GROUP of TWENTY

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Global Economic Prospects and Policy Challenges

Prepared by Staff of the International Monetary Fund

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EXECUTIVE SUMMARY

The global recovery is off to a stronger start than anticipated earlier, but it is proceeding at different speeds in the various regions. Recovery in advanced economies is being largely driven by extraordinary policy support and the turn in the inventory cycle, with strong domestic demand and higher commodity prices adding to the growth impetus in key emerging economies.

The speed of recovery is expected to vary considerably across G-20 countries, with weaker and more fragile growth in advanced economies contrasting with robust expansions in emerging economies, particularly in Asia. After contracting by 0.8 percent in 2009, global output is expected to expand by around 4 percent in 2010 and 4.3 percent in 2011, an upward revision of ¾ and 0.1 percentage points, respectively, relative to the October World Economic Outlook

Risks to the outlook are on balance moderately to the downside. The most immediate risk is intensifying market concerns about fiscal sustainability in some smaller advanced economies, leading to contagion of rising risk premia across sovereign bond markets and higher borrowing costs for households and companies.

A multispeed recovery means that policy challenges vary across countries. With recovery in most advanced G-20 economies expected to be weak, policy stimulus should be maintained at least through 2010. However, macroeconomic support cannot substitute for restructuring in securing durable growth; in particular, financial system reform needs to proceed with greater urgency to support aggregate credit while limiting future risks. Some major emerging economies may have to unwind stimulus faster due to more rapid recoveries.

Policymakers need to formulate and begin to implement strategies for exiting from crisis-related intervention policies. The appropriate timing, pace, and mode of exits depend on the state of the economy and the health of the financial system. Expansionary fiscal policy has a direct impact on debt, while accommodative monetary policy has no obvious direct downside, other things remaining unchanged (e.g., the absence of price pressures in goods, labor, and asset markets). Hence, on balance, fiscal consolidation should take priority. In some emerging economies monetary policy may have to be tightened relatively soon and ahead of fiscal consolidation, due to rising inflation or incipient financial vulnerabilities

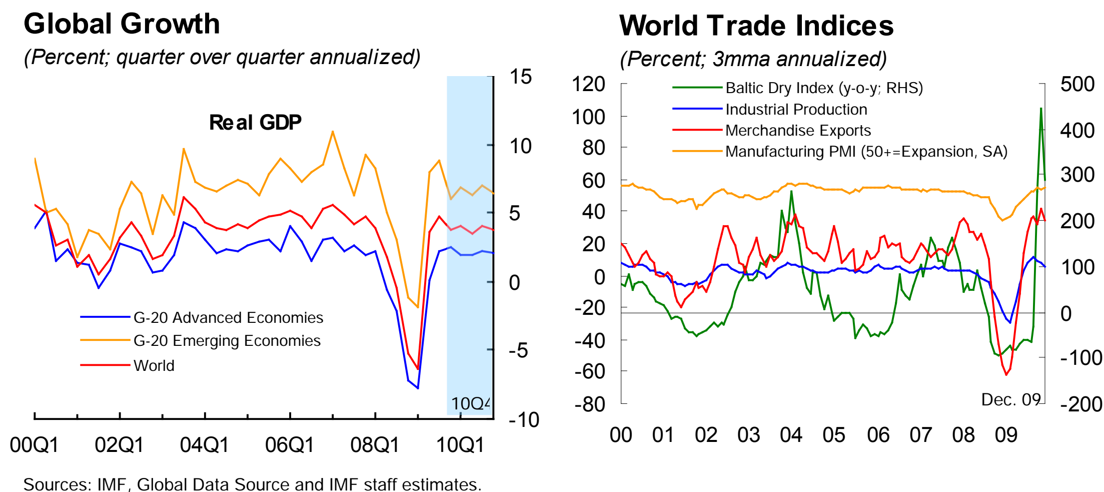
Some emerging market countries will have to design policies to manage a surge of capital inflows. The right responses differ across countries, including fiscal tightening to ease pressure on interest rates and greater exchange rate flexibility. Macro-prudential policies aimed at limiting the emergence of new asset price bubbles, reserves accumulation, and carefully designed capital controls can also be part of the appropriate response in certain circumstances.

Global Economic Prospects and Policy Challenges[1]

The global recovery is off to a stronger start than anticipated earlier, but it is proceeding at different speeds in the various regions. Following the deepest global recession in recent history, economic growth returned and broadened to advanced economies in the second half of 2009. In 2010, world output is expected to rise by 4 percent, an upward revision of ¾ percentage point from the October 2009 WEO. A multi-speed recovery warrants greater differentiation in the timing and sequencing of exit from crisis-related policies. In major advanced economies, the recovery is expected to remain sluggish by past standards. With few clear signs of self-sustaining domestic demand, policy stimulus will need to be maintained through 2010. In many emerging economies, activity is expected to be relatively vigorous, largely driven by buoyant internal demand. Hence, an earlier exit from policy stimulus than in their counterparts among the advanced economies will likely be warranted. Risks to the outlook are on balance moderately to the downside.

I. A Policy-Driven Multispeed Recovery

1. **The global recovery accelerated and broadened during the second and third quarters of 2009, with emerging economies continuing to contribute a large share to overall G-20 growth.** Output in the G-20 increased by about 4 percent (seasonally adjusted, annualized) during this period, with emerging economies contributing over 80 percent of total growth. After stabilizing in the second quarter, growth in the advanced G-20 economies reached about 2¼ percent in the third quarter. Momentum in the emerging G-20 economies has been much stronger, reaching 9 percent in the third quarter, up from 8 percent in the previous quarter. China, India, Indonesia, and Brazil continue to lead emerging economy growth. Recovery spread in the third quarter, including to Mexico, Russia, and South Africa.



Sources: IMF, Global Data Source and IMF staff estimates.

[1] Prepared by Krishna Srinivasan, Shaun Roache, and Eric Bang of the Research Department, with input from the Fiscal Affairs and Monetary and Capital Markets Departments.

2. **Recovery in advanced economies is being largely driven by extraordinary policy support and the turn in the inventory cycle, with strong domestic demand and higher commodity prices adding to the growth impetus in key emerging economies**. Policy support has helped avoid a systemic meltdown, prompting a sooner-than-expected return of confidence in the financial system and in the real economy, although markets' conviction about the sustainability of growth remains fragile. Global production and trade recovered strongly in the second half of 2009.

