Group of Twenty

G-20 Leaders Summit
September 24, 2009
Pittsburgh, U.S.A.

Global Economic Prospects and Policy Challenges[1]

Prepared by Staff of the International Monetary Fund

[1] This note summarizes the more in-depth analysis provided in the report circulated for the meeting of G-20 Ministers and Deputies, held in London on September 3-4, 2009.

Key Messages

Global economic outlook

- The global economy is beginning to grow again, but the recovery is likely to be sluggish and policy support needs to be sustained until the expansion is firmly established.
- Financial conditions have continued to improve, but the global financial system is far from normal, and many markets remain dependent on public support. Banking systems are still undercapitalized and saddled with impaired assets, suggesting that deleveraging pressures will remain a constraint on bank credit for some time.
- The overarching risk to the outlook is that the recovery stalls, either because of a premature exit from accommodative macroeconomic policies or because measures to restore health to bank balance sheets are not fully implemented. Fiscal sustainability issues are also coming to the fore.

Policy implementation and effectiveness

- Bold and wide-reaching policy measures implemented by G-20 economies have helped stabilize confidence, limit the threat of further financial instability, and provided an impetus to economic growth.
- Policymakers must, however, avoid becoming complacent, and should move rapidly to implement policies already proposed. Most notably, greater progress needs to be made in recapitalizing viable banks as needed.
- Considerable fiscal stimulus remains in the pipeline through 2010 for the G-20 as a whole, and should be implemented expeditiously to maximize the impact on growth and employment.

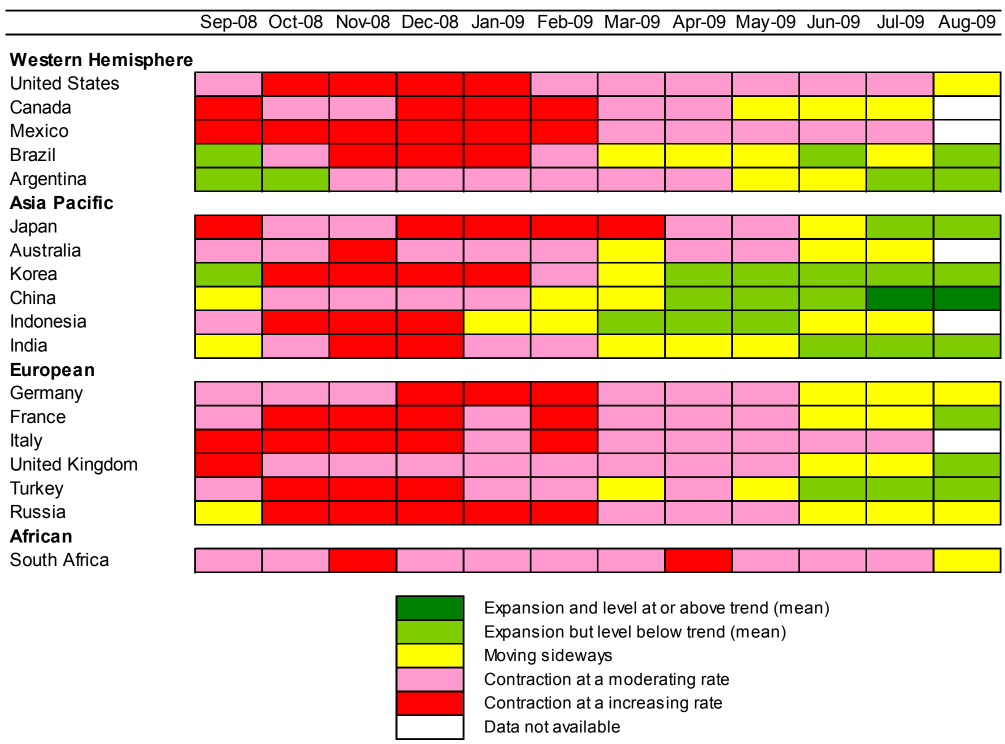
Exit strategies

- The key challenges involve mapping a course between unwinding public interventions too early and too late, and maintaining market confidence in the sustainability of public finances. Clear communication of exit strategies will be critical.
- Central banks will eventually need to unwind their extraordinary liquidity and credit support, but may need to start tightening their monetary stance well before balance sheets are fully restored.
- Fiscal support should be maintained while the recovery is still fragile. Eventual adjustment will need to be large, particularly for advanced economies where public debts are rising rapidly, underpinned by a major reform of entitlements.

