GROUP of TWENTY

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Global Economic Prospects and Policy Challenges

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Executive Summary

The global recovery has evolved better than previously anticipated, but it is proceeding at different speeds within and across regions. Recovery in advanced economies is being largely driven by extraordinary policy support and the turn in the inventory cycle, while in key emerging economies strong domestic demand, improvement in global trade and higher commodity prices are adding to the growth impetus.

The speed of recovery is expected to vary considerably across G-20 countries, with weaker and more fragile growth in most advanced economies contrasting with robust expansions in most emerging economies, particularly in Asia. After contracting by 0.6 percent in 2009, global output is expected to expand by 4.2 percent in 2010, an upward revision of 0.3 percentage points from the January *World Economic Outlook* update, with growth projected at 4.3 percent in 2011.

Concerns about advanced country fiscal sustainability and sovereign risks have come to the fore. There is an urgent need to design and implement credible fiscal policy strategies to bring down gross debt-to-GDP ratios over the medium. In the short term, absent such plans, high debt ratios could impede fiscal flexibility, increase the vulnerability of fiscally challenged economies, and constrain growth.

A multispeed recovery means that policy challenges will vary due to individual country circumstances. With recovery in most advanced G-20 economies expected to be weak, the fiscal stimulus planned for 2010 should be implemented fully. Tightening could begin in 2011, when the recovery is expected to become self sustaining.

Looking further ahead, policymakers have outlined strategies for exit from crisis-related intervention policies, although these are not underpinned by sufficiently specific measures in all cases. For countries with high levels of public debt, a clarification of strategies would be essential, with fiscal consolidation taking priority and with monetary policy able to play a balancing role to achieve a desired level of overall stimulus. In some emerging economies, particularly in Asia, monetary policy may have to be tightened relatively soon and ahead of fiscal consolidation due to concerns about overheating, credit quality, and asset price bubbles. In others, particularly some in Latin America, the opposite sequencing will be appropriate.

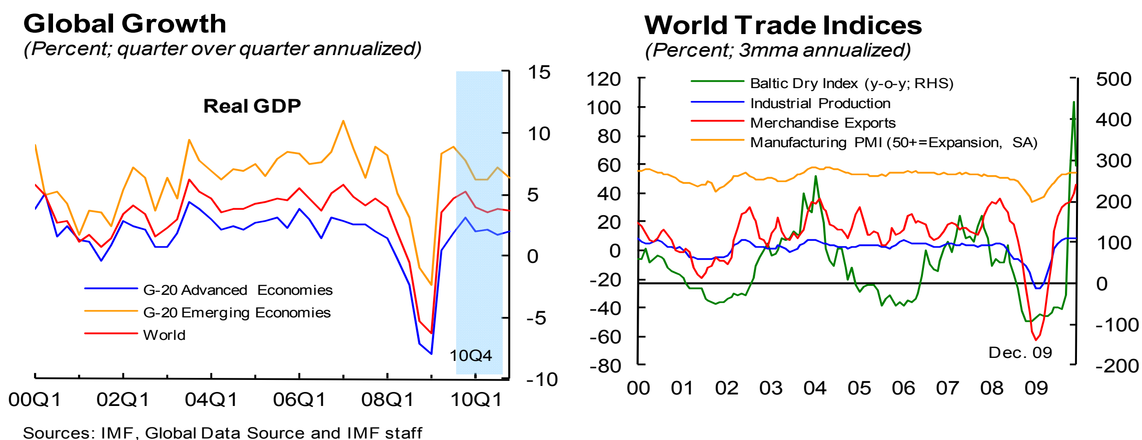
Some emerging market countries may have to adopt policies to manage large capital inflows. The resumption of capital flows to these countries, which is fundamentally welcome, is being driven rapid growth and yield differentials, and has led to concerns about asset price bubbles in some cases. The right responses to inflows will 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 asset price bubbles, reserves accumulation, and carefully designed changes to capital controls may also be part of the appropriate responses in certain cases.

GLOBAL ECONOMIC PROSPECTS AND POLICY CHALLENGES

The global recovery has been stronger than previously anticipated, but it is proceeding at different speeds within and across regions. In 2010, world output is expected to rise by about 4.2 percent. In major advanced economies, activity remains dependent on accommodative macroeconomic policies. Fiscal and monetary policies should maintain a supportive thrust this year to further sustain growth and employment; on current projections, withdrawal of stimulus can begin in 2011. However, room for countercyclical policy maneuver has sharply diminished as fiscal fragilities have come to the fore. These economies need to urgently adopt credible strategies to achieve fiscal sustainability. In many emerging economies, where activity is expected to be relatively vigorous, largely due to buoyant internal demand, an earlier exit from policy stimulus is warranted. The global outlook is subject to risks that, on balance, are to the downside, with increasing concerns over sovereign risks.

I. A POLICY-DRIVEN MULTISPEED RECOVERY

1. **The global recovery has evolved more strongly than expected, reflecting a pickup in confidence among consumers and businesses as well as in financial markets, and is progressing at different speeds within and across regions.** In the G-20, real output growth increased by nearly 5 percent at an annualized rate in the fourth quarter of 2009. Growth in the *advanced G-20 economies* was about 3 percent in the same period, led by the United States, Canada and Japan. Momentum in *emerging G-20 economies* continued to be stronger, with output growth at nearly 8 percent. Strong performance in China, India, and Brazil was accompanied by a broadening of the recovery to Russia and South Africa.



Sources: IMF, Global Data Source and IMF staff

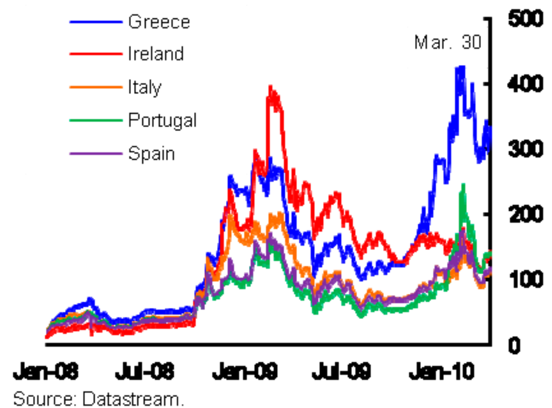
2. **The recovery in advanced economies remains dependent on policy support, boosted by a turn in the inventory cycle and improved financial conditions, while strong domestic demand and recovering trade have driven the recovery in emerging economies**. Extraordinary policy interventions helped lay a foundation for the recovery, and have been

essential to prevent adverse feedbacks between the financial and real economies, although the risk of deflation cannot yet be dismissed.

- *Among advanced economies*, a turn in the inventory cycle, alongside strong orders and a recovering corporate bond market have helped foster investment. Slowing deterioration in U.S. labor markets has also contributed to positive developments. However, the euro area's strong dependence on impaired bank credit has curbed activity. Large appreciation of the yen may have weighed on the recovery of Japan's exports.

- In *emerging economies*, the recovery has been driven by strong domestic demand and the normalization of global trade, which has helped lift external demand. This is particularly the case in major emerging economies—China, India, and Brazil—where output significantly exceeds pre-crisis levels. Commodity price increases and the rebound in global trade have also been important, particularly in Russia, South Africa, and Mexico.

