Making the Most of an Historic Opportunity: Three Principles for Reshaping the Global Economic and Financial Framework

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As Prepared for Delivery

It is my great pleasure to be with you today. I wish to thank Governor Yilmaz and the Central Bank of Turkey for inviting me to speak to you, and the Reinventing Bretton Woods Committee for their help in preparing this event. More generally, I thank the central bank, the Government of Turkey, and of course the city and people of Istanbul for hosting the Annual Meetings of the IMF and the World Bank.

Just a few weeks ago, we marked the first anniversary of the collapse of Lehman Brothers. The year that has passed since then has been incredibly difficult, and we will be dealing with the aftermath of the crisis for years to come. But this terrible crisis has also provided us with an historic opportunity to reshape the global economic and financial framework—and thus to lay the foundations for strong and sustainable economic growth going forward.

The decisions taken at the recent G-20 summit have been tremendously important in this regard. The leaders have provided the world with the tools to adapt global economic cooperation to the needs of the 21st century. This includes giving new voice to emerging economies. And a new mandate to the IMF. They have also bolstered the Fund's ability to support this endeavor, by committing to a rebalancing of quota shares that will go far in securing the Fund's legitimacy, and hence its effectiveness.

I believe we can achieve even more. Sixty years ago, following the calamities of the Great Depression and World War II, the world's leaders came together to create a new global order to advance peace and economic cooperation and established the United Nations and the Bretton Woods organizations.

Today, our leaders have a similar opportunity: to emerge from the financial crisis and achieve fundamental and lasting change that will benefit many generations to come. By recognizing that a globalized world demands global cooperation on economic and financial matters, our leaders are committed to working in new and more collaborative ways—to ensure prosperity and peace for all of us.

As we take on the challenge of reshaping the global economic and financial framework, we should keep our key objective firmly in focus: namely to obtain growth that is balanced, and that thus can be sustained. In other words, we must find ways to move beyond the costly boom and bust cycles that have been the hallmark of recent decades.

I see three principles that can frame our efforts to re-shape the post-crisis world in this manner:

First, international policy collaboration is essential.

Second, financial stability demands better regulation and supervision.

And third, the international monetary system must be more stable, and anchored by a global lender of last resort.

Economic Backdrop and Outlook

Let me begin with a few words on the economic backdrop and the outlook for the near-term. This will help set the stage for my remarks on the policy imperatives.

It is hard to exaggerate the damage inflicted by the crisis. Asset markets sold off across the world, decimating the savings of countless ordinary citizens. Global economic activity and trade experienced their steepest drops since World War II. Unemployment in the OECD economies has reached a post-war record high. And up to 90 million people in low-income countries may have been pushed into extreme poverty on account of the crisis.

Fortunately, the global economy has already embarked on a recovery. But growth will be slow—about 3 percent in 2010—and fragile, even if risks appear to be receding. And over the medium term, growth is likely to remain modest, and lower than in previous post-crisis episodes, reflecting the deep and lasting damage caused by the financial crisis.

What are the main risks next year? The biggest one is that the recovery stalls. This could happen if private demand in the advanced economies is too weak to take over as the main engine of growth, once policy stimulus and inventory restocking—which have been driving the recovery so far—lose steam. There is also a risk of reversal in financial markets, in particular if non-performing loans increase more than expected. Of course, things may also turn out better than expected, and we have had some favorable surprises in recent months.

What is certain to get worse, however, is unemployment. This is not just an economic problem that will affect demand, but a serious social problem, with painful consequences for families and communities. The crisis has already thrown about 15 million people out of work in the advanced economies—with more to follow as unemployment continues rising next year. Policies that support labor demand—for example, temporary cuts in employers' social security contributions and subsidies for workers put on short-time—are already working in many economies to stem job losses. More countries should adopt such measures. Also, active labor market policies, such as job search assistance and training, would help. Finally, we must do more to cushion poorer segments of the labor force from the unemployment crisis. Earned-income tax credits or similar support could work in this regard.

Given the risks I have just mentioned, macroeconomic and financial support measures must be kept in place until a sustainable recovery is underway, one that can deliver a lasting decline in unemployment. I am therefore very encouraged that the leaders of the G-20 pledged at Pittsburgh to avoid any premature withdrawal of stimulus.

But this does not mean that countries should delay preparing for the eventual unwinding of crisis support measures. Such preparations are essential for ensuring the credibility of macroeconomic policies going forward, and in particular for addressing legitimate concerns about fiscal sustainability.