I. Recent Developments, Prospects, and Risks

1. **The global economy is beginning to grow again, but the recovery is uneven and remains dependent on policy support**. Following a sharp decline in the first quarter of 2009, output increased modestly in the second quarter. Real GDP expanded in some advanced economies—notably France, Germany, and Japan—while it has fallen at a much more modest pace elsewhere, including the United States. Emerging economies, notably in Asia, are turning around even more strongly. Recent data also suggest that the recovery is spreading, although the advanced economies continue to lag as consumers remain cautious (Figure 1). That said, the recent uptick in activity and the arrest of decline in private demand is largely driven by policy stimulus, including measures such as the cash-for-clunkers program, and a turn in the inventory cycle.

Figure 1: 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.

4/ Retail sales and IP are based on real data, whereas, exports are based on nominal data and PMI on survey data.

2. **Financial market conditions have continued to improve, but the global financial system is far from normal, with many markets remaining heavily dependent on public support.**

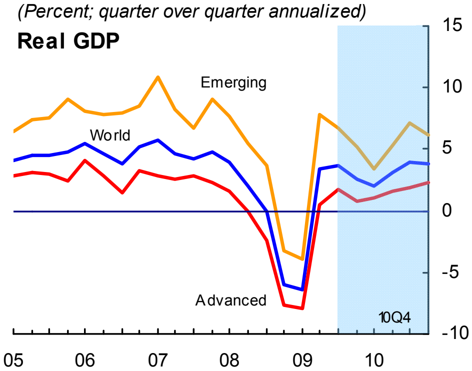
- The unprecedented response of both financial and macroeconomic policies has reduced the risk of systemic collapse, which when combined with brightening growth prospects has contributed to restoring market confidence and a pick-up in risk appetite. At the same time, however, banking systems remain undercapitalized and saddled with impaired assets—particularly in Western Europe—suggesting that deleveraging pressures will remain a constraint on bank credit for some time. Securitization activity also remains limited to where it has been supported by the public sector. Moreover, large public interventions have transferred risk to sovereign balance sheets, raising market concerns.

- Financial pressures have receded in emerging economies. That said, economies with large current deficits—notably in Europe—remain vulnerable to deleveraging in mature markets and the associated decline in cross-border bank flows. The Fund's new Flexible Credit Line and resource expansion have, however, helped curtail concerns about sudden stops. By contrast, some emerging economies, notably in Asia, are experiencing rapidly rising equity prices on the back of renewed large capital inflows, raising concerns of a possible resurgence of asset price booms.

3. **Going forward, the global economic recovery is expected to be sluggish**. Policy support and the turn in the inventory cycle—which are driving the recovery at the moment—will gradually lose impetus. At the same time, a sustained rebound in advanced economy private demand is likely to be held back for some time by limited credit availability, household desire to rebuild balance sheets, and still rising unemployment. The Fund's assessment remains that the recovery will be gradual, particularly in the advanced economies. In particular, the October 2009 *World Economic Outlook* projects that global activity will contract by 1.1 percent in 2009, before expanding by about 3.1 percent in 2010 (Table 1).

Global Growth

(Percent; quarter over quarter annualized)



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

- *Activity in the advanced economies is projected to decline by just under 3½ percent in 2009, followed by a modest rebound in 2010*. Projected quarterly growth rates in 2010 still fall short of potential until late in the year, implying continuing increases in unemployment.

- *Activity in emerging and developing economies is projected to continue gaining momentum during the second half of 2009 and 2010, albeit with notable differences across regions*. Overall, growth in these economies is projected at about 1¾ percent in 2009 before rebounding to around 5 percent in 2010. The recovery is being led by the strong rebound in Asian economies, fueled mainly by China and India.

4. **Output gaps will continue to widen and inflation will remain low.** Given the sluggish recovery, output gaps are projected to widen through the end of 2010, even after taking into account reductions in potential output as a result of the crisis. As a result, unemployment is likely to continue to rise in the advanced economies well into 2010 and inflation pressures should remain subdued, notwithstanding the recent upturn in commodity prices.