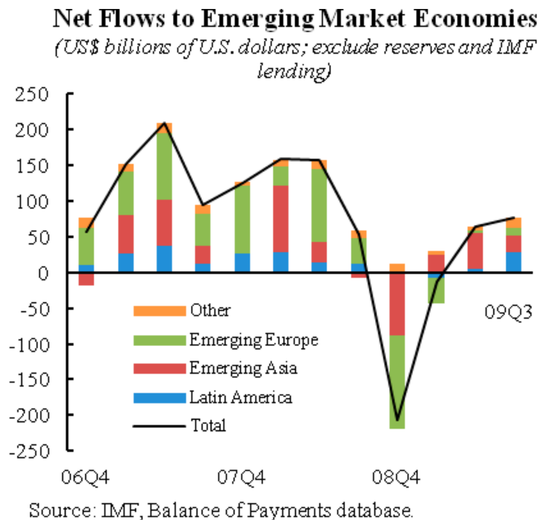
3. **Concerns about advanced country sovereign risks have risen sharply.** Sovereign risk premiums for some of the more fiscally vulnerable economies have again seen a steep increase. Deterioration of fiscal balances and rapid accumulation of public debt has led to concerns about the sustainability of sovereigns' balance sheets. Specifically, there is concern that sharply higher sovereign risks in Greece can spillover to the domestic banking system and across borders.



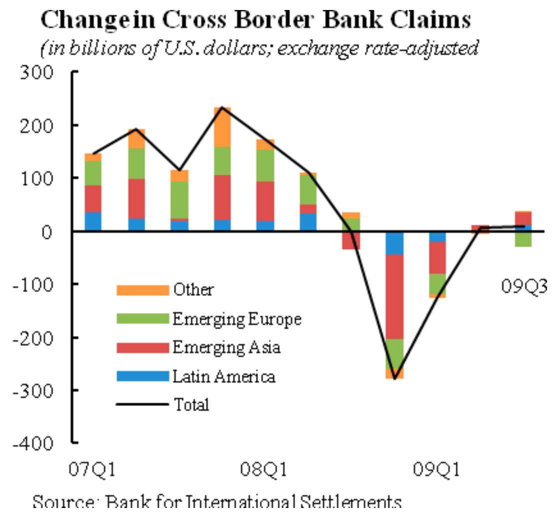
4. **Banking system health has improved, but deleveraging pressures and funding concerns suggest that credit recovery will be slow and shallow**. In many advanced G-20 economies, expected bank write-downs have been lowered and some banks have raised private capital and posted strong earnings, resulting in lower aggregate capital needs. However, the anticipation of further writedowns and a more stringent regulatory environment, along with large refinancing requirements in the next two years suggests that bank balance sheets are likely to remain constrained, particularly in Europe. Among emerging G-20 economies, credit is accelerating in emerging Asia; in China, while credit growth is now decelerating, growth rates are still high and the Chinese authorities have taken various measures to moderate the pace of lending.

5. **Capital flows to emerging economies have resumed, leading to a welcome easing of financial conditions but also raising concerns about overheating, credit quality, and asset price bubbles in some economies**. Prospects of strong growth, higher interest rates,

and lower sovereign credit risks than in mature economies lie behind the strong inflows into emerging economies. Portfolio inflows have led the way. However, direct investment and cross-border bank lending have not recovered to the same extent, with the latter reflecting continued deleveraging by advanced economy banks.

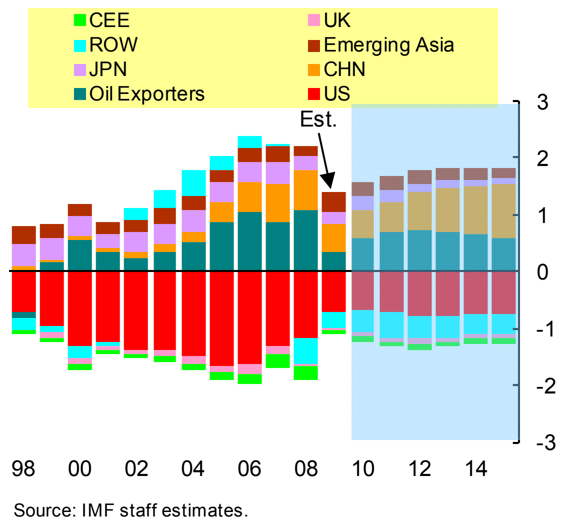


Source: IMF, Balance of Payments database.



Source: Bank for International Settlements.

6. **The multispeed nature of the recovery, renewed risk appetite, and rebounding capital flows to emerging economies have led to some exchange rate changes between the first and last quarters of 2009, but currency appreciation has been resisted in some cases**. Improving global financial conditions have resulted in depreciation of the U.S. dollar in real terms since early 2009, as exchange rates for commodity exporters and emerging economies with floating currencies (e.g., Brazil, Indonesia, and South Africa) have appreciated. While many emerging economies have permitted some currency appreciation in response to capital inflows, others have resisted appreciation and preferred to build up reserves. For instance, the Chinese renminbi has depreciated in real effective terms in parallel with the U.S. dollar and remains substantially undervalued from a medium-term perspective. The recent narrowing of global current account imbalances has a significant temporary component, with current account balances expected to rise noticeably as commodity prices increase and global trade continues to recover.



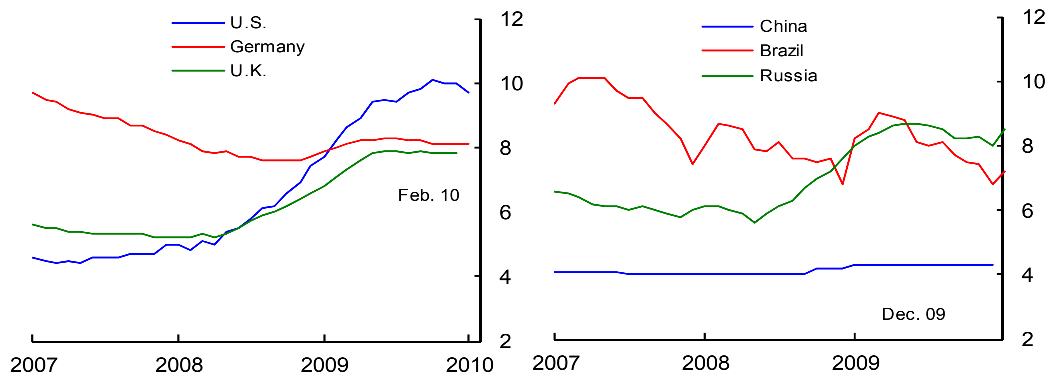
Source: IMF staff estimates.

7. **Commodity prices increased strongly at the onset of the recovery, driven largely by robust growth in emerging economies, and upward price pressures will likely continue.** Earlier and stronger-than-expected recoveries in emerging economies, particularly emerging Asia, have boosted commodity prices. Upward pressures on prices will remain as global growth strengthens through 2010-11. However, price dynamics will also depend on the supply response to rising demand, with still above average spare capacity and inventories in some commodity sectors likely to provide some cushion. Oil prices have risen above the $70-$80 a barrel range in recent weeks, as markets are testing producers' readiness to tap spare capacity with rapidly improving demand.

