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September 4, 2009**

As Prepared for Delivery

*“Beyond the Crisis: Sustainable Growth  
and a Stable International Monetary System”*

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Sixth Annual Bundesbank Lecture  
Berlin – September 4, 2009

It is a great pleasure to be here today, speaking to this eminent audience at such a pivotal time in global economic and financial affairs.

I will begin with a few words on the economic outlook, before addressing three key issues that arise when we think about moving beyond the crisis.

The global economy appears to be emerging at last from the worst economic downturn in our lifetimes. Several advanced economies, including France and Germany, have already returned to growth, and emerging economies are recovering even more strongly.

However, I expect this recovery to be relatively sluggish. In the advanced economies, it is still largely driven by policy stimulus and restocking, with underlying private demand remaining weak. The outlook for the emerging economies is considerably better, though the pace of recovery in advanced trading partners remains a risk.

Given the fragility of the recovery, there are risks that it could stall—though thankfully these risks appear to be receding. Premature exit from accommodative monetary and fiscal policies is a principal concern. In addition, problems in the

financial sector could persist or even intensify further, particularly if efforts to restore banks to health are not completed.

Let me also add that international coordination of exit strategies will be just as important, if not more important, than the very good coordination we have seen already in response to the crisis.

Looking ahead, I am concerned about the third phase of this crisis following on the heels of the financial and economic phases—namely high unemployment. We expect unemployment to continue rising through next year, as economic growth falls short of potential. And a jobless recovery remains a risk. Having so many people out of work has significant economic costs, ranging from lower private demand to a decline in potential growth if structural unemployment rises. The social consequences are potentially even more worrisome.

For these reasons, I believe that policy makers should err on the side of caution as they decide when to exit from their crisis response policies. Having said this, I do think the time is right for policymakers to develop their exit strategies—because failure to clarify and formulate these plans will risk undermining confidence and the recovery process itself.

In my remarks today, I want to focus on three questions related to the global economy's transition beyond the crisis.

- First, what will be the new sources of growth?
- Second, are we addressing problems in the financial sector with sufficient urgency?
- And third, how can the stability of the international monetary system be improved?

Of course, there are other issues. One of the most important is probably what needs to be done to support the low-income countries. I will address this point in detail in a separate speech this month.

## I. WHAT WILL SUSTAIN THE RECOVERY IN THE COMING YEARS?

Let me now turn to the first of my three points: what is needed to sustain global growth in the coming years.

### A. Demand-side issues

Let me begin with the fundamental question at hand, namely what the sources of growth will be in the coming years.

At the national level, the baton will eventually need to be passed from the public to the private sector as crisis response policies are unwound. However, as I will discuss in more detail later, the time to exit from stimulus measures will depend to a large extent on the recovery of private sector demand.

At the global level, weaker demand in some economies will need to be offset by stronger foreign demand in other countries. In fact, dramatic changes in global demand are already taking place. For example, household saving in the U.S. has risen to 5 percent of disposable income, from about zero a few years ago. This, combined with weaker investment, has reduced the U.S. current account deficit dramatically. Similar changes are taking place in other current-account deficit countries.

These developments are in line with what the Fund had been asking for many years already. Our assessment was that the very high current account deficits that some countries had been running were unsustainable in the medium term, given rising concerns about foreign indebtedness. Indeed, the need for rebalancing underpinned the IMF-sponsored Multilateral Consultations on Global Imbalances that took place in 2006/07.

The policy imperatives for achieving a sustainable rebalancing of global demand will be familiar to many of you.

- In advanced economies, rapid progress toward fixing the financial system is essential to support productivity and growth.
- In emerging Asia (notably China), structural efforts that boost domestic spending, such as improving access to credit for households and small-scale

business, should be accelerated. Stronger social security systems and higher spending on education and health would also help reduce precautionary saving.

- Also in emerging Asia and oil exporters, public investment spending (concentrated on infrastructure and also on “green” initiatives) would boost domestic demand.
- More flexible exchange rate management in some countries would be a valuable policy complement, increasing demand for imports in current-account surplus countries and encouraging a shift in resources from tradable to non-tradable sectors.

Global rebalancing of demand could also have important implications for investment and innovation. With consumers in emerging markets playing a bigger role, the composition of global production is likely to change. For example, we could see demand for high-technology goods decline. This makes it all the more important for policy makers to accelerate reforms that reduce barriers to competition and thus support innovation.