5. **Downside risks to the recovery are receding gradually but remain a key concern**. The overarching risk is that the recovery stalls, either because of a premature exit from accommodative monetary and fiscal policies or because financial strains persist in the event that efforts to restore bank balance sheets to health are not forcefully implemented. Other risks relate to rising market concerns about fiscal sustainability in the face of widening deficits and surging public debt, which could contribute to rising long-term bond yields and limit countries' ability to pursue countercyclical fiscal policies. In the case of emerging economies, while external financing pressures have largely abated, there is a risk that banks in advanced countries continue to further reduce their cross-border positions, leading to a "sudden stop" of capital inflows.

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

	Year over Year						Q4 over Q4 2/	
			Projections		Difference from July 2009 WEO Projections		Projections	
	2007	2008	2009	2010	2009	2010	2009	2010
World output 3/	**5.2**	**3.0**	**-1.1**	**3.1**	**0.3**	**0.6**	**0.8**	**3.2**
Advanced economies	2.7	0.6	-3.4	1.3	0.4	0.7	-1.3	1.7
Euro area	2.7	0.7	-4.2	0.3	0.6	0.6	-2.5	0.9
Emerging and developing economies 4/	8.3	6.0	1.7	5.1	0.2	0.4	3.8	5.5
G-20 2/	5.0	2.8	-1.0	3.3	0.2	0.5	1.1	3.5
Argentina	8.7	6.8	-2.5	1.5	-1.0	0.8	-5.4	6.0
Australia	4.0	2.4	0.7	2.0	1.2	0.7	1.4	2.8
Brazil	5.7	5.1	-0.7	3.5	0.6	1.0	2.2	3.5
Canada	2.5	0.4	-2.5	2.1	-0.2	0.5	-1.5	3.0
China	13.0	9.0	8.5	9.0	1.0	0.5	10.1	9.2
France	2.3	0.3	-2.4	0.9	0.6	0.5	-0.9	1.4
Germany	2.5	1.2	-5.3	0.3	0.9	0.9	-2.9	0.8
India	9.4	7.3	5.4	6.4	0.0	-0.1	5.1	7.0
Indonesia	6.3	6.1	4.0	4.8	0.5	0.3	4.2	5.4
Italy	1.6	-1.0	-5.1	0.2	0.0	0.3	-3.2	0.8
Japan	2.3	-0.7	-5.4	1.7	0.6	0.0	-1.3	1.4
Korea	5.1	2.2	-1.0	3.6	2.0	1.1	4.3	3.5
Mexico	3.3	1.3	-7.3	3.3	0.0	0.3	-4.1	3.4
Russia	8.1	5.6	-7.5	1.5	-1.0	0.0	-2.7	-0.9
Saudi Arabia	3.3	4.4	-0.9	4.0	0.0	0.1	…	…
South Africa	5.1	3.1	-2.2	1.7	-0.7	-0.6	-2.1	2.9
Turkey 5/	4.7	0.9	-6.5	3.7	-1.4	2.2	0.7	2.7
United Kingdom	2.6	0.7	-4.4	0.9	-0.2	0.7	-2.5	1.3
United States	2.1	0.4	-2.7	1.5	-0.1	0.7	-1.1	1.9
European Union	3.1	1.0	-4.2	0.5	0.5	0.6	-2.5	1.1

Note: Real effective exchange rates are assumed to remain constant at the levels prevailing during July 30-August 27, 2009. Country weights used to construct aggregate growth rates for groups of countries were revised.
1/ October 2009 World Economic Outlook.
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.
5/ For Turkey, the projections reported in the July 2009 World Economic Outlook were prepared prior to the release of the June 30 Q1 data.

II. Policy Implementation and Effectiveness

G-20 economies have implemented bold and wide-ranging measures to address the financial crisis and global recession, yielding tangible benefits. With the recovery still at an early stage, policy support will need to remain in place longer, and further strengthened in some key areas. However, to safeguard price and financial stability and the soundness of public finances, policymakers will need to form credible and coherent exit strategies from extraordinary short-term support toward sustainable medium-term policies.

Financial Sector Policies

6. **Policy responses to the global crisis have helped stabilize confidence and limit the threat of further financial instability**. Financial sector policies have reduced counterparty concerns and eased liquidity pressures. Significant public injections of capital into financial institutions have been critical in shoring up confidence and reducing extreme

financial stress. At the same time, bank liability guarantees have helped to reassure creditors that their claims on financial institutions would be protected.

