

EXECUTIVE SUMMARY

The global economy is in a severe recession inflicted by a massive financial crisis and acute loss of confidence. While the rate of contraction should moderate from the second quarter onward, world output is projected to decline by 1.3 percent in 2009 as a whole and to recover only gradually in 2010, growing by 1.9 percent. Achieving this turnaround will depend on stepping up efforts to heal the financial sector, while continuing to support demand with monetary and fiscal easing.

Recent Economic and Financial Developments

Economies around the world have been seriously affected by the financial crisis and slump in activity. The advanced economies experienced an unprecedented 7½ percent decline in real GDP during the fourth quarter of 2008, and output is estimated to have continued to fall almost as fast during the first quarter of 2009. Although the U.S. economy may have suffered most from intensified financial strains and the continued fall in the housing sector, western Europe and advanced Asia have been hit hard by the collapse in global trade, as well as by rising financial problems of their own and housing corrections in some national markets. Emerging economies too are suffering badly and contracted 4 percent in the fourth quarter in the aggregate. The damage is being inflicted through both financial and trade channels, particularly to east Asian countries that rely heavily on manufacturing exports and the emerging European and Commonwealth of Independent States (CIS) economies, which have depended on strong capital inflows to fuel growth.

In parallel with the rapid cooling of global activity, inflation pressures have subsided quickly. Commodity prices fell sharply from mid-year highs, causing an especially large loss of income for the Middle Eastern and CIS econo-

mies but also for many other commodity exporters in Latin America and Africa. At the same time, rising economic slack has contained wage increases and eroded profit margins. As a result, 12-month headline inflation in the advanced economies fell below 1 percent in February 2009, although core inflation remained in the 1½–2 percent range, with the notable exception of Japan. Inflation has also moderated significantly across the emerging economies, although in some cases falling exchange rates have dampened the downward momentum.

Wide-ranging and often unorthodox policy responses have made limited progress in stabilizing financial markets and containing the downturn in output, failing to arrest corrosive feedback between weakening activity and intense financial strains. Initiatives to stanch the bleeding include public capital injections and an array of liquidity facilities, monetary easing, and fiscal stimulus packages. While there have been some encouraging signs of improving sentiment since the Group of 20 (G20) meeting in early April, confidence in financial markets is still low, weighing against the prospects for an early economic recovery.

The April 2009 *Global Financial Stability Report* (GFSR) estimates write-downs on U.S.-originated assets by all financial institutions over 2007–10 will be \$2.7 trillion, up from the estimate of \$2.2 trillion in January 2009, largely as a result of the worsening prospects for economic growth. Total expected write-downs on global exposures are estimated at about \$4 trillion, of which two-thirds will fall on banks and the remainder on insurance companies, pension funds, hedge funds, and other intermediaries. Across the world, banks are limiting access to credit (and will continue to do so) as the overhang of bad assets and uncertainty about which institutions will remain solvent keep private capital on the sidelines. Funding strains have spread

well beyond short-term bank funding markets in advanced economies. Many nonfinancial corporations are unable to obtain working capital, and some are having difficulty raising longer-term debt.

The broad retrenchment of foreign investors and banks from emerging economies and the resulting buildup in funding pressures are particularly worrisome. New securities issues have come to a virtual stop, bank-related flows have been curtailed, bond spreads have soared, equity prices have dropped, and exchange markets have come under heavy pressure. Beyond a general rise in risk aversion, this reflects a range of adverse factors, including the damage done to advanced economy banks and hedge funds, the desire to move funds under the “umbrella” provided by the increasing provision of guarantees in mature markets, and rising concerns about the economic prospects and vulnerabilities of emerging economies.

An important side effect of the financial crisis has been a flight to safety and return of home bias, which have had an impact on the world’s major currencies. Since September 2008, the U.S. dollar, euro, and yen have all strengthened in real effective terms. The Chinese renminbi and currencies pegged to the dollar (including those in the Middle East) have also appreciated. Most other emerging economy currencies have weakened sharply, despite the use of international reserves for support.