## **B. Supply-side issues**

Allow me to turn now to some important supply-side issues more generally.

History suggests that the financial crisis may inflict long-term damage on the supply capacity of the economy. The sharp fall in investment may lower effective capital, and job losses may be translating into higher structural unemployment.

Reforms that boost productivity have therefore taken on renewed importance. Labor market reforms, including those that increase labor market flexibility and support job search and training, can facilitate the redeployment of workers from crisis-hit sectors to other, more vibrant parts of the economy. Product market reforms—particularly in services—could create new jobs and boost productivity. Financial sector reforms would also boost efficiency (even though financial sectors are likely to shrink in advanced economies).

Here in Europe, I would urge leaders to recommit themselves to the Lisbon agenda. Reforms under this program had already helped raise employment across the continent before the financial crisis erupted. But for many EU economies (including Germany), there is still room for improvement in service sector productivity. Reducing regulatory constraints would be a good step in this direction.

Efforts to boost the “green” economy could also play a role. A number of countries have already undertaken “green” stimulus measures—for example, to improve energy efficiency—that are helping to sustain aggregate demand and employment. These measures could also have powerful induced effects on technological innovation. Advances in “green” technology could even become the microprocessor revolution of tomorrow—while at the same time helping address global climate change.

### **C. Exit policies**

As I said earlier, I see a real danger that policy makers may jeopardize the recovery by exiting from crisis measures too soon. Having said this, the time is right for policy makers to formulate their exit strategies.

Addressing concerns about fiscal sustainability—and hence macroeconomic stability—is of the first order of importance. The advanced economies are currently on an unsustainable path, with the average public debt-to-GDP ratio set to rise to 115 percent of GDP by 2014. Significant fiscal adjustment will therefore be essential to ensure debt sustainability. Given the scale of the problem, plans for achieving this adjustment are needed now to anchor market expectations and contain long-term interest rates.

The most important step is to contain pension and health care costs. Indeed, in the advanced economies the net present value of future spending due to aging is more than 10 times the fiscal cost of the crisis. While cost-cutting reforms in this area may be politically difficult, they are essential to ensure fiscal sustainability. In some countries, reforming spending beyond education and health may also be necessary, while tax reform may be critical in others.

Turning to central banks, they will face challenging decisions of when and how to tighten policy. I do not see this as an immediate concern, since inflation is unlikely to reemerge until the recovery is firmly underway. However, exiting will require difficult decisions, complicated further by the complex technical and operational problems posed by the enormous expansion of central bank balance sheets. For example, unwinding the unconventional measures taken by central banks (such as term lending facilities) will affect monetary conditions. Therefore, to anchor inflation expectations securely, central banks will need to be exceptionally clear in communicating their assessment of price pressures—as well as their view of conditions in the financial markets.

Central banks may also face challenges to their independence. Political pressures to “inflate the debt away” could emerge. These must be resisted, given the serious and potentially long-lasting costs of inflation. In addition, concerns about potential capital losses from expanded balance sheets could distract central banks from focusing on price stability and supporting economic recovery. Governments must therefore provide assurances that they will back up their central bank’s capital.

Finally, let me repeat how important it is to continue supporting demand until the recovery has firmly taken hold. Unwinding the stimulus too soon runs a real risk of derailing the recovery, with potentially significant implications for growth and unemployment. Therefore, exit policies should only be launched once there are clear indications that the recovery has taken hold and that unemployment is set to decline.

## **II. REFORM OF THE FINANCIAL SECTOR**

I turn now to my second question, which focuses on the financial sector.

With the one-year anniversary of the Lehman Brothers’ collapse just around the corner, it’s a good time to take stock of the progress made so far in reforming the financial sector—and of what still needs to be done.

### **A. Crisis response measures**

I am heartened by the stabilization of financial markets that has taken place over the last year. Credit and equity markets have rebounded. Bank liquidity is plentiful, thanks to central bank provisions, and wholesale money markets have reopened. Capital markets are showing renewed signs of life, and are contributing to the recovery of financial institutions.

But I still see serious downside risks to financial stability. Mounting delinquencies mean banks remain under strain, with developments in the commercial real estate sector of particular concern. Private securitization markets are still impaired. And households and the financial sector continue to deleverage.

