INTERNATIONAL MONETARY FUND

Key Issues Note by the IMF Managing Director to the IMFC on the Global Economy and Financial Market—Outlook and Policy Responses

September 30, 2009

Sustaining the recovery. The global economy appears to be expanding again and financial conditions have improved markedly. Financial market sentiment and risk appetite have rebounded, banks have raised capital and wholesale funding markets have reopened, and emerging market risks have eased. The triggers for this rebound are strong public policies that have allayed concerns about systemic financial collapse, supported demand, and all but eliminated fears of a global depression. However, the recent recovery is not yet self-sustaining. The forces that are driving the current rebound are temporary in nature, including restocking and major fiscal stimulus, and will diminish in the course of 2010. Limits on credit availability will also be a key constraint on the pace of recovery. Meanwhile, consumption and investment are gaining strength only slowly, held back by large increases in unemployment, the need for balance sheet repair, and high excess capacity, as well as financing constraints. The WEO projections see activity contracting by about 1 percent in 2009 and expanding by about 3 percent in 2010, well below rates achieved before the crisis, and downside risks remain a concern.

Do Ministers and Governors agree that the current rebound remains very dependent on supportive macroeconomic and financial policies? How do they see the pressures for premature exit from these policies? How should exit policies be coordinated?

Reconciling short and long-run fiscal challenges. Global fiscal stimulus needs to be sustained until the recovery is on a firm footing, and may even need to be amplified or extended beyond current plans if downside risks to growth materialize. At the same time, governments need to step up their efforts to constrain future spending, by advancing reforms to entitlements and by committing to large reductions in deficits once the recovery is on a solid footing. This is essential to maintain fiscal credibility and policy effectiveness in the face of large and rising public debt stocks.

How do Ministers and Governors see fiscal policy challenges? Do Ministers see political constraints on further stimulus implementation? What initiatives would help support the credibility of fiscal sustainability and provide room for short-term fiscal stimulus if needed?

How to exit from easy monetary conditions. The key issues facing monetary policymakers are when to start tightening and how to unwind large central bank balance sheets. Advanced and emerging economies face different challenges. In *advanced economies*, central banks can (with few exceptions) afford to maintain accommodative conditions for an extended period since inflation is likely to remain subdued as long as output gaps remain wide. Moreover, monetary policy will need to anticipate the impact of the gradual withdrawal of fiscal support. If and when necessary, instruments exist to start tightening monetary conditions even while central bank balance sheets remain much larger than usual, allowing the unwinding of balance sheet expansions to be tailored to improvements in credit market conditions. The situation is more varied across *emerging economies*, but the moment for starting to remove monetary accommodation is likely to materialize sooner in a number of these economies than in advanced economies. In some countries, warding off risks for new asset price bubbles may (aside from strong prudential policies) call for greater exchange rate flexibility, to allow monetary policy tightening relative to easy stances in advanced economies.

Do Ministers and Governors agree that inflationary pressures are likely to remain low over the foreseeable future or do they see appreciably upside risks? Do they foresee difficulties in raising policy rates even while central bank balance sheets remain larger than usual? Looking beyond the crisis, how should monetary policy frameworks be enhanced to help preserve economic and financial stability?

Repairing and reforming financial sectors. Two challenges need to be addressed. The first is to ensure that markets and banks can support economic recovery. This calls especially for renewed efforts to increase bank capital and repair bank balance sheets. Official stress tests are important instruments to help achieve this. In addition, exit strategies from public support need to be clearly articulated to help guide markets. Programs need to be phased out very gradually, using market-based incentives to encourage reduced reliance on public support. The second challenge is to put in place reforms that forestall a similar crisis in the future. This will require a major overhaul of micro- and macro-prudential policies. Several issues deserve particular attention: First, the perimeter of regulation needs to be broadened and made more flexible, covering all systemically important institutions, alongside measures that address the problems posed by institutions presently considered "too big or too connected to fail." Second, macroprudential frameworks must induce banks to build more capital in good times to support continued lending in bad times and combat other forms of procyclicality. Third, international collaboration and coordination need to be improved.

How do Ministers and Governors see the progress with respect to restoring the stability of the banking system? With political and market resistance to critical financial sector reforms on the rise, how can reform momentum best be sustained to ensure that the financial system is overhauled and the likelihood of future crises reduced?

Rebalancing global demand. Achieving sustained healthy growth for all countries over the medium run also depends critically on rebalancing the pattern of global demand. Specifically, many current account surplus economies that have followed export-led growth strategies will need to rely more on domestic demand growth to offset likely subdued domestic demand in deficit economies that have undergone asset price/housing busts. By the same token, many external deficit countries will have to shift from domestic to externally-led growth. This will require changes in fiscal policies as well as significant structural reforms, notably measures to repair financial systems; improve corporate governance and financial intermediation; support public investment; and to improve labor and product markets as well as social safety nets.

How do Ministers and Governors see prospects for rebalancing global demand? What part can the IMF play to ensure adequate progress is made?