- *Across advanced economies*, consumption growth in the United States has been firmer than expected, while the turn in the inventory cycle and rebounding trade have been particularly important for the recoveries in the euro area and Japan.

- In *emerging* economies, the recovery has been driven by strong domestic demand, due in part to large, front-loaded fiscal stimulus, notably in Asia and Brazil. Rebounding commodity prices and international trade, boosted by restocking, have also been important, particularly for Mexico and South Africa.

Assessing Growth Momentum 1/ 2/ 3/ 4/

Sources: Global Data Source; Haver Analytics; Bloomberg L.P.; and staff calculations.
1/ The above chart is based on the four economic indicators, including industrial production (IP), real retail sales (RS), merchandise exports (EX), and purchasing managers index (PMI).
2/ Some of the ratings—particularly for recent months—are based on both actual data as well as projections of the underlying variables.
3/ Saudi Arabia is not included because there is no available data and the European Union is not included due to limited data availability for all member countries.
4/ Retail sales and IP are based on real data, whereas, exports are based on nominal data and PMI on survey data.

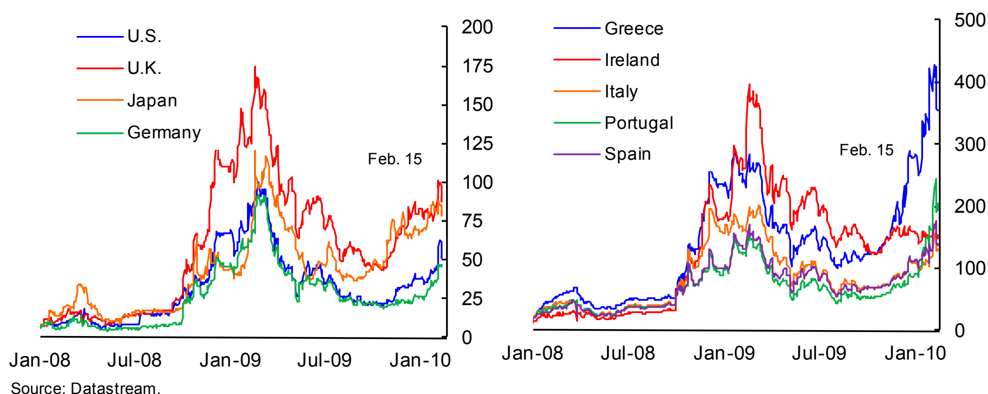
3. **Financial market conditions continue to improve, but bank credit is likely to remain sluggish in many advanced G-20 economies, while some sovereign debt markets are facing growing pressures**. In addition, the financial sector is still benefiting from public support, raising important questions about the timing and coordination of exits. Consumers and SMEs may well face credit constraints going forward. Public lending

schemes and guarantees have been critical in channeling needed and safe credit to these sectors, but have only been partially successful.

- *Bank credit will be crucial for recovery prospects*. In many advanced G-20 countries, bank balance sheet deleveraging, repair, restructuring, and recapitalization have yet to run their course, while bank funding challenges remain. Expectations of higher regulatory capital requirements, continuing high credit risk (for example in commercial real estate), and worries about the sustainability of earnings (which have thus far been supported by steep yield curves) have made banks cautious about expanding lending. Bank lending standards remain tight, although they have shown some recent signs of modest easing.

- *Capital markets have rebounded strongly, but vulnerabilities remain*. Corporate bond issuance has reached record levels, but has not been sufficient to offset the decline in bank financing. Securitization is recovering, albeit in some cases due to substantial public support.

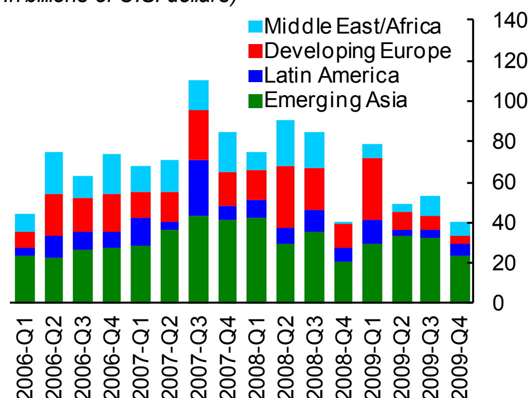
- *Market concerns about fiscal sustainability have risen sharply in a few advanced economies (notably Greece), increasing the risk of spillovers.* This is reflected in the rising volatility in sovereign CDS spreads or yields of some countries, notably in Europe, as investors increasingly differentiate across countries with regard to government deficits and debt. In part, this is due to a shift of some balance sheet weaknesses from the private sector to the public sector. However, the global recession and conditions in international debt markets have exacerbated underlying vulnerabilities in the structural fiscal position of some countries. For most major emerging economies, sovereign credit spreads have remained stable after declining through much of 2009.



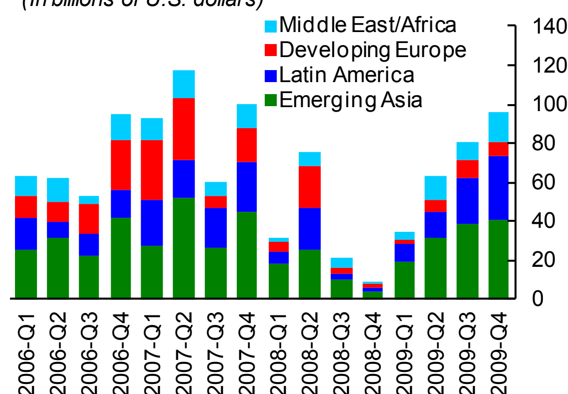
4. **For emerging economies, surging capital inflows are complicating the policy response to rapid recoveries.** Inflows have risen sharply in recent quarters. This can be

explained by a combination of factors, including rapidly improving growth prospects, a rise in risk appetite, and large interest-rate differentials. Capital inflows are complicating monetary policy responses in many of these economies, notably where there may be a need to tighten policy owing to a pick-up in inflation or to slow excessive credit growth (e.g., Brazil, China, India, and Indonesia). Although the surge in capital flows to emerging markets is in its early stages, it is already heightening concerns about the potential for nominal exchange rate overshooting. Where exchange rate intervention policies are leading to rapid reserve accumulation, inflows are contributing to inflation, rising pressures on asset prices, and domestic credit booms.