International Policy Collaboration is Critical

Allow me to turn now to three principles that can support our efforts to build a better global economic and financial framework.

The first principle is that international policy collaboration must be an essential element of the post-crisis global economy. Such collaboration was critical for resolving the crisis, and will be critical for achieving strong, sustainable, and balanced growth in the future.

Over the last year, the resolute and rapid actions of policy makers across the globe were instrumental in averting a much deeper crisis. The decision to adopt a coordinated fiscal and monetary stimulus arrested the decline in output and stabilized financial markets. Countries have also been working together toward adopting sweeping reforms in the financial sector.

As we head into economic recovery, countries must continue to work together to achieve a successful transition to more normal economic conditions. Unlike during the crisis, when it made sense for stimulus measures to be adopted at the same time, I expect the timing and sequencing of normalization policies to vary across countries. Each nation's own pace of economic recovery and financial sector repair, as well as their available policy space, will matter. However, I do consider it important for countries to adopt common principles for the unwinding of crisis-related support measures.

Over the longer horizon, international policy collaboration will remain essential for achieving more balanced, and hence more sustainable, economic growth. Each country will need to do its part to achieve this goal. In some countries, savings will need to be increased further. In others, policies are needed to support increased domestic demand, including via structural reforms.

In the financial sphere, the crisis demonstrated clearly that because financial markets and institutions are so globally interconnected, policy makers in one country could not act unilaterally without consequences for other countries. In the post-crisis world there is a danger that to protect their economies and systems from external shocks, some countries will want to ringfence their institutions and withdraw from global markets. The concerns of these countries need to be taken seriously. We therefore should redouble our efforts to find ways for all countries to benefit from increasing financial integration, while at the same time ensuring that potential negative spillovers are contained.

At their Pittsburgh summit, the leaders of the G-20 made a strong commitment to international policy collaboration across a wide range of policy areas. Perhaps most importantly, they launched the "Framework for Strong, Sustainable and Balanced Growth". A key element will be a cooperative process of mutual assessment—or "peer review"—of their countries' policy frameworks, and the implications of these frameworks for global growth. The G-20 leaders also agreed to ensure that the regulatory system for banks and other financial firms reins in the excesses that led to the crisis.

The G-20 has given the IMF an important role in supporting such international policy collaboration. We have been asked to assist in the process of mutual assessment, by developing a forward-looking analysis of whether policies pursued by individual countries are collectively consistent with more sustainable and balanced trajectories for the global economy. The leaders noted that their mutual assessment process could only be successful if it is supported by candid, even-handed, and balanced analysis of their policies—and thus called on the IMF to support the process.

This new responsibility is very much in line with our mandate, which requires the Fund to assess the consistency of all our members' policies, and their implications for the stability of the global economic and financial system. These surveillance efforts allow us to provide critical inputs to the international policy debate—for example, our call for an early and significant fiscal stimulus to cushion the crisis.

However, our recommendations have not always been able to bring about effective policy action. In this regard, the G-20 peer review could be a valuable complement to IMF surveillance. Other ways our surveillance could gain better traction include better use of our cross-country perspectives, as well as new forms of engagement. For example, we have launched an Early Warning Exercise (in close cooperation with the Financial Stability Board) that focuses on systemic tail risks and vulnerabilities.

Financial Stability Requires Better Regulation and Supervision

The second principle stems from the most straightforward lesson of the crisis, namely that financial stability demands better regulation and supervision.

While we can identify many factors that contributed to the crisis, one key failing was inadequate regulation and supervision. Even where appropriate regulation was in place, implementation and enforcement could have been much stronger. And because the regulatory environment focused on risks of individual institutions or markets, the potential for a buildup of systemic risks was not sufficiently appreciated. Supervision problems also played a role, with an attitude of "the private sector knows best" leading to serious lapses in oversight.

These lessons are widely recognized, and have provided the basis for ongoing reform efforts. Valuable progress has already been made in several areas, including strengthening prudential oversight, improving risk management, increasing transparency, promoting market integrity, and reinforcing international cooperation.

But more work is needed. In their Pittsburgh communiqué, the leaders of the G-20 called for speeding up progress in several areas, which in my view are essential for creating a new financial regulatory framework that can deliver stability yet at the same time not stifle innovation.

They committed to developing, by the end of 2010, international rules to improve both the quantity and quality of capital and to discourage excessive leverage.

They endorsed the recommendations of the Financial Stability Board on compensation practices, which aim at aligning compensation with long-term value creation rather than excessive risk-taking.

