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Global Challenges in 2012

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As prepared for delivery

Good afternoon. It's a great honor for me to be here, in Germany, in this great city of Berlin. Germany plays a vital role in Europe, in the global economy, and on the global stage. There can be no resolution to the crisis without Germany, and a lack of resolution will in turn hurt Germany, the euro area's economic linchpin. I can think of no more suitable place to make this point than the German Council on Foreign Relations, which has been at the forefront of the debate on Germany's role in the world for the past fifty years.

Before going any further, I would like to pay tribute to the tireless efforts of my good and highly-respected friends Chancellor Merkel and Minister Schäuble in seeking solutions to this crisis.

As we turn the page on a turbulent year, a year in which so much of what could go wrong did go wrong, many look to the future with trepidation and foreboding. They worry about uncertain economic prospects, dwindling job opportunities, and rising inequality. About what kind of future awaits their children.

Indeed, in the economic outlook that the IMF will release tomorrow, we will lower growth forecasts for most parts of the world. Even these lower forecasts assume a constructive policy path that is by no means assured.

In too many places, uncertainty is holding back demand and the willingness to lend. A legacy of high public and private debt is hurting economic prospects. The global financial system remains fragile.

In an interconnected world like ours, these forces are feeding each other across borders. Capital flows to emerging markets have already dropped off, and growth is expected to slow even in the most vibrant parts of the world economy. Low-income countries are especially vulnerable.

Yet before we indulge in yet another bout of collective pessimism, which is becoming something of a global sport, let me ask a simple question—why did 2011 turn out so badly?

I would argue that it was not because of any fresh wound to the global economy. No, it was driven instead by a lack of a collective determination to reach a cooperative solution. We saw many false starts and half measures in 2011—in Europe, but also, for instance, in the United States with its debt ceiling debacle.

Put simply, policymakers let an old wound fester, and in doing so made the situation worse.

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Looking at it from this perspective, 2012 must be a year of healing. But as Hippocrates put it long ago: "Healing is a matter of time, but it is sometimes also a matter of opportunity".

And today, it has to be an opportunity of our making. Otherwise, we could easily slide into a "1930s moment". A moment where trust and cooperation break down and countries turn inward. A moment, ultimately, leading to a downward spiral that could engulf the entire world.

I remain ever hopeful. I believe we can avoid such a scenario. I say this for a simple reason: we know what must be done. That is my core message to you today—although the economic outlook remains deeply worrisome, there is a way out. Now the world must find the political will to do what it knows must be done.

I would like to lay out the core elements of a policy path forward, in three broad aspects:

First, the path for the euro zone.

Second, the role of the rest of the world.

Third, the particular role and responsibility of the IMF.

Policies in the euro zone

I will start with Europe, which is at the center of concerns—not only because of the historical project it represents but, more pointedly, because of the extensive trade and financial linkages that bind everyone else to it.

In coming to grips with Europe's crisis, I want to acknowledge up front just how far the euro zone has come in addressing the new realities it faces.

Eurozone countries have established their cross-border safety net with the European Financial Stability Facility (the EFSF) and outlined a permanent version of it with the European Stability Mechanism (the ESM)—only two years ago, this was heresy. They have taken a harmonized approach to recapitalizing banks, and set up a systemic risk board. Governance reforms to enforce stronger and more effective fiscal discipline are in train and individual countries are taking tough decisions to rein in fiscal deficits. In addition, the European Central Bank has unleashed impressive resources to make long-term liquidity available to banks.

These major steps must be recognized. Yet I would not be the first to argue that these moves form pieces, but pieces only, of a comprehensive solution. Many within Europe are themselves making this point with increasing forcefulness.

Let me therefore offer my perspective on what remains to be done. There are three imperatives—stronger growth, larger firewalls, and deeper integration.

First, stronger growth. This has a number of dimensions.

With the euro area economy slowing sharply, inflation is already declining and we see a sizable risk that it will fall well below target next year, raising debt burdens and further hurting growth. Additional and timely monetary easing will be important to reduce such risks.