Emerging Market Syndicated Loans Issuance
(In billions of U.S. dollars)

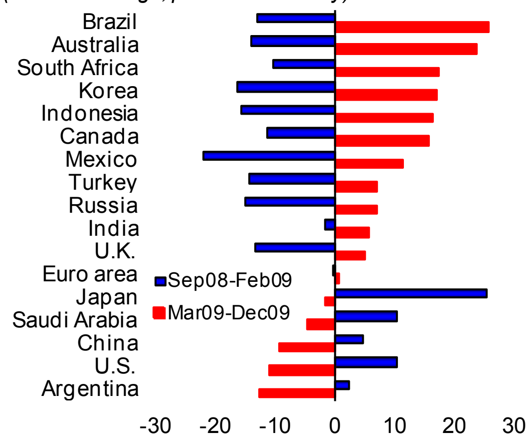


Emerging Market External Bond and Equity Issuance
(In billions of U.S. dollars)



5. **The multispeed nature of the recovery, renewed risk appetite and, rebounding capital flows to emerging economies have led to important exchange rate changes**. With improving financial conditions and receding systemic fears, the U.S. dollar has depreciated in real effective terms since early 2009, as flight-to-safety flows have unwound, and exchange rates for commodity exporters and emerging economies with floating currencies have appreciated significantly (e.g., Australia, Canada, Brazil, Indonesia, and South Africa). Currency appreciation is being resisted in some emerging economies and while this may be appropriate in some cases, it contributes to delaying the normalization of monetary policy and complicates global rebalancing in others. While the dollar is still somewhat overvalued, it has moved closer to its medium-run equilibrium. The recent real depreciation of the euro has moved it towards its fundamental value. The yen is broadly in

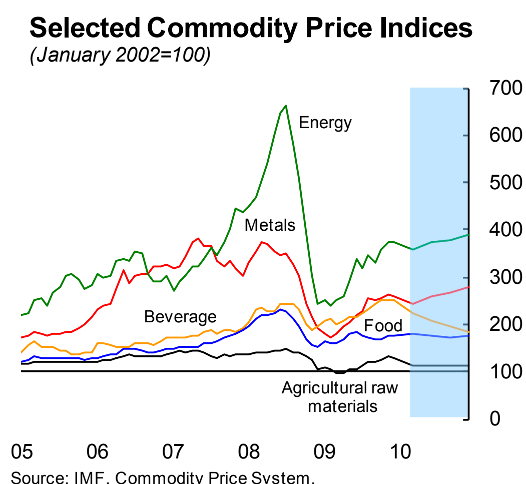
Real Effective Exchange Rate Movement
(Percent change; per local currency)



Source: IMF, Global Data Source.

line with medium-term fundamentals, following a substantial appreciation since late 2008. The Chinese renminbi has depreciated in real effective terms in tandem with the U.S. dollar and is assessed to be substantially undervalued from a medium-term perspective.

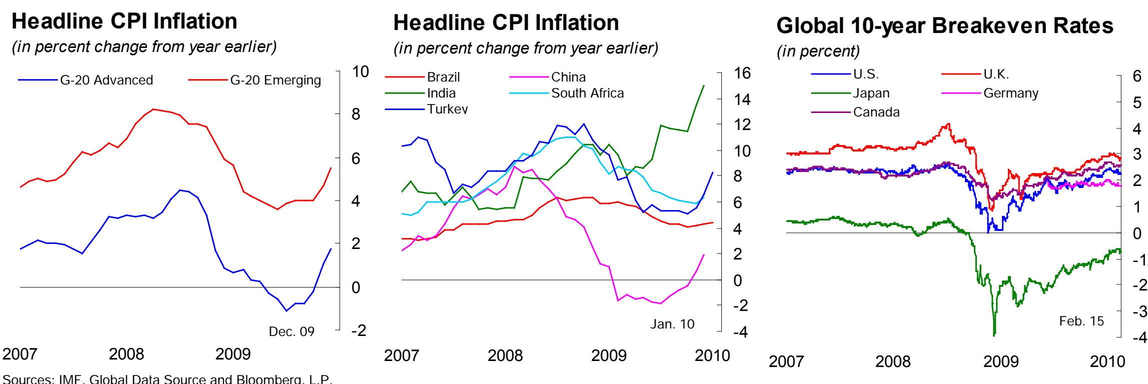
6. **Commodity prices increased strongly at the onset of the recovery, driven largely by buoyant growth in emerging economies, particularly in Asia**. Recent data indicating that commodity imports into China remained strong at the end of 2009 have bolstered expectations for ongoing strong Chinese demand across a broad range of commodities, including crude oil. Indications of improving advanced economy demand during the fourth quarter of 2009 have also pushed up prices. However, recently price increases have moderated and upward pressures are likely to remain modest through 2010 given above average inventories and significant spare capacity for most commodities.



7. **Advanced economy inflation remains subdued and expectations well anchored, but upward pressures have come to the fore in some emerging economies**.

- In *advanced* economies, following several month of negative CPI rates, driven largely by energy prices, twelve-month headline inflation turned positive towards end-2009 in the United States and the euro area, reaching 2.7 percent and 0.9 percent, respectively, in December. Consumer prices in Japan continued to decline, but at a slower pace. Advanced economy core inflation has hovered around 1 percent since mid-2009 and inflation expectations remained anchored around central banks' inflation objectives.

- Inflation in *emerging economies* has picked up and risks of further upward pressures have risen in some countries. Inflation developments have diverged widely across countries, with rapidly closing output gaps and agricultural supply shocks in some economies leading to a marked rebound, or relatively high inflation (e.g., India), while wider output gaps and nominal exchange rate appreciation in other economies have limited upward pressures (e.g., South Africa).