They called for improvements in over-the-counter derivatives markets that improve transparency, mitigate systemic risks, and protect against market abuse.

Finally, they aim to make significant progress, also by the end of 2010, in addressing problems related to cross-border resolution issues and systemically important financial institutions.

Returning to more immediate concerns, we need to move faster to repair bank balance sheets. This matters because financial institutions still saddled with impaired and illiquid assets are slowing credit creation, with worrisome knock-on effects for growth. In addition, stress tests of bank balance sheets are still needed in several countries to gain a full understanding of where more capital is needed—and where future problems may arise.

To get credit intermediation going again, we also need to restart securitization markets. Understandably, these markets have gotten a very bad name as a result of the crisis—after all, it was securitized sub-prime loans that got the mess started. However, if properly regulated, these markets can provide significant benefits, namely by diversifying credit risk outside the banking system, and by providing an alternate source of funding.

What relevance do the lessons of the recent crisis have for financial development in emerging and developing countries? It would be tempting to conclude that the "modern" financial model should be consigned to the dustheap of history—and that therefore, financial development should be halted. But this would be the wrong conclusion. By enabling banks and capital markets to match up savers and investors—both within and across countries—ever more efficiently, financial development has played a vital role in supporting economic growth. It should be allowed to continue to play this dynamic role—though of course within a framework that controls excess risk, at the same time that it rewards innovation and effort.

This financial reform agenda is without doubt both challenging and complex, and meaningful progress will take time. But let us not forget that time is the enemy of reform. I am very concerned that as financial markets recover, complacency is setting in. Also, a clear vision for the future of financial system regulation is needed urgently to reduce uncertainty and boost confidence.

There is also a danger that in the absence of any new regulatory constraints, asset bubbles may emerge once again. The abundant liquidity pumped into the system in response to the crisis—which was an essential lifeline for the financial sector—is now available to investors as they search for higher returns, for example in emerging markets. While these flows are not harmful per se, they do raise risks of a sudden reversal of capital when advanced economies embark on monetary tightening. Another risk relates to systemically important institutions, which are now even larger as a result of the consolidation that occurred during the crisis. New rules and regulations that address the particular risks that these institutions pose to the financial system and economy at large are therefore needed urgently.

The IMF is not the global financial regulator. But ongoing improvements of our financial sector surveillance could help in this effort. We have also modernized the Financial Sector Assessment Program, by sharpening the focus of assessments, making them more flexible and nimble, and strengthening their analytical content.

It is clear that we must make use of this historic window of opportunity to revamp the financial sector framework. The time is now to build a safer, more stable financial system that can support sustainable economic growth over the long term.

A Strengthened International Monetary System, with A Global Lender of Last Resort

Finally, let me put forward a third important principle for the post-crisis global economy, which is namely the need for a stable international monetary system that is anchored by a global lender of last resort. In recent years, we have seen a very large increase in official foreign reserves, primarily in the emerging economies, but also in developing countries. Overall, foreign reserve holdings have risen from about $2 trillion in the late 1990s, to over $8 trillion today. What has driven this accumulation? In my view, the absence of adequate insurance to guard against sudden stops in private capital flows has played a major role.

In theory, the IMF should have been able to provide the financial insurance demanded by these countries. However, concerns about the amount of financing available from the Fund, and also the conditions attached to this financing, caused countries to self-insure instead.

But such self-insurance—as opposed to collective financial insurance—is costly. At the country level, investing in foreign reserves is inefficient because of foregone alternative investments, such as education or infrastructure, which could have a much higher social return. It also complicates monetary and exchange rate policy, since accumulating reserves means injecting domestic liquidity into the system, which can stoke inflation.

There have also been costs at the international level. Countries wishing to build up their reserves—to protect themselves from capital outflows—have tended to follow export-led growth strategies, which have produced current account surpluses. These, in turn, have contributed to ever-widening global imbalances, with damaging consequences for the sustainability of economic growth and the stability of the international monetary system.

The recent experience has demonstrated that fast-paced and hard-hitting financial crises can lead to an extraordinarily large demand for official resources. And given the costs associated with reserves accumulation, there is clearly a need for reliable emergency financing—and hence for a global lender of last resort.

I believe that the Fund has the potential to serve as an effective and reliable provider of such insurance.