Stronger growth also means preventing banks from going into reverse gear, contracting credit in the face of market pressure. Solutions should focus on raising capital levels—rather than cutting back lending—as the way to boost capital ratios. Maintaining orderly funding conditions is also imperative.

On fiscal policy, resorting to across-the-board, across-the continent, budgetary cuts will only add to recessionary pressures. Yes, several countries have no choice but to tighten public finances, sharply and quickly. But this is not true everywhere. There is a large core where fiscal adjustment can be more gradual. Automatic stabilizers, which let tax revenues fall and spending rise as the economy weakens, should certainly be allowed to operate. And those with fiscal space should support the common effort by reconsidering the pace of adjustment planned for this year.

Some countries still have much to do to boost their competitiveness and growth potential. For this, structural reforms are critical, however medium or long-term their impact might be. As experience tells us, fiscal sustainability depends, ultimately, on generating long-term growth.

Second, we need a larger firewall. Without it, countries like Italy and Spain, that are fundamentally able to repay their debts, could potentially be forced into a solvency crisis by abnormal financing costs. This would have disastrous implications for systemic stability. Adding substantial real resources to what is currently available by folding the EFSF into the ESM, increasing the size of the ESM, and identifying a clear and credible timetable for making it operational would help greatly. Action by the ECB to provide the necessary liquidity support to stabilize bank funding and sovereign debt markets would also be essential.

We must also break the vicious cycle of banks hurting sovereigns and sovereigns hurting banks. This works both ways. Making banks stronger, including by restoring adequate capital levels, stops banks from hurting sovereigns through higher debt or contingent liabilities. And restoring confidence in sovereign debt helps banks, which are important holders of such debt and typically benefit from explicit or implicit guarantees from sovereigns.

This brings me to my third point—deeper integration. In a sense, the crisis is a crisis of incomplete integration. At the euro-area level, the fundamentals look good—the current account is balanced and inflation and the fiscal deficit are both low. But the euro area does not handle internal imbalances well. In addition, a single financial market cannot rely on legal and institutional frameworks that operate on an asymmetric national basis.

To break the feedback loop between sovereigns and banks, we need more risk sharing across borders in the banking system. In the near term, a pan-euro area facility that has the capacity to take direct stakes in banks will help break this link. Looking further ahead, monetary union needs to be supported by financial integration in the form of unified supervision, a single bank resolution authority with a common backstop, and a single deposit insurance fund.

The euro area also needs greater fiscal integration—it is not tenable for seventeen completely independent fiscal policies to sit alongside one monetary policy. To complement its "fiscal compact", the area needs some form of fiscal risk-sharing, which would allow for common support before economic dislocation in one country develops into a costly fiscal and financial crisis for the entire euro area.

A number of financing options are available to support such risk sharing, including the creation of euro area bonds or bills or, as proposed by the German Council of Economic Advisors, a debt redemption fund. Political agreement on a joint bond to underpin risk sharing would help convince markets of the future viability of European economic and monetary union.

Policies in the rest of the world

Let me now turn to my second broad area—policies in the rest of the world. I have dwelt on Europe only because it is at the epicenter of the current crisis and thus key to the global outlook. But other economies have at least as important a role in getting to a better outcome.

The United States, as the world's largest economy and the center of the global financial system, has a special responsibility. Yes, it is recovering, but at a timid pace, and unemployment—while declining—remains unacceptably high.

The key policy priorities must be to relieve the burden of household debt and to deal decisively with the issue of public debt.

On housing, we have been calling for ways to make mortgage debt sustainable, including programs to facilitate write-downs. I understand the legal and political complexities but the current strategy is not working satisfactorily, and we need a rethink.

On public debt, American policymakers need to find a way past the partisan impasse, grasping all reasonable means of bringing down tomorrow's deficits—including by reforming entitlements and raising revenue—without bringing down today's economy.

This brings me to another worrisome tendency in many quarters—to view fiscal policy as a morality play between profligacy and responsibility. Political and market commentary is too often cast in these terms. Yet markets themselves have been schizophrenic about fiscal tightening, at times rewarding it with lower interest rates, and at other times recoiling at the implied growth slowdown and pushing up interest rates.