I also worry that the improvement in financial markets is leading to complacency in dealing with remaining and difficult problems in the banking system. I see several areas where progress in restoring financial stability must be accelerated:

- A comprehensive diagnosis of banking systems remains extremely important, especially given that non-performing loans may increase over the coming months.
- Launching asset-management programs is also critical. This is needed not only to deal with assets already on bank books, but also to offset the impact of rising non-performing loans.
- And formal policy coordination across countries must be strengthened. This will become particularly important as countries begin to design their exit strategies.

I urge policy makers to remain focused on completing this crisis-response agenda. Not doing so raises serious concerns that systemic risks could re-emerge in the global financial system, with clear knock-on effects for economic growth. Greater clarity in communicating policy intentions to the public is also essential to shore up confidence.

## **B. Regulatory reform**

Let me now look beyond crisis response measures, and to the regulatory reforms needed to create a safer and more stable financial sector.

The good news is that there is broad-based agreement on the principal lessons of the financial crisis, namely that regulation and supervision must do a better job of mitigating systemic risks. Preventive measures are needed to reduce the likelihood of crises. These include widening the regulatory perimeter and making it more flexible; increasing the amount and quality of bank capital and the liquidity buffers they carry; allowing prudential frameworks to play a greater stabilizing role over the business cycle; and intensifying the regulation and supervision of systemically important institutions. Measures to improve crisis management are also critical, and include addressing difficult cross-border resolution issues.

The bad news, however, is that the reform effort is not proceeding as quickly as is necessary to address the problems raised by the crisis. To be sure, this is no simple task: reforms must be sufficiently forward-looking to anticipate tomorrow's problems, yet not so restrictive that they stifle innovation and growth in the financial sector.

Some progress has already been made on strengthening microprudential regulation. For example, the Basel Committee has made recommendations for strengthening the regulatory capital framework. But more work is needed here. In particular, a key lesson of the financial crisis is that capital requirements cannot be lenient. They must

therefore not only be increased, but also made more variable in order to prevent excessive risk taking.

Development of an operational framework for macroprudential supervision remains work in progress. There is broad agreement on the needed components for such a system: procyclicality of regulation must be dampened, and systemically important financial institutions must be supervised better. However, methodological issues have posed challenges to international agreement on new regulations.

Addressing cross-border resolution issues remains one of the greatest challenges. We must keep pressing ahead—for in the absence of an agreement for how to solve conflicts across borders, the risk of national interests being put ahead of the greater global good increases significantly.

We must also act decisively to promote the reform of compensation policies in the financial industry. The risk-taking culture that has been the hallmark of major financial firms—with generous bonuses rewarding high short-term profits, and insufficient regard for longer-term risks—contributed to problems of procyclicality and hence was an important factor in the crisis. And I worry that as the financial sector emerges from crisis, a “business as usual” mentality may prevent serious progress from being made.

The international community must stand together to make meaningful progress in this area. This will help overcome governments’ concerns about the potential loss of competitiveness if only a few countries adjust their compensation policies. I expect that more traction on this issue may emerge following this weekend’s G-20 Finance Ministers’ meeting in London.

### **C. The IMF’s Role in Financial Sector Reform**

What is the Fund’s role in regulatory reform?

At the outset, let me be clear that we are not a global financial regulator—nor do we aspire to be! That is the responsibility of national regulatory and supervisory agencies.

Having said this, we do take very seriously our responsibility to support national and multilateral efforts to strengthen financial regulation. Besides contributing to the formulation of new regulations and providing technical assistance in this area, our key mandate is surveillance of the financial sector. We are therefore stepping up our



monitoring of the adoption and implementation of new standards and regulatory changes. This is in line with the G-20's request that our monitoring include the evolving framework of macroprudential supervision.

### **III. BOLSTERING THE STABILITY OF THE INTERNATIONAL MONETARY SYSTEM**

Turning to my third question, let me now share some thoughts with you on the international monetary system. By this, I mean the broad set of rules and institutions that govern international payments.

In the wake of the financial crisis, concerns about the current system have once again emerged. Critics have noted that the role of the U.S. dollar may have been seriously undermined by the United States' economic and financial problems. In particular, they worry that its large fiscal imbalances present serious risks to the value of the dollar, and hence of disorderly adjustment.

I note, however, that the U.S. dollar actually strengthened during the crisis. In my view, this reflects the dollar's status as an unrivaled safe haven asset.