8. **Unemployment has begun to stabilize in some major advanced economies, but unemployment rates will stay high through 2011.**

- In *major advanced economies*, unemployment has begun to stabilize. It remains high in the United States and Spain, but relative to output declines, subdued in Germany and the United Kingdom. Given the sluggish expected recovery and the lingering effects of the financial crisis, unemployment rates are projected to stay high through 2011, although employment growth is expected to turn positive in many countries during 2010.

- In most *emerging economies*, increases in unemployment were more contained than in the advanced economies, except in emerging Europe, particularly the Baltic nations and the CIS. Unemployment also remains at very high levels in Russia and South Africa.



Source: IMF, Global Data Source.

II. PROSPECTS

9. **The recovery will continue to be multi-speed across G-20 countries, with tepid growth in most of the advanced economies contrasting with robust expansion in emerging economies, particularly in Asia**. Global output is expected to rise by 4.2 percent in 2010 and 4.3 percent in 2011 at annualized rates. Among *G-20 economies*, output growth is projected to be about 4.6 percent in 2010, reflecting an upward revision of about 0.3 percentage point from the January WEO update, followed by 4.5 percent in 2011.

- In *advanced economies*, output is projected to expand by 2.3 percent in 2010 and 2.4 percent in 2011, a sluggish recovery by historical standards, with real output remaining below its pre-crisis level until late 2011. The turn in the inventory cycle will help the recovery, as will improvements in financial conditions. Nonetheless, policy support will remain essential for the recovery, until there are clear signs that private demand is self-sustaining. Credit will remain constrained as banks repair balance sheets, investment will be held back by low capacity utilization and unemployment will weigh on consumption.

- In *emerging and developing economies*, the recovery will be more robust than in advanced economies, but uneven. Emerging Asia—notably, China, India, and Indonesia— and to a lesser extent Latin America, will lead the way, fuelled by strong internal and recovering external demand. Inventory investment is likely to make a significant contribution to growth in the short run on account of the normalization of globalization trade. The rebound of commodity prices will help growth in commodity exporters. Recovery is lagging in emerging Europe, although some are beginning to rebound from deep troughs. Overall, growth in emerging and developing economies is expected to be about 6–6½ percent during 2010–11, following a modest 2½ percent in 2009.

10. **Th*e outlook for public finances div*erges significantly, with further deterioration projected in advanced economies and more favorable prospects for emerging economies**.

- Among *advanced G-20 economies*, large fiscal deficits are expected to continue, due in part to large structural revenue losses and spending pressures, with improved positions projected only in Japan and Korea. Large continuing deficits are projected to raise the gross debt-to-GDP ratio to 120 percent in 2015, from around 80 percent in 2008. The crisis-related stimulus plays a relatively minor role, accounting for only one-tenth (4 percentage points) of the debt increase. Although sizable structural adjustments are projected through 2015, these are not enough to return fiscal positions to pre-crisis levels and still need to be supported with concrete revenue and spending measures.

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

	Year over Year						Q4 over Q4 2/	
					Difference from January Jan 2010 WEO Projections			
		Est.	Projections				Projections	
	2008	2009	2010	2011	2010	2011	2010	2011
World output 3/	**3.0**	**-0.6**	**4.2**	**4.3**	**0.3**	**0.0**	**3.9**	**4.5**
Advanced economies	0.5	-3.2	2.3	2.4	0.2	0.0	2.2	2.5
Euro area	0.6	-4.1	1.0	1.5	0.0	-0.1	1.2	1.8
Emerging and developing economies 4/	6.1	2.4	6.3	6.5	0.3	0.2	6.3	7.3
G-20 2/	2.9	-0.5	4.6	4.5	0.3	0.1	4.3	4.7
Argentina	6.8	0.9	3.5	3.0	0.0	0.0	2.5	3.1
Australia	2.4	1.3	3.0	3.5	0.5	0.5	2.9	4.0
Brazil	5.1	-0.2	5.5	4.1	0.8	0.4	4.2	4.2
Canada	0.4	-2.6	3.1	3.2	0.5	-0.4	3.4	3.3
China	9.6	8.7	10.0	9.9	0.0	0.2	9.4	10.1
France	0.3	-2.2	1.5	1.8	0.1	0.1	1.5	1.9
Germany	1.2	-5.0	1.2	1.7	-0.3	-0.2	1.2	2.1
India	7.3	5.7	8.8	8.4	1.1	0.6	10.9	8.2
Indonesia	6.0	4.5	6.0	6.2	0.5	0.2	6.4	5.2
Italy	-1.3	-5.0	0.8	1.2	-0.2	-0.1	1.4	1.3
Japan	-1.2	-5.2	1.9	2.0	0.2	-0.2	1.6	2.3
Korea	2.3	0.2	4.5	5.0	0.0	0.0	3.4	6.2
Mexico	1.5	-6.5	4.2	4.5	0.2	-0.2	2.3	5.5
Russia	5.6	-7.9	4.0	3.3	0.4	-0.1	1.7	4.2
Saudi Arabia	4.3	0.1	3.7	4.0	-0.2	-0.1	...	...
South Africa	3.7	-1.8	2.6	3.6	0.6	0.3	3.5	3.6
Turkey	0.7	-4.7	5.2	3.4	1.7	-0.6	0.6	5.1
United Kingdom	0.5	-4.9	1.3	2.5	0.0	-0.2	2.3	2.6
United States	0.4	-2.4	3.1	2.6	0.4	0.2	2.8	2.4
European Union	0.9	-4.1	1.0	1.8	0.0	-0.1	1.3	2.0

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 as of April 12, 2010.
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.

- The 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. Further, deficits should remain markedly lower in emerging G-20 economies, reflecting the accelerating recovery in Asia and Latin America, some discretionary tightening planned for 2010, the pick-up of commodity prices, and in some cases, an initial exit to reduce vulnerabilities. There are nevertheless risks to public finances for emerging economies with weaker fundamentals, particularly from possible international spillovers, as the large debt buildup in advanced economies could lead to higher borrowing costs.

