to an extended period of peace and prosperity, cooperation and stability.

The IMF was born into this world. It was born into a world were multilateralism mattered. It was born into a world where the gains of growth were broadly shared. It was born into a world where the state and the market complemented and balanced each other.

Our task today is to rebuild this kind of world. Obviously, we do not want to go back to the 1940s. We do not want to go back to a time when a small number of countries dominated. We do not want to turn our backs on openness. But we can go back to the principles upon which this postwar economy was built. We can borrow from the past to reach the future.

The IMF has a key role to play here. It must reconnect with its original mission, which is to promote cooperation and fight the economic roots of war.

Many of you here are future leaders. Ask yourselves: what kind of world do you want to live in? Surely one that is *more intelligent*, *more just*, and *more virtuous* than the old one. Thank you very much.

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