7. **Nonetheless, restoring the financial system to full health will require additional policy actions aimed at diagnosing the condition of banks and recapitalizing them as needed**. Bank stress tests in the *United States* and the *United Kingdom* have been helpful in identifying capital needs and reducing uncertainty. The priority is now to ensure that losses are fully recognized and capital cushions rebuilt. In the *euro area*, the ongoing stress test assessments should also be used as a base to ensuring capital meets identified needs. Banking systems in other emerging economies generally appear less vulnerable, but authorities should still assess their soundness in the context of the deep economic downturn.

8. **Policies to deal with impaired assets have had limited success so far**. The *European Union*, *Germany*, the *United States,* the *United Kingdom*, and *Korea* have all announced plans for dealing with impaired assets, but implementation has been slow. Further progress in this area will be needed to reduce balance sheet vulnerability and help pave the way for banks to increase lending.

Monetary Policy

9. **Major central banks have been effective in supporting economic activity and credit creation, albeit using different approaches**. Most major advanced economy central banks have reduced policy interest rates to close to zero and signaled that they are likely to remain low for an extended period. Central banks have also used a range of instruments, tailored to the circumstances of their economies, to support financial intermediation and encourage credit flows. Policy actions, including forceful monetary easing and interventions aimed at enhancing credit and liquidity support, have helped ease financial stress and improved the functioning of money, foreign exchange, and commercial paper markets. Securitization activity, however, remains largely limited to where it has been supported by the public sector, and needs to be rebuilt to deliver on its promise to transfer and disperse credit risks from the banking system to capital markets.

10. **In emerging economies, there remains scope to cut policy rates if needed to support demand.** That said, in some countries, notably in Asia, rising asset prices and a vigorous turnaround in economic activity suggest that policy may need to be tightened. In *China*, for instance, the monetary expansion has fed through to the domestic economy and there may be a need to curtail sharply rising credit growth. In countries where financing conditions are easing and exchange rates have appreciated, there may be scope for limited policy easing to support a resumption of growth.

Fiscal Policy

11. **G-20 countries have provided substantial fiscal stimulus, which when fully implemented will have a sizeable impact on growth.** Planned crisis-related discretionary

measures are estimated at 2 percent of GDP in 2009 and 1.6 percent of GDP in 2010.[1] A full progress report on implementation of fiscal stimulus packages in G-20 countries to date is difficult, given operational challenges in reporting and limited specific information.[2] In general, however, implementation rates are reported to be higher for revenue measures and social transfers and lower for infrastructure projects. This contributes to cross-country variation in overall implementation, as the composition of stimulus differs by country. The crisis is, however, having a substantial impact on fiscal positions in G-20 countries, with overall deficits projected to increase by 5.6 percentage points and 5.3 percentage points of GDP in 2009 and 2010, respectively, from pre-crisis levels.

12. **Considerable fiscal stimulus remains in the pipeline through 2010 for the G-20 as a whole, and should be implemented expeditiously to maximize the impact on growth and employment**. The stimulus measures implemented most rapidly—tax breaks and transfer payments—typically have lower multipliers. Implementation of higher multiplier items is likely to pick up in the second half of 2009, particularly in infrastructure, suggesting that growth and employment impacts could increase during the remainder of the year. Estimated growth impacts range from 1.2 to 4.5 percentage points in 2009 and from zero to 0.8 percentage points in 2010, both with respect to the previous year.[3]

13. **Governments and central banks have also continued to provide direct support to the financial and other sectors, which has been both broadly effective and considerably less costly than originally announced**.[4] The latter reflects a variety of factors including the precautionary nature of initial announcements, increasing stability and bank liquidity, and mixed progress in implementing recapitalization and asset purchase programs. Upfront government financing needs connected with financial support operations are estimated at around 5½ percent of GDP for the advanced G-20 countries and about ½ percent of GDP for the emerging G-20 countries.

---

[1] Assuming phased implementation of stimulus spending initiated this year and carryover of tax provisions.

[2] Only a few G-20 countries report stimulus spending systematically. Challenges include lack of a standard definition for implementation, especially for spending (e.g., transfers to agencies or subnational governments, commitment and payment stages), stimulus measures that do not involve new or separate budget items, and lags in reporting or provision (e.g., due to tax filing schedules).