Outlook and Risks

The *World Economic Outlook (WEO)* projections assume that financial market stabilization will take longer than previously envisaged, even with strong efforts by policymakers. Thus, financial strains in the mature markets are projected to remain heavy until well into 2010, improving only slowly as greater clarity over losses on bad assets and injections of public capital reduce insolvency concerns, lower counterparty risks and market volatility, and restore more liquid market conditions. Overall credit to the private sector in the advanced economies is expected

to decline in both 2009 and 2010. Meanwhile, emerging and developing economies are expected to face greatly curtailed access to external financing in both years. This is consistent with the findings in Chapter 4 that the acute degree of stress in mature markets and its concentration in the banking system suggest that capital flows to emerging economies will suffer large declines and recover only slowly.

The projections also incorporate strong macroeconomic policy support. Monetary policy interest rates are expected to be lowered to or remain near the zero bound in the major advanced economies, while central banks continue to explore ways to use both the size and composition of their balance sheets to ease credit conditions. Fiscal deficits are expected to widen sharply in both advanced and emerging economies, as governments are assumed to implement fiscal stimulus plans in G20 countries amounting to 2 percent of GDP in 2009 and 1½ percent of GDP in 2010. The projections also assume that commodity prices remain close to current levels in 2009 and rise only modestly in 2010, consistent with forward market pricing.

Even with determined policy actions, and anticipating a moderation in the rate of contraction from the second quarter onward, global activity is now projected to decline 1.3 percent in 2009, a substantial downward revision from the January *WEO Update*. This would represent by far the deepest post–World War II recession. Moreover, the downturn is truly global: output per capita is projected to decline in countries representing three-quarters of the global economy, and growth in virtually all countries has decelerated sharply from rates observed in 2003–07. Growth is projected to reemerge in 2010, but at just 1.9 percent would be sluggish relative to past recoveries, consistent with the findings in Chapter 3 that recoveries after financial crises are significantly slower than other recoveries.

The current outlook is exceptionally uncertain, with risks weighed to the downside. The dominant concern is that policies will continue to be insufficient to arrest the negative feedback

between deteriorating financial conditions and weakening economies, particularly in the face of limited public support for policy action. Key transmission channels include rising corporate and household defaults that cause further falls in asset prices and greater losses across financial balance sheets, and new systemic events that further complicate the task of restoring credibility. Furthermore, in a highly uncertain context, fiscal and monetary policies may fail to gain traction, since high rates of precautionary saving could lower fiscal multipliers, and steps to ease funding could fail to slow the pace of deleveraging. On the upside, however, bold policy implementation that is able to convince markets that financial strains are being dealt with decisively could revive confidence and spending commitments.

Even once the crisis is over, there will be a difficult transition period, with output growth appreciably below rates seen in the recent past. Financial leverage will need to be reduced, implying lower credit growth and scarcer financing than in recent years, especially in emerging and developing economies. In addition, large fiscal deficits will need to be rolled back just as population aging accelerates in a number of advanced economies. Moreover, in key advanced economies, households will likely continue to rebuild savings for some time. All this will weigh on both actual and potential growth over the medium run.

Policy Challenges

This difficult and uncertain outlook argues for forceful action on both the financial and macroeconomic policy fronts. Past episodes of financial crisis have shown that delays in tackling the underlying problem mean an even more protracted economic downturn and even greater costs, both in terms of taxpayer money and economic activity. Policymakers must be mindful of the cross-border ramifications of policy choices. Initiatives that support trade and financial partners—including fiscal stimulus and official support for international financing

flows—will help support global demand, with shared benefits. Conversely, a slide toward trade and financial protectionism would be hugely damaging to all, a clear warning from the experience of 1930s beggar-thy-neighbor policies.

Advancing Financial Sector Restructuring

The greatest policy priority at this juncture is financial sector restructuring. Convincing progress on this front is the sine qua non for an economic recovery to take hold and would significantly enhance the effectiveness of monetary and fiscal stimulus. In the short run, the three priorities identified in previous GFSRs remain appropriate: (1) ensuring that financial institutions have access to liquidity, (2) identifying and dealing with distressed assets, and (3) recapitalizing weak but viable institutions. The first area is being addressed forcefully. Policy initiatives in the other two areas, however, need to advance more convincingly.