To reiterate our advice: credible measures that deliver and anchor savings in the medium term will help create space for accommodating growth today—by allowing a slower pace of consolidation.

What about other countries and regions?

In Japan, there is no way to avoid a credible consolidation plan that brings down public debt in the years ahead. Japan also needs reforms to raise long-term growth.

Countries with current account surpluses, whether advanced or emerging, also have a role to play—primarily by shifting to domestic demand to support global growth. After all, global deficits will shrink only if surpluses shrink too.

Here, China can help itself and the global economy by continuing to shift growth away from exports and investment, toward consumption. To get there, I'm thinking of such measures as fiscal support to household consumption and expanding social safety nets, and liberalizing the financial system. These are all reforms that the Chinese government itself has embraced.

One more point: We must not let financial regulation slip off the policy agenda. We simply cannot carry on with the financial sector that gave us the global financial crisis. We need a safer and more stable financial system, one that serves rather than destabilizes the real economy. While policymakers have made a lot of progress, they still need to complete the reform agenda and ensure that the new standards are implemented in a way that is consistent across countries.

The role of the IMF

Let me now turn to the role of the IMF, my third and final issue.

Clearly, a cooperative path means that all countries must work together with a common diagnosis toward a common solution.

A key role of the IMF is to lay out the inter-dependencies between countries and push for a cooperative outcome.

But the IMF can provide much more than analysis, advice and exhortation.

It can also provide financing when needed. I am convinced that we must step up the Fund's lending capacity. The goal here is to supplement the resources Europe will be putting on the table, but also to meet the needs of "innocent bystanders" infected by contagion, anywhere in the world. A global world needs global firewalls.

In the coming years, we estimate a global potential financing need of $1 trillion. To play its part, the IMF would aim to raise up to $500 billion in additional lending resources. Right now, we are exploring options and consulting the membership.

In addition to resources, the IMF can also provide a "commitment mechanism" to lock in good policies when funding is not needed. Italy's request for IMF monitoring of its policies is a good example of this.

Finally, because there has been so much loose talk about special "European bailouts", let me reiterate a few points. Our financing is for all members, euro area or otherwise. We only lend to individual countries that request support and make strong policy commitments. That said, any support we provide to euro area countries must be anchored in a clear policy framework for the entire euro area. To safeguard our members' resources, we have a responsibility to lend into sustainable debt positions. Our role is to catalyze, not indefinitely replace, private financing.

Conclusion

Let me wrap up. Although we all know what must be done, I realize that none of this will be easy. I understand the great political challenges facing policymakers.

I understand the frustration of the Europeans, who have built such a remarkable project out of the ruins of World War II. No, monetary union did not get everything right, but the global financial crisis that started across the Atlantic exposed its vulnerabilities more starkly. I also understand why Europeans feel that the difficult decisions they have taken are not being sufficiently recognized.

I also understand the frustrations of the rest of the world. Just as they were picking up the pieces after the 2008 crisis, they watch their recovery being blown off course by trouble in Europe. They wait for a resolution to this crisis that never seems to come, on a continent they feel is rich enough to resolve its problems on its own.

I understand the pain felt in those European countries that need to adjust, and the difficulty of sharing the burden in a way that is socially fair. But I also understand the feelings in countries that have been thrifty, asked to help those who could have managed their economies more prudently.

But what we must all understand is that this is a defining moment. It is not about saving any one country or region. It is about saving the world from a downward economic spiral. It is about avoiding a 1930s moment, in which inaction, insularity, and rigid ideology combine to cause a collapse in global demand.

The longer we wait, the worse it will get. The only solution is to move forward together. Our collective economic future depends on it.

More than most, Germany understands the virtues of determined solidarity. Through its experiences with its Soziale Marktwirtschaft and unification, it showed what can be accomplished by bringing everybody together in service of the common good. The world needs a strong leadership role from Germany today, and it is Germany's core interest to provide such a role.

Let me end with a quote from Goethe: "It is not enough to know, we must apply. It is not enough to will, we must do." (Es ist nicht genug, zu wissen, man muss auch anwenden; es ist nicht genug, zu wollen, man muss auch tun). This is the challenge of our year ahead.

Thank you very much.