[3] These estimates include spillovers to other countries (via imports) and reflect the impact of the *full* fiscal expansion and not only the discretionary stimulus.

[4] For example, advanced economies for which data are available allocated 3½ percent of GDP on average for capital injections, but the amount utilized so far has been just over two-fifths of that (1½ percent of GDP). Purchases of assets and treasury lending is even lower, at less than one fifth of the allocated amount.

III. Exiting From Extraordinary Public Actions

Policymakers will need to bridge from extraordinary short-term support to medium-term policy requirements through credible and coherent exit strategies. The key challenge is to map a course between unwinding public interventions too early, which would jeopardize progress in securing financial stability and economic recovery, and withdrawing them too late, which would distort private incentives and create new risks. Clear communication of exit strategies is essential.

Financial Sector Support

14. **Additional policy actions are still needed to help restore financial sector health, but policymakers should begin to lay the groundwork and clearly communicate the strategies for eventual exits**. Plans will need to be tailored to specific policy areas to assure markets that exits consistent with medium-term policy goals can be achieved without short-term disruptions. Restarting healthy intermediation of credit will also depend on prudential framework reform to ensure stronger risk management. International coordination will also be essential to securing a level playing field and preventing destabilizing cross-border capital flows as a result of regulatory differences.

15. **Exits from financial sector policies will need to be gradual and in line with market developments**. To the extent possible, priority should be given to exiting from programs that have the greatest distortionary impact on financial market decisions and/or involve considerable contingent liabilities to the government.

- *Healthy banks should be encouraged to repay public capital injections, issue non-guaranteed debt, and end recourse to asset guarantees as a signal of their viability.* This process should be encouraged by gradually reducing public subsidies and tightening access terms, particularly with respect to reducing banks' reliance on guaranteed debt. Chronically weak institutions should be resolved expeditiously, rather than kept on life support.

- *Governments that have purchased impaired assets to help banks cleanse their balance sheets may need to hold them for an extended period*. Disposal of these assets may need to be a slow process, especially given that investor appetite for complex and illiquid assets may not return for some time. Priority should be given to ensuring that assets are well-managed and their value maximized.

Central Bank Support

16. **Credible exit strategies for unwinding monetary policy support need to be prepared and communicated now, for swift implementation, once recovery is firmly underway.** Interest rates should be raised as economies recover and output gaps narrow, but the path should take account of the withdrawal of fiscal support. To ensure transmission of

tighter monetary conditions to the real economy, central banks should ready instruments to reabsorb liquidity at the appropriate time, including by engaging in reverse repurchase operations, raising interest rates on deposits to banks, or issuing their own paper.

17. **Interest rate hikes will likely be needed sooner in emerging than advanced economies, given more favorable growth outlooks and attendant inflation pressures**.

- *In advanced G-20 economies, central banks can afford to maintain low interest rates for an extended period, as underlying inflation is expected to remain very low*. The risk of inflation and excessive risk taking is limited over the near term, as weak balance sheets are likely to weigh on credit availability. Nonetheless, once a recovery is firmly underway, as signaled by recovering employment, monetary policy will need to be tightened.

- *The situation is more varied across emerging G-20 economies, but monetary accommodation will likely need to be withdrawn sooner*. A number of these economies, notably in Asia, are already enjoying relatively vigorous rebounds of activity, significant asset price increases, and robust credit growth in response to low interest rates. Some emerging economies should consider prudential actions to limit excessive credit creation.

18. **Conventional monetary tightening will need to be accompanied by steps to offset the impact of large central bank balance sheets**. The composition of central bank assets will in part determine the approach to be taken.

- *For central banks that have relied on short-term instruments to expand their balance sheets, excess reserves can be absorbed by simply letting these instruments mature*. This unwinding has already started to some degree as funding markets improve and banks reduce demand for precautionary excess reserves.