The question about what shape the international monetary system should take is an important one, and one of the oldest in international finance. As early as the 1940s, John Maynard Keynes proposed the creation of a super-sovereign currency, the so-called "bancor". More recent proposals call for the creation of a new world reserve currency, possibly based on the SDR—the composite currency issued by the IMF. Another possibility, and perhaps the least unlikely alternative, is for a multi-reserve currency system to emerge, with currencies like the euro, the yen, and even the renminbi serving as co-equal anchors.

It is my sense that this question will be decided over the coming decade, rather than the coming months, based as much on political considerations as economic ones. As the global economy evolves, we are likely to see new currencies rise in stature and international usage, leading perhaps to a system with several co-equal anchor currencies. The international community may even decide that the creation and promotion of a new reserve currency is what would be best, though this would of course require a significant step-up in global policy coordination.

It is my view that the current international monetary system, despite its problems, is working better than is often said. It proved resilient during the recent crisis, and near-term concerns about the dollar can be eased with appropriate policy actions from the

U.S. authorities. Indeed, durably anchoring the fiscal, monetary and financial regulatory policies of the main reserve issuer would go a long way towards stabilizing the international monetary system.

But I believe it could be made even more resilient if countries' appetite for self-insurance—and hence their demand for reserves—could be reduced. This demand, which is expected to rise further in the wake of the crisis, is at the heart of a recurring source of instability of the IMS: it makes it considerably more challenging for the main reserve issuer to achieve fiscal and external balance while providing sufficient safe assets to the rest of the world. (Economists refer to this as the “Triffin dilemma”.) Moreover, large stockpiles of foreign reserves breed uncertainty since the management of these assets could be driven by non-market considerations.

Because self-insurance is costly, reducing the demand for reserves would also deliver dividends to individual countries. By investing in foreign reserves rather than in their own economies, countries with large reserve stockpiles have missed out on potentially high-return domestic investments, like education and infrastructure.

I see various ways to reduce the need for self-insurance. At the country level, sound economic policies clearly can reduce the need for insurance over time as policy credibility is enhanced and confidence in currencies is strengthened. At the global level, we should seek ways to reduce the impact of volatile capital flows and hence their potential to disrupt financial systems. Third-party insurance should in theory be the most efficient alternative, but pricing uncertainties and significant counterparty risks have prevented the emergence of a market for this. Borrowing from a global or regional reserves pool, or through access to a lender of last resort, is in practice the most likely alternative.

Indeed, in recognition of the need to strengthen systemic insurance mechanisms, the international community has taken steps to strengthen the Fund's role. At its April summit, G-20 leaders called for a near tripling of our lending resources to \$750 billion, and over the past year a number of steps have been taken to reform and expand the Fund's lending facilities.

I believe that the IMF could do even more to support the international monetary system in the future:

- The procedures related to accessing our short-term Flexible Credit Line and other lending facilities could be modified to make this form of insurance more predictable.
- SDR allocations could be made more responsive to global developments and flexible to country circumstances.
- The Fund's resource base (or insurance pool) could be increased further. Even after its recent tripling, it is still smaller as a share of global GDP—and even smaller as a share of global capital flows—than it was when the Fund was created.

#### IV. CONCLUDING THOUGHTS

In my remarks today, my goal was to focus our attention on some of the key questions that relate to the global economy's transition beyond the crisis.

While global growth appears to have turned the corner, we should not forget that so far, this has been mainly due to massive policy support. And while it is right—and in fact policy makers' responsibility—to start formulating exit policies now, they should by no means be implemented until there are clear signs that the recovery is firmly underway. In particular, given the high and lasting cost of unemployment, policy makers should err on the side of caution rather than jeopardize the recovery.

We are definitely making progress towards creating a safer and more stable financial system—but much remains to be done. In particular, capital requirements need to be strengthened, so that they are not only larger, but also reflect better the riskiness of bank activities. And on compensation policy, we need to align bankers' incentives much better with longer-term performance than with short-term profits.

Finally, let me close with a renewed call for international policy coordination—and express my support for Minister Steinbrueck's recent remarks on this issue.

The crisis has shown that international policy coordination is an essential part of a crisis response. Thanks to concerted and forceful policy actions, the world's policy makers were able to keep this once-in-a-lifetime crisis from becoming a full-blown depression.

The crisis also demonstrated the irreplaceable role of the multilateral institutions. Whether in support of the international policy response, or as providers of financing, they have played a critical role in the global response to the crisis. Looking ahead, they must remain at the center of reshaping the international financial system.

Thank you for your kind attention. I would be happy to take some of your questions.