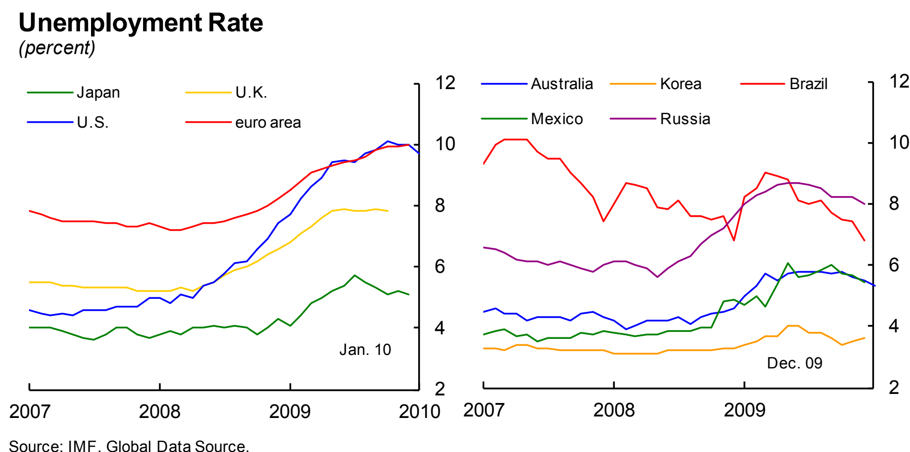


8. **Unemployment has stabilized in the major advanced economies and begun to decline across many emerging economies.** Recent labor market developments have varied across countries, in particular:

- Among *major advanced economies*, increases in unemployment rates have varied, being particularly large in the United States and Spain but relatively subdued in Germany and the United Kingdom. Recent data in the United States suggest that the labor market may have stabilized. In other advanced economies, notably across the euro area, there has been significant labor hoarding and labor productivity has fallen markedly. This may entail that unemployment increases well into 2010.

- *Some advanced economies* (e.g., Australia and Korea) and *emerging economies* experienced a smaller increase in unemployment through the crisis. Labor markets in these economies are now improving, reflecting their more rapid pace of recovery.

- *High unemployment or underemployment poses a problem in many emerging economies*—available statistics point to major increases in emerging Europe (particularly the Baltic States) and the CIS. Unemployment also remains at very high levels in some economies, including South Africa.



II. PROSPECTS

9. **The speed of recovery is expected to vary considerably across G-20 countries, with weaker and more fragile growth in advanced economies contrasting with robust expansions in most emerging economies, particularly in Asia**. After contracting by 0.8 ercent in 2009, global output is expected to expand by around 4 percent in 2010 and 4.3 percent in 2011 on an annual average basis, an upward revision of ¾ and 0.1 percentage points, respectively, relative to the October World Economic Outlook (Table 1).

- In the *advanced economies*, output is expected to expand by 2.1 percent in 2010 and by 2½ percent in 2011, which makes for a sluggish recovery by historical standards, with real output remaining below its pre-crisis level until late 2011. Underlying fragilities, including high unemployment rates and public debt and, in some cases, weak household balance sheets are expected to remain a drag on private demand. Credit will be held back by the need to repair bank balance sheets. This will impact more on those regions where the financial system is largely bank-based and impede access to credit for SMEs—which have less access to capital markets—and consumers.

- In the *emerging and developing economies*, recovery will be generally more robust than in advanced economies, but uneven. The recovery in these economies is led by the strong rebound in emerging Asia and to a lesser extent Latin America—notably China, India, Indonesia, and Brazil—fueled by strong domestic demand, intra-regional trade, and stimulus measures. The rebound of commodity prices will also help support growth in commodity exporters, including Russia and South Africa. Other emerging economies are staging modest recoveries, supported by policy stimulus, increased momentum in trade, and improvements in financial conditions. Overall, growth in emerging economies in 2010 is projected at about 6 percent.

- *G-20 economies* as a group are expected to grow by about 4¼ percent in 2010, reflecting an upward revision of about 1 percentage points compared with the October WEO, and by around 4½ percent in 2011.

Table 1. Overview of World Economic Outlook Projections 1/
(Percent change)

	Year over Year						Q4 over Q4 2/	
		Est.	Projections		Difference from October Oct 2009 WEO Projections		Projections	
	2008	2009	2010	2011	2010	2011	2010	2011
World output 3/	**3.0**	**-0.8**	**3.9**	**4.3**	**0.8**	**0.1**	**3.9**	**4.3**
Advanced economies	0.5	-3.2	2.1	2.4	0.8	-0.1	2.1	2.5
Euro area	0.6	-3.9	1.0	1.6	0.7	0.3	1.1	1.8
Emerging and developing economies 4/	6.1	2.1	6.0	6.3	0.9	0.2	6.4	6.9
G-20 2/	2.9	-0.7	4.3	4.4	1.0	0.0	4.3	4.6
Argentina	6.8	-2.5	3.5	3.0	2.0	0.5	3.2	2.9
Australia	2.2	0.8	2.5	3.0	0.5	-0.3	3.4	3.1
Brazil	5.1	-0.4	4.7	3.7	1.2	0.2	3.9	3.7
Canada	0.4	-2.6	2.6	3.6	0.5	0.0	3.6	3.5
China	9.6	8.7	10.0	9.7	1.0	0.0	9.3	9.4
France	0.3	-2.3	1.4	1.7	0.5	-0.1	1.6	1.6
Germany	1.2	-4.8	1.5	1.9	1.2	0.4	1.0	2.5
India	7.3	5.6	7.7	7.8	1.3	0.5	9.6	8.3
Indonesia	6.1	4.3	5.5	6.0	0.7	1.0	6.5	5.6
Italy	-1.0	-4.8	1.0	1.3	0.8	0.6	1.3	1.1
Japan	-1.2	-5.3	1.7	2.2	0.0	-0.2	1.8	2.5
Korea	2.2	0.2	4.5	5.0	0.9	-0.2	2.6	5.9
Mexico	1.3	-6.8	4.0	4.7	0.7	-0.2	3.2	5.4
Russia	5.6	-9.0	3.6	3.4	2.1	0.4	2.4	4.3
Saudi Arabia	4.4	0.1	3.9	4.1	-0.1	-0.2	…	…
South Africa	3.7	-1.9	2.0	3.3	0.3	-0.5	3.0	3.4
Turkey	0.9	-6.0	3.5	4.0	-0.2	0.0	-2.3	7.9
United Kingdom	0.5	-4.8	1.3	2.7	0.4	0.2	1.9	3.1
United States	0.4	-2.5	2.7	2.4	1.2	-0.4	2.6	2.4
European Union	1.0	-4.0	1.0	1.9	0.5	0.1	1.3	2.2