The global community has already provided a strong endorsement of the IMF as the key institution for meeting the financial needs of economies in crisis. At their summit in April, the G-20 called for a tripling of IMF lending resources to $750 billion. I am pleased to report that we have already received commitments to meet this target, and even expect to exceed it. This has allowed us to deploy financial resources in unprecedented amounts to support a broad array of countries, thus erasing earlier doubts about the Fund's ability to meet financing needs. To date, we have already committed more than twice the amount that we lent during the Asian crisis.

We have also made important changes to our lending instruments that improve their reliability. With the introduction of the Flexible Credit Line, the so-called FCL, the IMF now offers a pre-emptive insurance facility for members with strong policies. So far, Mexico, Poland and Colombia have used this facility. Their decision to take out financial insurance with the IMF was well-received by markets, as reflected in the decline in their sovereign spreads. More generally, IMF lending instruments have been made more responsive to conditions in member countries.

Finally, to boost global liquidity, our membership agreed a $283 billion SDR allocation. Of this, about $110 billion has gone to emerging and developing economies, thus providing a welcome boost to their reserve holdings.

The resources made available and pledged to the IMF were extremely helpful in stabilizing markets at the peak of the crisis. But they are temporary or contingent. Specifically, the $500 billion in new lending resources have been made available through the so-called New Arrangements to Borrow, a system of credit arrangements with a number of member countries and institutions. These are arrangements are temporary, requiring approval every five years. They are also contingent, because they are activated only when a crisis is either clearly looming or already underway. These conditions could add an element of uncertainty to the availability of Fund crisis financing. And while our new lending resources have proved sufficient so far, they may not be enough to reassure our members and financial markets that they would be sufficient to meet future crises.

This uncertainty means that the IMF cannot yet serve as a credible global lender of last resort. And because providing global financial insurance is so critical for crisis resolution and crisis prevention, the resource base of the IMF should be increased further. How much is needed is of course a difficult question—some have said $1 trillion, while others think the resource base should be far larger than that. There is also the question of how additional resources would be provided. To ensure credibility, a quota increase—which entails securing permanent additional resources—would be an important part of the solution. At the same time, we should also assess the role that regional reserve pooling arrangements could play as additional providers of financial insurance, and of possible cooperation between the IMF and such arrangements.

We could also do more to explore other options to enhance the stability of the international monetary system. For example, to address global liquidity pressures, SDR allocations could be made more responsive to global developments and flexible to country circumstances.

Finally, we should find ways to make our resources serve our members better. One possibility is to build on the success of the FCL and enhance predictability of access to IMF crisis financing. A specific option here would be to make consideration of FCL eligibility an automatic part of regular surveillance. And for members that do not qualify for the FCL, we could consider designing alternative contingent instruments that also have an element of automaticity.

Closing Thoughts

There is one more issue that I wish to address, which matters greatly for the effectiveness and relevance of the Fund across the entire range of its responsibilities: governance reform.

The Fund cannot succeed in its efforts—whether surveillance, financial support, or technical assistance—unless all our members regard it as *their* institution, furthering *their* common interest and *their* strategic goals. Such legitimacy is essential for our surveillance to be considered even-handed and independent, and hence for it to be effective. It is also a critical prerequisite for the IMF to serve as a credible global lender of last resort.

It is for this reason that the G-20's recent agreement to modernize IMF governance is truly historic. The leaders committed to a shift in quota share to dynamic emerging market and developing countries of at least five percent, from over-represented to underrepresented countries. The current IMF quota formula will be used as a basis from which to work. The leaders also committed to protecting the voting share of the poorest members of the IMF.

I call on all 186 of our member countries to move quickly to make this commitment a reality, hopefully before January 2011. In this regard, I also urge our members to proceed swiftly with the ratification of the April 2008 quota and voice reform.

A number of other reforms would also improve governance at the Fund. We should strengthen the channels by which the Fund's Governors give strategic direction to the institution, and hold it accountable for following them. We should also ensure that the selection of the Managing Director of the IMF, and of our senior leadership, is based on an open, transparent, and merit-based process.

I am firmly convinced that these changes will allow the Fund to make a valuable and lasting contribution to building a new global economic and financial framework. This will not only help the world secure prosperity, but will also provide a basis for a more harmonious, and hence more peaceful, coexistence of the entire world's people.

As we work together to resolve the problems of today and meet the challenges of tomorrow, I find inspiration in the words of Kemal Atatürk, the founder of the Republic of Turkey. About 75 years ago, he said that "Countries are diverse, but civilization is one, and it is necessary to participate in this single civilization for the progress of the nation."

For the good of your own people, and for the good of all people—let us continue to work together, in building a stable and prosperous global economy.