The critical underpinning of an enduring solution must be credible loss recognition on impaired assets. To that effect, governments need to establish common basic methodologies for the realistic valuation of securitized credit instruments, which should be based on expected economic conditions and an attempt to estimate the value of future income streams. Steps will also be needed to reduce considerably the uncertainty related to further losses from these exposures. Various approaches to dealing with bad assets in banks can work, provided they are supported with adequate funding and implemented in a transparent manner.

Recapitalization methods must be rooted in a careful evaluation of the long-term viability of institutions, taking into account both losses to date and a realistic assessment of the prospects of further write-downs. Subject to a number of assumptions, GFSR estimates suggest that the amount of capital needed might amount to \$275 billion–\$500 billion for U.S. banks, \$475 billion–\$950 billion for European banks (excluding those in the United Kingdom), and

\$125 billion–\$250 billion for U.K. banks.¹ As supervisors assess recapitalization needs on a bank-by-bank basis, they will need assurance of the quality of banks' capital; the robustness of their funding, business plans, and risk management processes; the appropriateness of compensation policies; and the strength of management. Supervisors will also need to establish the appropriate level of regulatory capital for institutions, taking into account regulatory minimums and the need for buffers to absorb further unexpected losses. Viable banks that have insufficient capital should be quickly recapitalized, with capital injections from the government (if possible, accompanied by private capital) to bring capital ratios to a level sufficient to regain market confidence. Authorities should be prepared to provide capital in the form of common shares in order to improve confidence and funding prospects and this may entail a temporary period of public ownership until a private sector solution can be developed. Nonviable financial institutions need to be intervened promptly, leading to resolution through closures or mergers. Amounts of public funding needed are likely to be large, but requirements are likely to rise the longer it takes for a solution to be implemented.

Wide-ranging efforts to deal with financial strains will also be needed in emerging economies. The corporate sector is at considerable risk. Direct government support for corporate borrowing may be warranted. Some countries have also extended their guarantees of bank debt to firms, focusing on those associated with export markets, or have provided backstops to trade finance through various facilities—helping to keep trade flowing and limiting damage to the real economy. In addition, contingency plans should be devised to prepare for potential

large-scale restructuring in case circumstances deteriorate further.

Greater international cooperation is needed to avoid exacerbating cross-border strains. Coordination and collaboration is particularly important with respect to financial policies to avoid adverse international spillovers from national actions. At the same time, international support, including from the IMF, can help countries buffer the impact of the financial crisis on real activity and, particularly in the developing countries, limit its effects on poverty. Recent reforms to increase the flexibility of lending instruments for good performers caught in bad weather, together with plans advanced by the G20 summit to increase the resources available to the IMF, are enhancing the capacity of the international financial community to address risks related to sudden stops of private capital flows.

Easing Monetary Policy

In advanced economies, scope for easing monetary policy further should be used aggressively to counter deflation risks. Although policy rates are already near the zero floor in many countries, whatever policy room remains should be used quickly. At the same time, a clear communication strategy is important—central bankers should underline their determination to avoid deflation by sustaining easy monetary conditions for as long as necessary. In an increasing number of cases, lower interest rates will need to be supported by increasing recourse to less conventional measures, using both the size and composition of the central bank's own balance sheet to support credit intermediation. To the extent possible, such actions should be structured to maximize relief in dislocated markets while leaving credit allocation decisions to the private sector and protecting the central bank balance sheet from credit risk.

Emerging economies also need to ease monetary conditions to respond to the deteriorating outlook. However, in many of those economies, the task of central banks is further complicated by the need to sustain external stability in the

¹The lower end of the range corresponds to capital needed to adjust leverage, measured as tangible common equity (TCE) over total assets, to 4 percent. The upper end corresponds to capital needed to raise the TCE ratio to 6 percent, consistent with levels observed in the mid-1990s (see the April 2009 GFSR).

face of highly fragile financing flows. To a much greater extent than in advanced economies, emerging market financing is subject to dramatic disruptions—sudden stops—in part because of much greater concerns about the creditworthiness of the sovereign. Emerging economies also have tended to borrow more heavily in foreign currency, and so large exchange rate depreciations can severely damage balance sheets. Thus, while most central banks in these economies have lowered interest rates in the face of the global downturn, they have been appropriately cautious in doing so to maintain incentives for capital inflows and to avoid disorderly exchange rate moves.