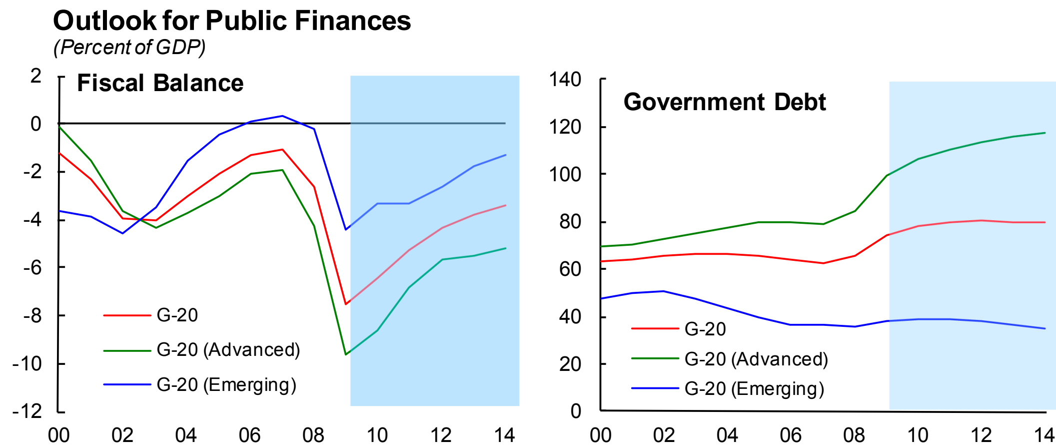
Note: Real effective exchange rates are assumed to remain constant at the levels prevailing during November 19 - December 17, 2009. Country weights used to construct aggregate growth rates for groups of countries were revised.
1/ IMF, World Economic Outlook Update, January 2010 published.
2/ G-20 yearly projections exclude European Union and quarterly projections exclude Saudi Arabia and European Union.
3/ The quarterly estimates and projections account for 90 percent of the world purchasing-power-parity weights.
4/ The quarterly estimates and projections account for approximately 77 percent of the emerging and developing economies.

10. **Projections for public finances diverge significantly, with deteriorations continuing in advanced economies and more favorable prospects for emerging economies**.

- For *advanced G-20 economies*, large fiscal deficits, reflecting cyclical factors, financial support measures, stimulus packages, and underlying structural spending pressures are expected to raise the general government gross debt-to-GDP ratio to about 120 percent in 2014, from around 80 percent in 2008.

- The sovereign debt outlook is generally more favorable for *emerging economies*, with debt ratios expected to decline moderately after 2010 and to remain, on average, below 40 percent of GDP in the medium term. This results from smaller output losses in the major emerging markets and lower primary deficits in the midst of the crisis, as well as the stronger rebound in growth accompanied by some discretionary tightening

to be implemented in 2010. Nevertheless, there are risks to public finances and debt management for emerging economies with weaker fundamentals, particularly from possible international spillovers. Specifically, large and rising issuance of sovereign debt in the advanced economies could lead to higher borrowing costs.



Source: IMF, World Economic Outlook, October 2009.

11. **Inflation is expected to remain contained in most advanced economies due to increasing unemployment and large output gaps, but some emerging economies will face ongoing upward inflationary pressures**.

- Capacity utilization in *advanced economies* will remain low, given the projected sluggish recovery. Also, output gaps will remain wide through 2010, even after accounting for the decline of potential output due to the financial crisis. Accordingly, inflationary pressures will remain subdued, despite the projected increase of commodity prices. In 2010, headline inflation in advanced economies is forecast to increase to 1¼ percent in 2010 (from zero in 2009), as slowing labor costs are more than offset by rebounding commodity prices,

- Inflation in *emerging economies* is expected to remain slightly over 5 percent. However, some emerging economies may face stronger upward price pressures due to more rapidly closing output gaps and increased capital inflows, which in some cases are leading to rapid reserve accumulation.

III. KEY RISKS

12. **Risks to the outlook are on balance moderately to the downside.** In particular, downside risks include:

- Sovereign vulnerabilities in the EU periphery, which could lead to rising risk premia across sovereign bond markets and a higher cost of borrowing for households and companies;
- Premature and incoherent exit from supportive policies, which could undermine confidence in the outlook and undercut the recovery before private domestic demand becomes self-sustaining;
- Slow progress in bank resolution, restructuring and recapitalization, which would unduly restrain the financial sector's ability to support the recovery by providing credit and leave the global economy and financial system vulnerable to further shocks;
- Slow progress in the reform of regulatory and supervisory arrangements, which would give rise to additional uncertainty about the future business models and prospects for the stability of the financial sector;
- Impaired financial systems and housing markets and/or rising unemployment holding back the recovery in household spending more than expected in key advanced economies; and
- Rallying commodity prices which could constrain the recovery in advanced economies.

13. **Upside risks include:** a quick resolution of fiscal sustainability concerns in some smaller advanced economies or greater clarity on the new financial regulatory framework, which could bolster financial market sentiment, bring about a further surge in capital flows to emerging markets, boost trade, and increase private demand; and new policy initiatives in the United States to reduce unemployment, which could provide a further impetus to U.S. and global growth.

IV. POLICY CHALLENGES

A multispeed recovery means that policy challenges vary across countries. With the recovery in most advanced economies expected to be weak, policy stimulus will need to be maintained at least through 2010 and possibly augmented in some cases. However, macroeconomic support cannot substitute for restructuring in securing durable growth; in particular, financial system reform needs to proceed with a greater sense of urgency. At the same time, however, policymakers need credible and coherent exit strategies to bridge from extraordinary short-term support towards the medium-term objective of strong, sustained, and balanced growth. This should include credible plans to put public finances on a sustainable path. Some major emerging economies may have to unwind stimulus faster due to more rapid recoveries and deal with robust capital inflows.

A. Macroeconomic Policies

14. **In the major advanced G-20 economies there will be a need for continued policy stimulus until private demand gathers sustainable momentum**, as the recovery will remain sluggish and fragile, notwithstanding the recent uptick in growth prospects. Central banks should maintain low interest rates for some time, given that underlying inflation is expected to remain subdued and unemployment high through 2010. Fiscal policies need to remain supportive of economic activity in the near term, and the fiscal stimulus planned for 2010 should be implemented fully. The fiscal impulse should start to be withdrawn in 2011, except in those economies where markets are rapidly losing confidence in fiscal sustainability and where tightening should start earlier. In the context of high unemployment, there may be merit in considering new policy initiatives aimed at boosting job creation in some countries. However, such measures should be cast within a framework that ensures sound medium-term fiscal balances.