Table 2. G-20 Countries—Public Debt, 2007-15
(in percent of GDP)

	2007	2009	2010	2011	2015
Argentina	67.9	59.8	51.4	47.6	50.4
Australia	9.4	15.5	19.8	22.2	20.9
Brazil	65.2	68.9	67.2	65.1	54.1
Canada	65.0	82.5	83.3	82.0	71.2
China	20.5	18.9	20.0	19.8	17.5
France	63.8	77.4	84.2	88.6	94.8
Germany	65.0	72.5	76.7	79.6	81.5
India	79.2	80.8	79.0	77.8	67.3
Indonesia	36.9	28.6	27.5	26.4	23.1
Italy	103.4	115.8	118.6	120.5	124.7
Japan	187.7	217.7	227.1	234.6	250.0
Korea	29.6	32.6	33.3	32.8	26.2
Mexico	38.2	44.9	44.5	44.1	42.4
Russia	8.5	9.0	8.1	9.1	13.0
Saudi Arabia	18.5	16.3	12.8	10.9	6.4
South Africa	28.3	31.5	34.7	36.6	35.7
Turkey	39.4	45.5	44.5	44.3	43.5
United Kingdom	44.1	68.2	78.2	84.9	90.6
United States	62.1	83.2	92.6	97.4	109.7
G-20 economies	61.3	72.5	76.8	79.1	82.5
G20 advanced economies	77.9	96.9	104.4	108.8	117.1
G20 emerging economies	37.3	37.4	37.0	36.4	32.7

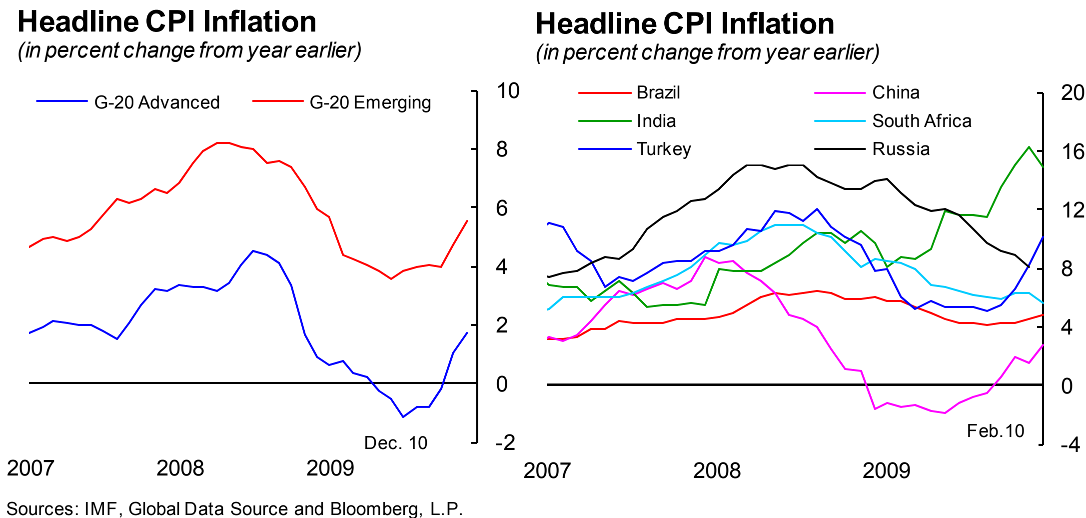
Source: April 2010 IMF World Economic Outlook.
1/ PPP GDP weighted averages for country groups (2009 weights).

11. **Inflation is likely to remain contained in most advanced economies as high unemployment and large output gaps persist, while some emerging economies may face stronger inflationary pressures.**

- In *advanced economies*, capacity utilization is likely to remain low given the projected sluggish recovery and output gaps are projected to remain wide through 2010 even after accounting for the decline of potential output due to the financial crisis. Accordingly, inflationary pressures will remain subdued so long as energy prices remain stable or increase only modestly. In 2010, headline inflation is forecast to increase to 1½ percent (from zero in 2009), as slowing labor costs are more than offset by rebounding commodity prices.

- Among *emerging and developing economies*, although sustained increases in inflation are not projected during the recovery, inflation risk is pertinent in countries where consumer prices are sensitive to commodity prices. Some emerging economies may face upward price pressures due to strong growth and little excess capacity. These include Brazil, India and Turkey, where markets are pricing in policy rate hikes

during 2010. Overall, inflation in emerging economies in 2010 is expected to remain around 6 percent.



III. KEY RISKS

12. **The outlook for activity remains unusually uncertain, even if systemic risks have receded. Broadly, key risks have moved from the financial sector to public finances, with immediate concerns about fiscal sustainability in some euro area countries and longer-term concerns at a global level. Downside risks to the outlook remain and include:**

- *A lack of progress on sovereign debt consolidation*. In the near term, the main concern is that sovereign liquidity and solvency problems in Greece could result in rapid re-pricing of sovereign risks, with spillover to the domestic banking system and across borders. More generally, in the absence of debt consolidation plans, risks related to sovereign debt could depress output for a variety of reasons. This could prompt premature withdrawal of fiscal stimulus that undermines recovery or limit the scope of new stimulus in response to new adverse shocks. As activity weakens, households and investors could lose confidence in governments' ability to design and implement sound consolidation plans and in response sharply reduce their spending because of concerns that taxes will increase or that prospects for growth, wages, and investment returns will diminish.

- *Slow progress on bank restructuring, resolution, and recapitalization, especially to address weak banks*. Along with continued bank deleveraging, this could unduly restrain the financial sector's ability to support the recovery by providing credit. Sectors that have only limited access to capital markets—consumers and small and

medium-size enterprises—are likely to continue to face tight borrowing conditions, hampering the recovery.

13. **Upside risks include positive surprises with respect to investor confidence**, which would induce a reduction in financial uncertainty, foster a stronger-than-expected improvement in financial market sentiment, and prompt a larger-than-expected rebound in capital flows, trade, and private demand**.**

IV. POLICY CHALLENGES: FISCAL SUSTAINABILITY AND FINANCIAL REFORM

Multispeed recoveries imply that policy challenges will vary according to individual country circumstances. With the recovery in most advanced economies projected to be sluggish, fiscal stimulus will need to be maintained in those economies through 2010, but tightening could begin in 2011, provided recovery then becomes self sustaining. In addition, consolidation may need to begin earlier in those countries with large public debts. Given prospects for relatively weak growth in advanced economies, the challenge for some emerging economies will be to absorb capital inflows and nurture domestic demand without triggering a new boom-bust cycle.

A. Macroeconomic Policies

Fiscal policy

14. **In many G-20 countries, restoring fiscal sustainability is a top priority and policy challenge, notably in light of the surge in government debt levels**. Ensuring fiscal sustainability depends on ensuring growth, and so the provision of fiscal support will need to be maintained until there are clear signs of a self-sustaining recovery. But beyond that, fiscal consolidation will need to gain rapid momentum, notably in advanced economies. Some major emerging economies will also need to return to medium-term fiscal considerations as the recovery is established.

- In many *advanced G-20 economies*, substantial consolidation will be needed to ensure fiscal sustainability, foster medium-and-long-term growth and restore fiscal space for future needs. This is particularly important for the United States, given its systemically important role in global financial markets, but also for other advanced economies that can affect the sovereign risk premiums of other countries.

- Fiscal challenges are less pronounced in *emerging G-20 and many advanced economies* which, as a group, entered the crisis with relatively low public debt levels. However, in some emerging economies with relatively large public debt, notably Brazil and India, public sector efforts to promote growth will have to be funded by scaling back less productive spending and closing loopholes in the

revenue base. As the recovery is firmly established, fiscal policy will need to refocus on medium-term considerations, including debt sustainability.

15. **Against this backdrop, exiting from fiscal stimulus should in general take priority over other policies, particularly in advanced economies.**

- *In sequencing an exit from crisis-related policies, fiscal policy should generally take priority.* Maintaining an expansionary fiscal stance has a direct impact on the build-up of debt. Accommodative monetary policy does not have such automatic consequences and can be reversed quickly; in the current juncture, inflationary pressures appear well contained. Furthermore, fiscal policy adjustment typically has a long lead time relative to monetary policy. Hence, plans for fiscal consolidation should generally take priority, all else given.