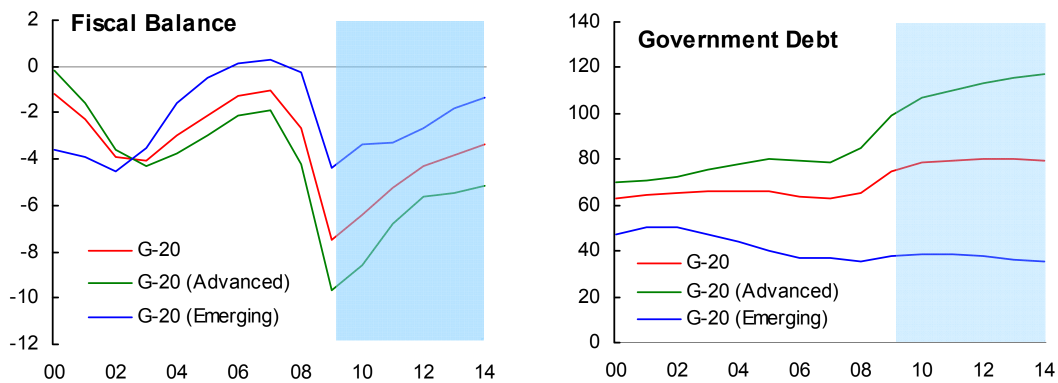
- *Selling assets associated with credit easing operations in specific markets may prove to be more difficult and would need to depend on the state of these markets*. There may be scope to reduce central bank holdings of government securities since markets are quite liquid, but the disposal of private or quasi-sovereign financial instruments may be more problematic.

Fiscal Support

19. **Despite a gradual expected reduction in fiscal deficits over the medium term, public debt is expected to rise sharply in advanced G-20 economies**. A revival of tax revenues and a phasing out of discretionary spending initiatives may be expected when conditions improve, but some of the revenue base may have been lost permanently due to the crisis. Overall fiscal deficits under current policies are projected to remain higher in 2014, compared with 2007, in both advanced and emerging G-20 economies. In advanced

G-20 economies, debt levels are projected to rise to close to 120 percent of GDP, up from about 80 percent before the crisis on account of higher deficits and weak economic growth. In emerging G-20 economies, debt levels are expected to decline slightly after the initial post-crisis peak, reflecting smaller deficits and relatively stronger projected economic performance. However, the outlook for debt would be far worse if global growth recovers more slowly.

Outlook for Public Finances
(Percent of GDP)



Source: IMF, World Economic Outlook.

20. **The increase in fiscal deficits and debt raises tradeoffs regarding the timing of stimulus withdrawal**. Premature withdrawal of stimulus would undermine the recovery, but delayed withdrawal could fuel investor concerns about sustainability, leading to higher bond yields, undermining the recovery and worsening the debt dynamics. At this stage, fiscal adjustment is premature, but is projected to get underway by 2011 in most countries (earlier in some) as fiscal stimulus measures expire and output gaps narrow.

21. **Regardless of the timing of adjustment, its necessary scale will be large, particularly for high-debt advanced economies**. Staff estimate that "high debt" advanced and emerging economies would need a further improvement in their general government primary balances from 2014 of 5½ percentage points and ¾ percentage point of GDP (on average for the subsequent fifteen years) to reduce debt-to-GDP ratios to 60 and 40 percent of GDP by 2029, respectively.

22. **Few G-20 countries have so far developed fully fledged medium-term fiscal adjustment strategies and consolidation policies have yet to be put in place**. Some have announced medium-term targets or have extended the horizon of their fiscal projections, but detailed plans have not been specified. Where proposed, measures have focused on fuel tax increases, greater income tax progressivity, and restraining expenditures. Under current policies, however, spending on pensions and health care is projected to increase substantially over the next two decades, especially in the advanced economies.

23. **Going forward, a strategy to ensure fiscal solvency should be articulated.** This should be based on: (i) a firm commitment and a clear strategy to contain aging-related spending, especially in advanced economies; (ii) growth-enhancing structural reforms; and (iii) fiscal policies cast within medium-term fiscal frameworks (and supportive institutional arrangements) that envisage a gradual fiscal correction once economic conditions improve. Reforms in the these areas will play a key role by: directly improving prospects for the primary balance, thereby helping to contain the debt-to-GDP ratio; and bolstering confidence in fiscal sustainability, which should help to limit increases in bond yields.

24. **Comprehensive medium-term macroeconomic strategies should be announced as soon as is feasible, to anchor expectations in credible paths for debt and deficit reduction.** During the crisis, countries with existing fiscal rules (e.g. the EU's Stability and Growth Pact) have generally retained them—in some cases making use of escape clauses. The crisis has tested their resilience and highlighted the importance of built-in flexibility. Entitlements reforms need to be put in place now to underpin fiscal sustainability.