15. **In some advanced and major emerging economies in the G-20, policy stimulus will likely need to be unwound sooner than in major advanced economies and unwinding is already underway in some.** Output gaps are rapidly closing in a few countries (e.g., Korea, emerging Asia, and Brazil) and this has already led to policy tightening in some cases (e.g., Australia). There are also nascent signs of asset price booms in a limited set of countries and, in some cases, increasing potential for deteriorating credit quality (e.g., China).

16. **Policymakers in all countries should remain proactive in preparing their exits from extraordinary stimulus, recognizing the challenge of mapping a course between exiting too early and too late.** Unwinding stimulus too early could jeopardize progress in securing economic recovery, and the balance of risks is still in favor maintaining stimulus for the coming quarters. In addition, it may be prudent to allow some extraordinary financial sector policy measures, even as they cease to be used, to remain dormant on the books and thus available for rapid deployment should conditions deteriorate again. However, delaying exit too long could distort private incentives and pose risks to price, financial, and fiscal

stability. Overall, the multispeed recovery means that the timing of exits will vary across countries. Most emerging G-20 economies must respond to a faster paced recovery, which will require exits sooner than in the major advanced economies.

17. **Exiting from crisis-related public support policies should be viewed in the context of bridging towards strong, sustained and balanced growth with price stability**. Attaining this objective will require meeting the onerous challenges to fiscal sustainability, normalizing monetary policy carefully withdrawing financial sector support, and avoiding policy inconsistencies across countries, as well as in the policy mix. To facilitate rebalanced global growth: advanced economies with large current account deficits should transition towards measures to raise savings; advanced economies with large surpluses should prioritize structural reforms in labor and product markets that would bolster domestic demand; and exits in emerging economies with excessive current account surpluses should be accompanied by exchange rate appreciation. Fiscal consolidation in major advanced economies will also mean that emerging economies will have to rely less on external sources of demand to support growth.

Advanced economies

18. **In most advanced G-20 economies, ensuring fiscal sustainability is a key priority and policy challenge, notably in light of the surge in government debt levels**. Maintaining an expansionary fiscal stance has a clear and direct impact on the build-up of debt. Maintaining an accommodative monetary policy stance, which can be reversed quickly, has few obvious direct downsides; the most important risk from this policy stance in the current low inflationary environment is the potential for liquidity spillovers, particularly to domestic asset markets and emerging economies. Also, a tightening of the fiscal stance may help monetary and debt management, while a monetary tightening will contribute to a worsening of the fiscal position. Hence, on balance fiscal consolidation should generally take priority, all else given. Achieving fiscal sustainability will be a difficult and prolonged process, making it imperative for consolidation to begin as soon as there is clear evidence of self-sustaining recovery. Given a path for fiscal policies, monetary policy can be set to achieve a desired level of overall stimulus, tightening as needed to counter inflationary risks and maintain price stability.

19. **While provision of fiscal support will need to be maintained until the recovery gains a solid footing, advanced G-20 governments should lay out credible medium-term plans to reduce public debt ratios**. Moreover, they should start implementing immediately elements of these medium-term plans that do not impact negatively on demand. This includes strengthening fiscal institutions to increase the likelihood that fiscal adjustment will take place, and undertaking those reforms of entitlement spending that do not depress consumption—such as increases in the retirement age—or that can be phased in gradually. A failure to implement these measures would threaten fiscal sustainability and

reduce growth prospects. To achieve fiscal sustainability, authorities need a credible medium-term fiscal policy strategy that would entail:

- *Clear timeframes to bring the gross debt to GDP ratio to sustainable levels that take into account longer-term spending pressures*. Stabilizing debt ratios at their likely post-crisis levels will not be sufficient, as high debt ratios would impede fiscal flexibility, raise economy-wide interest rates, and constrain growth. The appropriate debt target will depend on economy-specific characteristics, including debt composition, depth of domestic financial markets, vulnerability to shocks, and diversification of the investor base.

- *Sustained adjustment in primary structural balances*. Experience in past large consolidations indicates that this is the key element in a successful reduction of the debt ratio. In advanced economies, the primary balance adjustment required over the next ten years to return debt ratios to about 60 percent of GDP (80 percent of GDP in Japan) by 2030 is of the order of 8 percentage points of GDP (from a deficit of 3½ percent of GDP in 2010 to a surplus of 4½ percent of GDP in 2020 and keeping it at that level for the following decade). Winding down fiscal stimulus measures could provide only about 1½ percent of GDP—thus additional fiscal measures will be needed (e.g., reform of pension and healthcare entitlements).

- *Strong fiscal policy frameworks and institutions with comprehensive coverage of the public sector*. Formally adopting or strengthening fiscal rules with explicit fiscal targets and monitoring by independent fiscal agencies could help shore up the necessary broad consensus, anchoring expectations and guiding fiscal policy implementation over the medium term.

20. **Monetary policy can remain accommodative in the major advanced countries, but central banks need to prepare and clearly communicate credible strategies for unwinding the extraordinary monetary policy support**. The crisis compelled central banks to employ a wide range of crisis-intervention measures, in many cases unprecedented. Unwinding should be tractable and central banks have the tools needed to tighten policy, but there will be challenges.

- *The key objective will be to maintain price stability*, but where financial stability remains fragile, or key markets are not yet functioning, central banks may need to maintain crisis-intervention measures or possibly introduce new targeted ones, even within the context of an overall tightening of the monetary policy stance.

- *Central banks will need to unwind conventional and unconventional measures at different paces*. Some unconventional (or "balance sheet") measures are already being unwound, as funding markets improve and certain facilities expire or run off automatically. Central banks can further tighten the parameters of existing facilities,

or introduce new liquidity-absorbing instruments, if tightening is needed before their balance sheet has been restored to normal levels. However, reducing central banks' exposure to assets associated with credit easing operations and private or quasi-sovereign financial instruments will depend on the state of financial markets and may take considerable time.