- *In countries with excessive current account surpluses and solid public finances,* fiscal exit can wait while excess demand pressures are being addressed by reining in credit growth and allowing exchange rate appreciation. Greater currency adjustment in Asia would facilitate adjustment in other emerging economies that may fear losing market share if their currencies were to appreciate alone. Many emerging and developing economies also need to continue strengthening their financial stability frameworks to protect against speculative booms as they continue to attract capital.

- *In those emerging (and some advanced) economies experiencing faster recoveries*, particularly those with sufficient fiscal space, the desirable policy mix may be different. In emerging economies that have large current account surpluses, rebalancing their economies away from growth led by external demand to growth underpinned by domestic demand is a key challenge. These challenges could be met by strengthening social safety nets that result in reduced precautionary savings, or through improved corporate governance that helps reduce corporate savings.

16. **In many advanced G-20 economies, authorities will need to urgently devise and communicate credible medium-term fiscal policy strategies. These strategies should include:**

- *Clear timeframes to reduce gross debt-to-GDP ratios to sustainable levels*. To return debt ratios in advanced economies to relatively more prudent levels—for example, 60 percent of advanced-economy GDP by 2030 (the median level of debt in advanced economies prior to the crisis)—requires adjustment of the order of 8.8 percentage points of GDP in the next ten years.

- *Fiscal measures that seek to increase economies' medium-run growth potentials.* Winding down fiscal stimulus measures will provide only about 2 percent of GDP; additional fiscal measures will therefore be needed. Entitlement reforms and

improvements to tax and expenditure policies could help attain fiscal sustainability, while promoting medium-run growth.

- *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.

Monetary policy

17. **Monetary policy can remain accommodative in the major advanced countries, but monetary tightening may be considered in some emerging economies facing risks of overheating**.

- In *advanced economies*, central banks should maintain low policy rates through 2010, as inflation is expected to remain low and unemployment high for some time.[1] This can be achieved even while central banks begin to withdraw the emergency support provided to banks and financial markets. As the priority in major advanced economies is to put in place sound medium-term fiscal programs, tightening monetary policies prematurely, as fiscal support is phased out, could undercut global recovery.

- In some *emerging economies* (e.g., Brazil, emerging Asia), owing to rapidly closing output gaps or concerns about credit quality, monetary accommodation is already being removed or will need be to be removed relatively soon. In those economies with broadly balanced external positions, monetary tightening may be complicated as it could attract capital inflows that undermine competitiveness.

Coping with large capital inflows

18. **In those emerging economies where there are concerns that the resumption of capital inflows may cause new boom-bust cycles, there is a need to design policies to manage the inflows.** Some countries are resisting exchange rate appreciation that could reduce excessive current account surpluses, out of concern that appreciation could destabilize their economies. However, resistance to appreciation in some large economies could undermine trade patterns or financial conditions for other emerging or advanced economies.

- *In surplus economies, greater exchange rate flexibility* could help moderate capital inflows by mitigating one-way bets. Stronger currencies would raise purchasing

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[1] In Australia, an early recovery, compared to other advanced economies, has prompted the Reserve Bank of Australia to raise policy rates since the final quarter of 2009.

power for domestic consumers, encouraging the shift in productive resources from export to services sectors. Strengthening multilateral liquidity provisions and insurance mechanisms through IFIs could promote greater exchange rate flexibility by limiting incentives for excessive reserve accumulation.

- *Monetary and fiscal policies can be used to reduce inflows* where further reserve accumulation or exchange rate appreciation are not warranted. If the economy is not at risk of overheating, the appropriate policy response would be to lower interest rates and to tighten fiscal policy, thus reducing currency appreciation pressures. In economies facing high inflationary pressures, reducing interest rates is not an attractive option, while both political considerations and implementation lags may limit the scope for fiscal consolidation.

19. **In some emerging economies, improvements in macro-prudential and supervisory frameworks can help limit the risks from inflows, as changes in capital controls can temper inflows and liberalize outflows**.

- *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 and loan-to-value ratios, as well as well-managed margining and collateral systems in securities markets, may form part of this approach. However, deploying such policies requires changes in prudential infrastructure that may take time to implement.

- *Capital controls could also help, especially in stemming temporary flows, but need to be designed bearing mind costs, limitations, and constraints on implementation capacity:* (i) the likely erosion in their effectiveness over time in today's deep and sophisticated financial markets; (ii) 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 deleterious multilateral repercussions of capital controls*. Their widespread use could have adverse effects on the efficient allocation of investment and, for systemically important countries, they could impede global demand rebalancing by allowing countries to avoid appreciation where currencies are undervalued. 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

20. **Financial sector repair and reform is the other top priority in a number of advanced G-20 economies.** The policy challenge is shifting from unwinding extraordinary support measures to laying the foundation for a more robust financial system. Given the

increasingly integrated nature of financial markets and institutions, effective repair, reform, and deployment of macro-prudential tools will require coordination across countries.

21. **In the short term, major work is still needed to repair damage to the financial system wrought by the crisis**. These include:

- *Bank recapitalization*. Larger capital buffers are required to absorb the ongoing and expected deterioration in credit quality. Prudent bank managements should continue to build buffers of high quality capital now in anticipation of more demanding standards expected in the future, which would relieve some pressure on banks to deleverage their balance sheets, and also provide a solid base to extend credit necessary for the global recovery.

- *Bank consolidation, resolution, and restructuring*. Urgent priorities include: (i) swift restructuring and resolution of nonviable institutions to ensure a healthy core of viable financial institutions remains; and (ii) introduce market infrastructure, regulatory and legal reforms that address systemic risk.

- *Reviving securitization markets*. These remain impaired, yet had been a normal part of the bank lending process in many advanced economies. To promote sound securitization, measures need to be taken to improve monitoring along the securitization chain, including by improving disclosure standards, standardizing securitization structures, and restoring the integrity of the ratings process.

22. **Coordinated regulatory reforms to the financial sector, that are designed to reduce systemic risks, need to move forward expeditiously, after being adequately evaluated.** Reforms to the financial sector will entail more and better quality capital and liquidity buffers, that will help remove excess capacity and restrict a build-up in leverage. Three years after the onset of the crisis, questions still remain about how policymakers will address the potential of too-important-to fail (TITF) institutions to harm the financial system and impose costs on the public sector and its taxpayers. This will require measures on various fronts. In particular, there is an urgent need for some combination of *ex ante* preventive measures as well as improved *ex post* resolution mechanisms, and clarity on the legal powers that could intervene in troubled cross-border TITF institutions. Additional requirements could include calibrating institutions' capital requirements to systemic risks, as proposed by the Basel Committee. The window of opportunity for dealing with TITF institutions may be closing and should not be squandered, all the more so because some of these institutions have become bigger and more dominant than before the crisis erupted.