Looking further ahead, a key challenge will be to calibrate the pace at which the extraordinary monetary stimulus now being provided should be withdrawn. Acting too fast would risk undercutting what is likely to be a fragile recovery, but acting too slowly could risk overheating and inflating new asset price bubbles.

Combining Fiscal Stimulus with Sustainability

In view of the extent of the downturn and the limits to the effectiveness of monetary policy, fiscal policy must play a crucial part in providing short-term stimulus to the global economy. Past experience suggests that fiscal policy is particularly effective in shortening the duration of recessions caused by financial crises (Chapter 3). However, the room to provide fiscal support will be limited if efforts erode credibility. Thus, governments are faced with a difficult balancing act, delivering short-term expansionary policies but also providing reassurance about medium-term prospects. Fiscal consolidation will be needed once a recovery has taken hold, and this can be facilitated by strong medium-term fiscal frameworks. However, consolidation should not be launched prematurely. While governments have acted to provide substantial stimulus in 2009, it is now apparent that the effort will need to be at least sustained, if not increased, in 2010, and countries with fiscal room should stand ready to introduce new stimulus measures as needed

to support the recovery. As far as possible, this should be a joint effort, since part of the impact of an individual country's measures will leak across borders, but brings benefits to the global economy.

How can the tension between stimulus and sustainability be alleviated? One key is the choice of stimulus measures. As far as possible, these should be temporary and maximize “bang for the buck” (for example, accelerated spending on already planned or existing projects and time-bound tax cuts for credit-constrained households). It is also desirable to target measures that bring long-term benefits to the economy's productive potential, such as spending on infrastructure. Second, governments need to complement initiatives to provide short-term stimulus with reforms to strengthen medium-term fiscal frameworks to provide reassurance that short-term deficits will be reversed and public debt contained. Third, a key element to ensure fiscal sustainability in many countries would be concrete progress toward dealing with the fiscal challenges posed by aging populations. The costs of the current financial crisis—while sizable—are dwarfed by the impending costs from rising expenditures on social security and health care for the elderly. Credible policy reforms to these programs may not have much immediate impact on fiscal accounts but could make an enormous change to fiscal prospects, and thus could help preserve fiscal room to provide short-term fiscal support.

Medium-Run Policy Challenges

At the root of the market failure that led to the current crisis was optimism bred by a long period of high growth and low real interest rates and volatility, along with policy failures. Financial regulation was not equipped to address the risk concentrations and flawed incentives behind the financial innovation boom. Macroeconomic policies did not take into account the buildup of systemic risks in the financial system and in housing markets.

This raises important medium-run challenges for policymakers. With respect to financial policies, the task now is to broaden the perimeter of regulation and make it more flexible to cover all systemically relevant institutions. In addition, there is a need to develop a macroprudential approach to regulation, which would include compensation structures that mitigate procyclical effects, robust market-clearing arrangements, accounting rules to accommodate illiquid securities, transparency about the nature and location of risks to foster market discipline, and better systemic liquidity management.

Regarding macroeconomic policies, central banks should also adopt a broader macroprudential view, paying due attention to financial stability as well as price stability by taking into

account asset price movements, credit booms, leverage, and the buildup of systemic risk. Fiscal policymakers will need to bring down deficits and put public debt on a sustainable trajectory.

International policy coordination and collaboration need to be strengthened, based on better early-warning systems and a more open communication of risks. Cooperation is particularly pressing for financial policies, because of the major spillovers that domestic actions can have on other countries. At the same time, rapid completion of the Doha Round of multilateral trade talks could revitalize global growth prospects, while strong support from bilateral and multilateral sources, including the IMF, could help limit the adverse economic and social fallout of the financial crisis in many emerging and developing economies.