Emerging economies

21. **In major emerging (and some advanced) economies experiencing faster recoveries, including those with sufficient fiscal space, the desirable policy mix may be different.**

- In a number of emerging economies, monetary policy may have to be tightened relatively soon (or further where tightening has begun) and ahead of fiscal consolidation, owing to rising inflation or incipient financial vulnerabilities. In economies with broadly balanced external positions, monetary tightening may be complicated, as it could amplify exchange rate pressures. These economies may have to consider tightening their fiscal stance more quickly (while maintaining measures aimed at mitigating the social impact of the crisis). Fiscal tightening should also be the priority where stimulus measures have contributed directly to a strong rebound in domestic demand, or where market concerns regarding public debt sustainability are high or rising. Under some circumstances, reserve accumulation, restrictions on capital inflows and macro-prudential measures could also form part of the policy mix (see discussion below).

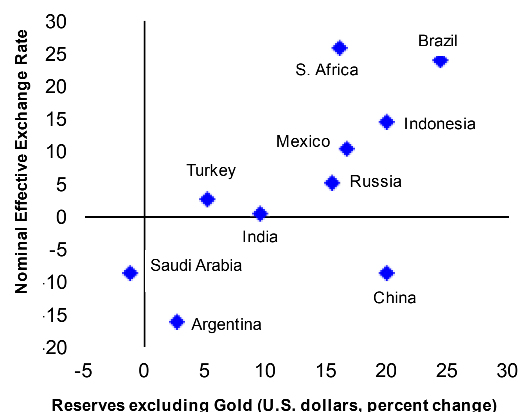
- Emerging economies that have largely relied on export-led growth, which has led to large current account surpluses, face a key challenge in the current environment. Specifically, they need to rebalance their economies away from growth led by external demand to growth that is increasingly underpinned by robust domestic demand. Measures to address these challenges could include additional reforms to reduce precautionary savings, through further efforts to strengthen social safety nets, reforms of their pension and healthcare systems, and improved corporate governance.

22. **Some emerging market countries will also have to design policies to manage a surge of capital inflows**. Inflows can provide many benefits to the recipient economy. At times, however, they can also be very large, partly transitory, and inflict lasting damage if not managed carefully. Addressing the challenges posed by inflows is a complex task. The right responses differ across countries, including some fiscal tightening to ease pressure on interest rates and exchange rate appreciation or greater flexibility. Macro-prudential policies, some reserves accumulation, and carefully designed capital controls on inflows can also be part of the appropriate response in certain circumstances.

23. **Greater exchange rate flexibility would help reduce capital inflows and facilitate rebalancing in major emerging surplus economies**. Exchange rate appreciation would help remove one-way bets and reduce capital inflows. At the same time, allowing currencies to strengthen on a multilateral basis in response to capital inflows would also help rebalance their sources of growth. Stronger currencies will raise purchasing power and expand the opportunity set for domestic consumers in these countries and encourage the needed shift in productive resources from export sectors to domestic services sectors.[2] As the counterpart, depreciating currencies in major deficit countries would facilitate a needed adjustment away from overstretched domestic demand. Strengthening multilateral liquidity provisions and insurance mechanisms through IFIs, could promote greater exchange rate flexibility, by limiting incentives for excessive reserve accumulation.

24. **Countries may choose to limit exchange rate appreciation and accumulate reserves, but this is not a long-term solution**. Many emerging G-20 economies have already built up large reserve buffers, reducing the social value of further accumulation in some cases. In some economies, ongoing accumulation has contributed to excessive domestic money and credit growth and increased risks of inflation, deteriorating credit quality, and asset prices bubbles. Sterilizing capital inflows is one alternative, but this can be costly. Also, the ability of shallow domestic debt markets to absorb large quantities of new central bank issuance is limited in many emerging economies.

Reserves and Nominal Exchange Rates 1/
(Percent change; March 2009-December 2009)



1/ China's reserves to October 2009; Brazil, Indonesia and Russia reserves to November 2009.

25. **Monetary and fiscal policies can help to reduce inflows** if the central bank has exhausted the sterilization possibilities and risks losing monetary control, or does not want to accumulate further reserves (assuming that further exchange rate appreciation would not be appropriate). The policy response would be to lower interest rates, thus reducing incentives for inflows, and to tighten fiscal policy–particularly when capital inflows are driven by fiscal expansion–thus reducing currency appreciation pressures. However, if the economy is at risk of overheating and there are inflationary pressures, reducing interest rates is not an attractive policy option, while both political considerations and implementation lags may limit the scope for fiscal consolidation.

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[2] For non-renewable resource economies, there are limits to domestic absorption as a mechanism for reducing surpluses, and, in some cases, few linkages between the production structure involving the natural resource and nontradable sectors.

26. **Domestic prudential regulation can help limit the risks from inflows, while capital controls can slow inflows down**.[3]

- *Macro-prudential policies may offer a broader and longer term solution but do not represent a panacea*. Such policies can be used to address the potential for bubbles at an early stage by limiting a buildup in risks. Limits on leverage, loan-to-value ratios, and well-managed margining and collateral systems in securities markets may usefully form part of this approach. However, deploying such policies requires changes in the prudential infrastructure that may take time to implement

- *Capital controls may be particularly useful if the inflow surge is short-term in nature*. However, they need to be designed bearing in mind their costs and limitations, and need to take account of implementation capacity, including: (i) the possible erosion in their effectiveness over time in today's deep and sophisticated financial markets; (ii) the implementation costs, such as those for an enhanced system of unremunerated reserves; and (iii) the creation of distortions in the domestic financial system.

- *Consideration should also be given to the multilateral repercussions of capital controls*. Their widespread use could have deleterious effects on the efficient allocation of investment across countries, and for systemic countries, could also impede necessary steps to address global imbalances by allowing countries to avoid appreciation where currencies are undervalued, and where appreciation is needed to support global demand rebalancing. Their adoption may also divert rather than prevent flows, complicating the management of inflows for other countries, and triggering contagion in the use of capital controls.

B. Financial Sector Policies

27. **The nature of the policy challenge in advanced G-20 economies is shifting towards an unwinding of extraordinary support measures and laying the foundation for a more robust and efficient financial system**. The concerted policy response to the crisis is ebbing gradually as confidence in financial markets gradually returns amid firming signs of economic revival.