V. PROGRESS ON EXITS FROM STIMULUS POLICIES

The appropriate timing, pace, and mode of exits depend on the state of the economy and the financial system. Unwinding stimulus too early could jeopardize progress in securing recovery while delaying exits too long could pose risks to price, financial, and fiscal stability. For many G-20 countries, restoring fiscal sustainability is a key priority that will require not only unwinding crisis-related fiscal stimulus but also substantial improvements in primary balances for a sustained period. Although most advanced G-20 countries have set out broad medium-term fiscal goals, few have specified how and when consolidation will proceed. Immediate steps can be taken on reforms (especially to entitlements) that would not depress current demand. Against this background, the following discussion takes stock of progress on exits from extraordinary fiscal, monetary and financial sector support.

Fiscal policies

23. **Most advanced G-20 countries have set out broad medium-term fiscal consolidation targets but few have specified the composition of the adjustment**. Medium-term plans are summarized in Table 4. Several countries have announced expenditure-based plans (France, Germany, United Kingdom, United States), but concrete steps have not as yet been taken. Plans should be clarified soon to bolster credibility.

24. **Fiscal exit plans in some advanced G-20 countries seem to be based on optimistic assumptions.** Staff projections for the April 2010 *World Economic Outlook* show higher deficits for most advanced G-20 countries, based on assumptions about paths for growth and revenues as well as uncertainties about the exact consolidation measures to be implemented.

25. **In most countries, a combination of revenue and spending measures will be needed.** Fiscal adjustment should aim to (i) stabilize age-related spending in relation to GDP, (ii) reduce non-age-related expenditure ratios, and (iii) increase revenues in an efficient manner. While the precise mix will vary across countries, the large size of the required adjustment in most advanced G-20 countries will likely require tax measures, as a freeze on real per capita spending (other than health and pensions) would be insufficient to generate the necessary adjustment. In emerging economies, stronger and better-targeted safety nets will be needed along with efficiency-enhancing revenue and spending measures.

More specifically:

- *Revenues.* High pre-existing tax burdens may limit the scope to raise tax rates without adverse efficiency effects. Countries may have scope to increase revenues from closing VAT gaps by eliminating exemptions and reduced rates, as well as from raising excises and fuel taxes. Pricing greenhouse gas emissions—by taxing carbon or auctioning emissions permits—could raise large sums. Property taxes are also an efficient source of revenues with a benign impact on growth. There may also be scope for stronger income taxation, in part to address equity objectives, though efficiency

concerns loom larger. In some emerging G-20 countries, the scope for improving revenue collections appears to be substantial, although adjustment needs are comparatively smaller.

- *Expenditures.* To ensure growth and equity**,** reforms of inefficient, poorly targeted, or inequitable spending areas will be needed, along with intensive efforts to contain pension and health pressures. A key focus should be on wages—containing the public sector wage bill has proven to be important in past consolidation episodes—as well as on subsidies and transfers. Social benefits could be better targeted, reducing overall spending levels without sacrificing equity objectives. Better targeting long-term unemployment benefits in some countries could provide savings and favorable labor market effects. Subsidies should also be lowered, especially for petroleum products, which absorb about 1 percent of world GDP.

26. **Only a few countries have already identified pension or health reforms as part of exit strategies**.[2] In France and Japan, for example, pension and health reforms are explicitly on the agenda, but concrete plans have not been announced. Many countries have plans to expand health or pension coverage (Brazil, China, Mexico, Saudi Arabia, South Africa, and U.S.).

- To stabilize pension spending, the typical options are: (i) raising the statutory retirement age, (ii) reducing benefits, or (iii) increasing contribution rates. An increase in the retirement age by two years would stabilize pension spending as a share of GDP at 2010 levels for the next two decades. This is roughly equivalent to a cut in benefits of 15 percent or a 2 percentage-point increase in payroll taxes. While higher retirement ages may be largely justified by increases in longevity over the next 20 years, these would need to be accompanied by steps to limit early retirement programs. Benefits could also be reduced by modifying the base used to calculate benefits, modifying indexation rules, or taxing pensions.[3] Cuts in pensions, however, should preserve benefits sufficient to keep the elderly out of poverty.

- In health care, the challenges are greater—while some countries have managed to reform their pension systems significantly, there have been few health reforms aimed at reducing spending. Reforms need to contain spending growth, while ensuring broad access to high quality care by addressing supply-side incentives, limiting public

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[2] In some advanced countries with moderate adjustment needs, pension reforms were introduced in recent years.

[3] Changes in rates of social contributions need to be assessed together with potential changes in the rate of personal tax on labor income, as this tax wedge likely affects labor participation and hours worked decisions. The incentive effects of social contributions, however, would depend on whether they are perceived as implying increased benefit entitlement.

benefits, and/or reducing demand for public health services. Cost-containing measures include: (i) reimbursing providers using case-based payment or global budgets rather than a fee-for-service basis; (ii) strengthening cost-effectiveness evaluations for new treatments and technology; and (iii) implementing health information technology to increase the efficiency of service delivery. Demand-side measures include increasing cost sharing and reducing subsidies to private health insurance.

- In major emerging economies with large surpluses, fiscal measures could usefully be targeted toward improved programs for health care, pensions, and education. China, in particular, can afford to maintain an expansionary fiscal stance as it seeks to rebalance externally generated and domestically driven growth, including by expanding subsidized health insurance for rural workers and strengthening its pension system.

Monetary Policies

27. **Conventional measures of monetary policy remain highly accommodative and will likely need to be maintained at least through 2010 (see above).** Central banks should continue their efforts to unwind liquidity provision as long as market conditions warrant, but they should remain alert to signs of stress and stand ready to take renewed support measures if needed. The timing and modalities of asset sales will need to be carefully managed to avoid disrupting financial and credit markets.

28. **With some exceptions, central banks have begun the process of gradually unwinding unconventional policies:**

- The Federal Reserve has ceased its program of purchasing residential mortgage-backed securities and debt ($1.25 trillion and about $175 billion, respectively). The Federal Reserve has also been closing the special liquidity facilities that it created to support markets during the crisis, leaving only the Term Asset-Backed Securities Loan Facility, which is scheduled to be closed in June 2010. The ECB has begun the process of unwinding its liquidity support program, by restricting the occasions on which it meets in full banks' demands for funds. In December, it announced the end of 12-month funds offers to banks, and, in February, made the last offering of six-month funds. It will continue to provide unlimited liquidity in weekly and monthly offers until at least October. The Bank of England has purchased bonds in the targeted amount of £200bn, with no current plans for an extension of the quantitative easing program. However, the Bank of Japan has stepped up its monetary stimulus in response to a fragile economic recovery.

- Foreign exchange swap arrangements between central banks to provide liquidity to offshore markets have mostly expired. The large asset purchases by central banks

have stopped and liquidity facilities to domestic funding markets have been scaled back. However, financial fragilities remain and unwinding remains dependent on financial and economic conditions.

Financial Sector Policies

29. **Although some governments have taken their first steps to end some of the public support measures put in place in response to the financial crisis, others have extended the existing facilities.** In the US, a limited six-month Emergency Guarantee Facility was established on October 31, 2009, upon expiration of the Debt Guarantee Program (DGP; part of the Temporary Liquidity Guarantee Program or TLGP). At the end of 2009, several European countries granted extension of their debt guarantee schemes for periods ranging from four months (Sweden) to six months (Austria, Greece, Portugal and Finland) to as much as twelve months (Germany). Ireland introduced a new guarantee program on new eligible debt issued through September 29, 2010. In contrast, Korea's authorization to provide state guarantees to domestic banks expired on December 31, 2009.

30. **Despite the extension of several programs, the use of government-guaranteed debt has declined substantially.** Guaranteed bonds issued by financial institutions have now fallen from a peak of over 40 percent of total gross supply in March 2009 to less than 5 percent during the first three months of this year. The decline in the use of support, however, has not occurred across all financial institutions. There is indeed evidence of multiple tiers at least in the US market, as some financial institutions continue to depend on government guarantees to issue debt. This has become evident since the second half of last year, as a subset of banks stopped issuing government-guaranteed bonds, whereas these instruments still made up a third of the new issuance for others. Going forward, wholesale guarantee schemes will likely close down in a few more countries, although previously guaranteed debt will remain a sovereign contingent liability until maturity.

31. **Deposit insurance schemes have not undergone significant changes since their expansion at the beginning of the crisis**. Most of these plans for temporary or special protection of deposits are due to expire between 2010 and 2013, with the majority occurring in 2010 and 2011. In October 2009, the US extended the temporary increase in the deposit insurance (which was to expire at the end of 2009) through the end of 2013. Other G-20 jurisdictions have not yet announced specific plans.

32. **Capital support schemes have also been extended in several instances, but actual capital injections have been modest lately**. Several recapitalization schemes that were supposed to expire at the end of 2009 have been extended for periods ranging between six and twelve months. Austria (on a reduced budget allocation basis) and Greece all lengthened their bank recapitalization schemes for another six months, whereas Germany's facility was extended for another year until the end of 2010. In the US, the Capital Purchase Program (CPP) ended on December 31, 2009, as planned. Actual capital injections have slowed down

markedly since their peak in late 2008, and new flows (net of divestments) in the first months of 2010 have been negligible, leaving outlays well below the pledged amounts for capital injections. These developments reflect enhanced stabilization of the financial system, although further possible write-down and growing nonperforming loans, could lead to greater fund raising needs that may not be absorbed entirely by the market.

Table 3. G-20 Countries: Medium-Term Fiscal Consolidation Plans

Advanced economies	
Australia	As the economy recovers, return budget to surplus by: allowing expected improvements in tax receipts to flow to the budget bottom line; and, when the economy is expected to grow at above-trend rates, restraining real growth in spending to 2 per cent a year until budget returns to surplus.
Canada	Return to balanced budget by 2014-15 through a winding down of the crisis Action Plan and restraint on direct program spending.
France	Reduce deficit to 3 percent of GDP by 2013 through revenue and spending measures and structural reforms. Revenue measures include increased taxes in the social security budget and reversal of 2010 revenue loss due to the abolition of the local business tax. Limit on real spending of 0.9 percent per year after 2010.
Germany	Consolidation to start in 2011, in line with SGP (deficit of 3 percent or less by 2013) and constitutional rule (0.35 percent of GDP federal structural deficit by 2016 and balanced state-level structural budgets by 2020). Consolidation program will be predominantly expenditure based, but no concrete measures announced. Income tax reform under consideration.
Italy	Gradual consolidation in line with SGP.
Japan	Announcement of a medium-term fiscal framework expected in the first half of 2010.
Korea	Fiscal consolidation envisaged through 2013, largely driven by expenditure measures such as suspension or downsizing of temporary projects as well as better prioritization. Tax measures planned, including some reduction in extensive allowances and incentives for CIT and PIT, increases in social security contributions, and higher environmental taxes. Further tax cuts planned, including additional targeted tax incentives and final stage of postponed rate cuts for the highest CIT and PIT brackets.
United Kingdom	Tax and spending measures to reduce public sector borrowing through 2013-14. Announced revenue measures include increases in some income tax rates, National Insurance contributions, and excises. Spending measures include limits to growth of public sector pay and pensions.
United States	Budget proposals include a 3-year freeze on non-security discretionary spending, fully repayment of TARP, allowing the 2001-03 tax cuts to expire for high-income households, and eliminating funding for inefficient fossil fuel subsidies.

Emerging economies	
Argentina	Growth recovery and functioning of automatic stabilizers.
Brazil	Growth recovery and functioning of automatic stabilizers. Return to pre-crisis fiscal targets in 2010, although public investment will remain high under the Growth Acceleration Program and related to the 2012 World Cup and 2016 Olympic Games.
China	Withdrawal of stimulus and growth recovery.
India	Gradual consolidation envisaged through 2012, with measures to raise voluntary tax compliance and reduce tax exemptions.
Indonesia	Gradual consolidation through 2014, with reforms to modernize tax administration and enhance collections and increase oil and gas production. Expenditure-to-GDP ratio is projected to increase gradually to support economic development and poverty reduction.
Mexico	Adjustment starts in 2010 with a tax package of 1 percent of GDP, including an increase of VAT, excise, and income tax rates. The authorities aim to return debt ratio to a declining trend by 2011 and the fiscal balance, as defined under the fiscal rule, to zero by 2012.
Russia	Unwinding of large anti-crisis package in 2010-11, lower spending on public administration and low-priority infrastructure projects, and higher social security contributions.
Saudi Arabia	Fiscal policy influenced by recovery of oil prices. Aim to save sufficient oil revenues to enable countercyclical action and to preserve intergenerational equity. Spending is expected to remain elevated to support medium term social and infrastructure initiatives.
South Africa	Fiscal deficit widening mainly due to automatic stabilizers and ongoing infrastructure program (World Cup, transport and energy). Deficit expected to narrow significantly as economy recovers and investment program winds down.
Turkey	Some exit measures implemented in 2009 (increases in excise taxes and reversal of reduced rates on VAT and special consumption tax), with additional measures introduced early 2010 (including further excise increases and controls on health spending) to achieve 2010 Medium-Term Plan target. Plan targets gradual fiscal adjustment during 2010-12 mainly through higher revenue, cost containment, and fiscal rule..

Sources: IMF staff estimates and projections; IMF country reports and authorities' reports.