28. **Major work still remains to repair the damage and reduce the distortions, wrought by the crisis on the financial system.** In particular:

- *Bank recapitalization*. Larger capital buffers are required to absorb the ongoing and expected future deterioration in credit quality and to meet higher capital standards

[3] The Staff Position Note "Capital Inflows: The Role of Controls" by Ostry, Ghosh, Habermeier, Chamon, Qureshi, and Reinhardt (SPN/10/04; February 19, 2010) discusses these issues in more detail.

expected in the future. This would also reduce the immediate pressures on banks to deleverage their balance sheets and would provide a solid base from which banks can provide the necessary credit to a recovering global economy. To facilitate a smooth adjustment to the new regime, higher capital requirements should be pre-announced and phased-in gradually.

- *Bank consolidation, resolution, and restructuring*. This will facilitate the return to health of the banking system and help avoid further turbulence from weaker institutions as extraordinary policy support is withdrawn. In the longer term, care must be taken that consolidation does not exacerbate the problem of institutions which are too big to fail. Urgent priorities include: (i) the development of concrete plans to address funding challenges, given the wall of debt rollovers and likely withdrawal of liquidity support measures from central banks; and (ii) a reduction in their reliance on wholesale funding markets. Other key priorities are the development of special resolution schemes (with a cross-border dimension) for systemically important institutions and, more generally, steps to address the risks posed by institutions which are too large and systematically interlinked.

- *Greater urgency and clarity in defining the regulatory framework* for a new and safer financial system. Credible plans and timetables for implementing regulatory reforms need to be developed and announced, to reduce regulatory uncertainty and to provide for phased implementation as conditions improve. The timing of implementation should be carefully chosen, in order to avoid pro-cyclical effects on a still fragile banking system.

- *Reviving securitization markets*, which remain impaired and dependent on official support. To promote sound securitization, measures could be taken to improve monitoring along the securitization chain, including by improving disclosure standards, simplifying and standardizing securitization structures, and restoring the integrity of the ratings process.

29. **Recent proposals of some G-20 countries may help to reduce systemic risks, provided they are part of broader, coordinated regulatory reforms**. The US administration, for example, has proposed simple and relatively transparent constraints on commercial bank activities and size which may serve as a useful back-up to risk-focused measures (such as capital ratios). It has also joined other G-20 countries in proposing measures to cover bailout costs and discourage leverage and excessive reliance on wholesale funding. Such proposals need to be viewed in the context of broader financial sector reforms, including an assessment of the trade-offs between greater regulation and financial sector taxation. In particular, proposals for a broad-based financial sector transactions tax should aim to charge for the commitment of possible sector support and align incentives so as to reduce systemic risks. Greater attention also needs to be paid to cross-border

supervisory coordination, to ensure a level-playing field for internationally active institutions.

30. **The timing of exits from financial support policies should remain conditional on the strength and stability of the underlying activity**. In particular:

- *Exiting from some programs could be relatively fast and easy*, especially those that support shorter-term funding markets and liquidity provision—some are falling into disuse as private market activity revives.

- *Other programs may need to remain in place* for some time due to persistent vulnerabilities, including: enhanced credit support programs through purchases of private sector securities; and securitization markets, such as for mortgage-backed paper. Policymakers should err on the side of caution in these areas as market pricing may give misleading signals on the timing of exit.

- *Some operational changes implemented during the crisis may warrant retention* even as their usage ends in order to guard against unexpected developments, including: measures to reduce market stigma, such as non-disclosure of standing facility use during times of stress; broader eligibility of high-quality collateral for central bank liquidity provision; and a larger number of open market operation counterparties, with due consideration of administrative costs, to increase the efficiency of money market transactions.

- *Exits will also need to be made consistent across countries* to avoid adverse spillovers, but this does not necessarily imply that they should be synchronized.

31. **Designing and implementing financial sector reform will require a high degree of domestic and cross-border coordination.** Regulators and fiscal authorities will have to make sure that policies in their respective areas are not working at cross-purposes or collectively leading to unduly burdensome outcomes. For instance, financial sector taxation, if implemented, will need to be coordinated with the prudential regime for financial institutions. Regulatory regimes will also need to be consistent across countries in order to reduce the scope for the inefficiencies that arise from regulatory arbitrage.

32. **The exit from the extraordinary support measures implemented in the crisis must lead to a financial system that is safer as well as sufficiently innovative to support strong, sustained, and balanced growth**. It is encouraging that plans are being developed to reform the financial system, but momentum must not be lost as market confidence rebounds. Measures are needed in several areas to resolve the shortcomings that led to a build-up of systemic risk. In particular:

- *Regulatory gaps* should be closed to prevent the transfer of risk to financial institutions that face different regulatory requirements by broadening the perimeter of regulation to cover all systemically-important institutions;

- *Risk coverage* should be enhanced to more adequately capture certain activities, such as those that lead to complex derivative, securitization, and repo exposures;

- *Financial sector supervision should be enhanced* and will need to be alert to new market practices, instruments and institutions, including those that develop in response to a new regulatory environment;

- *Risk management needs to be improved*. Regulation and oversight should encourage private financial institutions to work towards ensuring that risk management practices are robust and that the drive to increase market share is not undertaken at the expense of prudent risk management.

- *The quality and transparency of banks' capital and liquidity* should be raised to provide greater buffers against losses and absorb shocks, to include greater cross-border consistency;

- *Prudential frameworks* must play a greater stabilizing role over the business cycle to avoid the build-up of financial vulnerabilities during the boom phase and the fire sales and abrupt deleveraging that amplified the impact of the crisis;

- *Measures must reduce financial institutions incentives to become too big to fail or too interconnected*, including by charging for contributions to systemic risk through higher capital requirements and by encouraging the shifting of bilateral derivative exposures to strong central counterparties; and

- *Compensation policies* must provide effective alignment with prudent risk-taking and adequate oversight by regulators.

33. **Most emerging economies face fewer challenges in exiting from crisis interventions but they too must aim to strengthen their financial stability frameworks**. Emerging economy central banks implemented a more limited set of crisis measures focused on foreign exchange and domestic liquidity provision without reducing policy rates to the zero bound and sharply expanding balance sheets. A large portion of crisis intervention measures in these economies has already been unwound. The challenge now for them is to continue strengthening their financial stability frameworks to ensure that capital inflows are put to good use, with a view to avoiding the excesses manifested elsewhere in the run-up to this crisis.