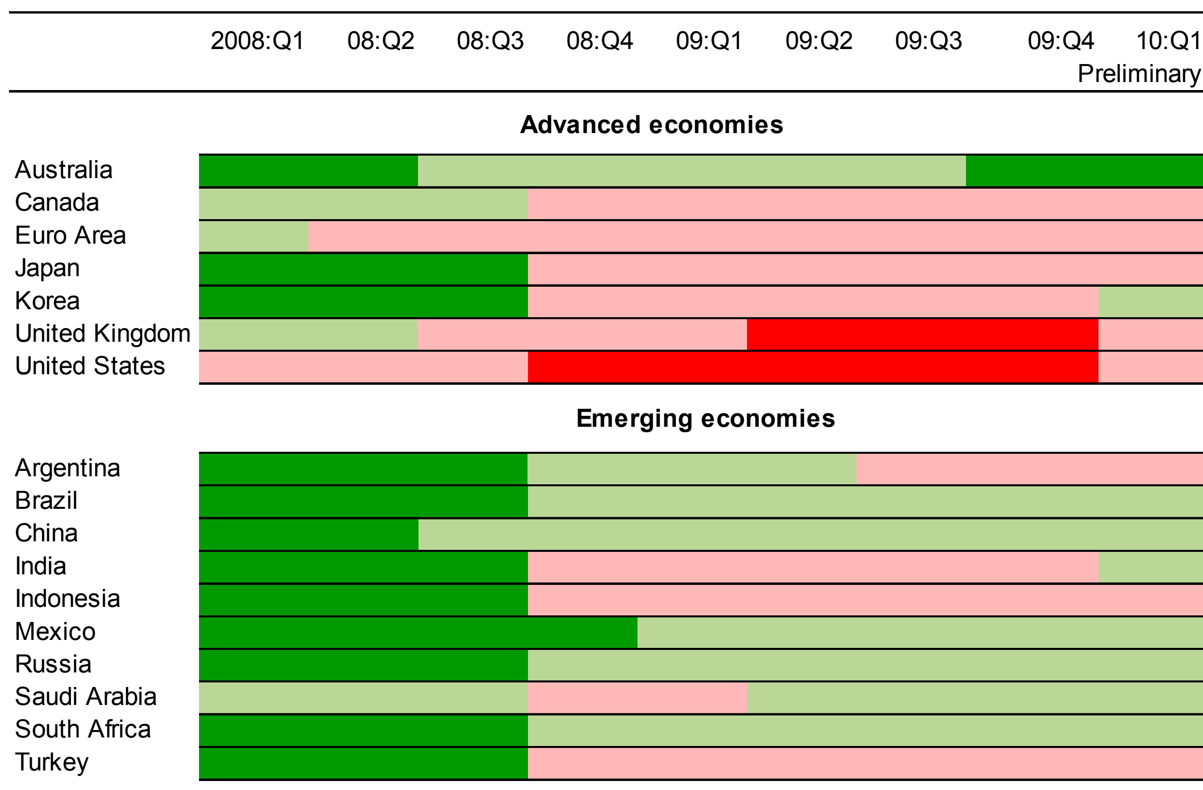
Table 4: Recent Developments in Exiting From Crisis Intervention Monetary Policies

Country	Policy rate 1/			Recent developments
	Latest peak (last date)	Latest bottom (last date)	Last change (date)	
Advanced economies				
Australia	7.25 (Sep.2, 08)	3.00 (Oct. 6, 09)	4.25 (Apr. 6, 10)	The policy rate has been raised five times since October 2009.
Canada	4.5 (Dec.3, 07)	0.25 (Current)	0.25 (Apr.21, 09)	The central bank has been unwinding extraordinary liquidity operations since October 2009 and, in April 2010, removed conditional commitment to maintain overnight rate at 0.25% until the second quarter of 2010.
Euro area	4.25 (Oct.7, 08)	1.00 (Current)	1.00 (May 7, 09)	The central bank scaled back longer-term operations, while maintaining low interest rate policy.
Japan	0.50 (Oct.30, 08)	0.10 (Current)	0.10 (Dec.19, 08)	Most of crisis-intervention facilities were expired at end-March. However, the central bank stepped up liquidity provision to stimulate the economy.
Korea	5.25 (Oct. 8, 2008)	2.00 (Current)	2.00 (Feb. 12, 09)	The central bank maintains low interest rate policy, while the use of crisis-intervention measures has been mostly discontinued.
United Kingdom	5.75 (Dec.5, 07)	0.50 (Current)	0.50 (Mar.5, 09)	The central bank completed the asset purchase under its quantitative easing policy in February 2010, while maintaining low interest rate policy.
United States	5.25 (Sep.17, 07)	0.0-0.25 (Current)	0.0-0.25 (Dec.16, 08)	Most of the crisis intervention measures have been expired, while the central bank maintains low interest rate policy.

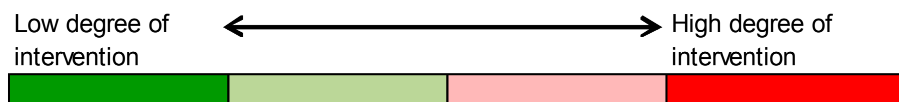
Emerging economies				
Argentina	13.0 (Oct.6, 07)	10.25 (Mar. 08)	11.5 (Oct. 21, 09)	The central bank continues the expansionary policy that started in early 2009.
Brazil	13.75 (Jan.20, 09)	8.75 (Current)	8.75 (Jul. 21, 2009)	In February 2010, the central bank tightened the reserve requirement framework, while maintaining low interest rate policy.
China	4.68 (Nov. 26, 08)	3.33 (Current)	3.33 (Dec.22, 08)	In January 2010, the central bank raised the reserve requirement ratio.
India	9.0 (Oct. 20, 08)	4.75 (Mar. 18, 10)	5.00 (Mar. 19, 10)	In January 2010, the central bank raised the reserve requirement ratio, and in March 2010, raised the policy rate.
Indonesia	9.5 (Dec. 9, 08)	6.5 (Current)	6.5 (Aug. 5, 09)	In October 2009, the central bank raised the reserve requirement ratio, while maintaining low interest rate policy.
Mexico	8.25 (Jan. 15, 09)	4.50 (Current)	4.50 (Jul. 17, 09)	Policy rates remain accommodative. The central bank has discontinued most of foreign exchange liquidity easing measures.
Russia	13.0 (Apr. 23, 09)	8.25 (Current)	8.25 (Mar. 29, 10)	In March, 2010, the central bank further expanded monetary policy by cutting the policy rate.
Saudi Arabia	5.5 (2008/4Q)	2.00 (Current)	2.00 (2009/1Q)	Under the dollar-pegged regime, the central bank continues low interest rate policy.
South Africa	12.0 (Dec. 10, 08)	6.5 (Current)	6.5 (Mar. 26, 10)	The central bank continues expansionary policy.
Turkey	16.75 (Nov. 19, 08)	6.50 (Current)	6.50 (Nov. 19, 09)	The central bank continues expansionary policy.

1/ For countries for which the single target interest rate is not available, the most relevant short-term interest rates are used.

Table 5: G-20 Countries: State of Monetary Policy Intervention 1/



Note: The colors indicate the status of exiting from intervention policies as following.



1/ The map is constructed based on policy rates, the size of central bank balance sheets, and the number of crisis-intervention measures.

Table 6: G-20 Countries: State of Financial Sector Intervention 1/

	2008:Q1	08:Q2	08:Q3	08:Q4	09:Q1	09:Q2	09:Q3	09:Q4	10:Q1
Advanced Economies									
Australia									
Austria									
Belgium									
Canada									
Denmark									
Finland									
France									
Germany									
Greece									
Ireland									
Italy									
Japan									
Korea									
Luxembourg									
Netherlands									
Portugal									
Spain									
Sweden									
United Kingdom									
United States									
Emerging Economies									
Argentina									
Brazil									
China									
India									
Indonesia									
Mexico									
Poland									
Russia									
Saudi Arabia									
Slovenia									
South Africa									
Turkey									

Sources: Dealogic, WEO, and Fund staff calculations.
Note: The colors indicate the status of exiting from intervention policies as following:

1/ The map is constructed based on the size of recapitalizations and the size of the issuance of government-guaranteed debts by financial institutions