Group of Twenty

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

Global Economy Beyond the Crisis—
Framework for Sustainable Growth

Prepared by Staff of the International Monetary Fund

Key Messages

In the aftermath of the financial crisis, a fundamental challenge for policymakers will be to sustain solid global growth. Lessons from past crises suggest that growth prospects may have been damaged by the impact on balance sheets and, possibly, productive potential.

In this setting, a framework for sustainable growth should contain the following essential elements—full repair of the financial system to restore efficient intermediation; and rebalancing the global sources of demand (including fiscal consolidation and entitlement reform) to sustain growth.

Reforms to restore a healthy and dynamic financial system, while safeguarding financial stability, are vital for supporting economic growth. This will require rebuilding key financial markets—such as securitization—on a sounder basis. At the same time, preventing and protecting against future crises will be essential, but more comprehensive solutions are needed—notably, how to limit the systemic risk posed by large financial institutions.

The pattern of global demand will need to be rebalanced along two key margins.

- *To sustain solid global growth, the sources of demand will need to shift from the public sector to the private sector, particularly in advanced economies with high public debt*. To achieve sustainable public finances, substantial fiscal consolidation once the recovery is established will critically require entitlement reform.

- *Second, a shift from internal to external demand in external deficit countries hit by pronounced credit and housing cycles, matched by counterpart adjustments in surplus countries that have been heavily reliant on export-led growth will be important*. Impediments could stand in the way of further rebalancing global demand.

Successful global rebalancing will require a concerted multilateral policy effort. Alongside public and private balance sheet repair in major deficit countries, structural reform efforts will be key to boost domestic spending in major surplus countries. Exchange rate appreciation in key surplus countries (depreciation in deficit countries) may be needed for rebalancing.

Finally, addressing rising unemployment will be an important policy challenge. Facilitating the reabsorption of workers displaced by the crisis can be achieved through programs assisting job search, matching, and retraining.

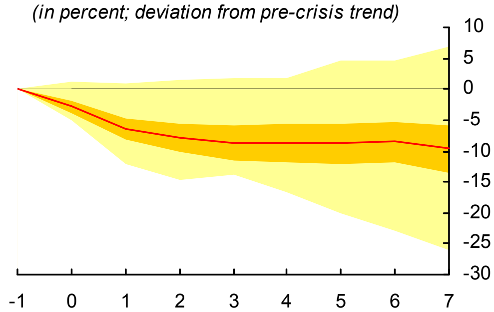
Sustaining solid global growth in the aftermath of the financial crisis will be a fundamental challenge due to the impact of the crisis on balance sheets and, possibly, productive potential. A framework for achieving sustainable growth should contain the following essential elements—full repair of the financial system and rebalancing the sources of global demand. Restoring efficient intermediation and innovation in the financial system, while safeguarding financial stability, will be vital for supporting economic growth. Second, the sources of global demand will need to be rebalanced—from public to private sector demand, and from internal to external demand in major external deficit countries, matched by counterpart adjustments in major surplus countries. Successful global rebalancing will require a concerted multilateral policy effort.

I. Potential Output After the Crisis and Policy Challenges

1. **The crisis may have damaged potential output through several channels**. Declines in capital formation, substantial and protracted increases in unemployment, and disruptions to the financial system all could weigh on future growth. The output effects are likely to be most severe in those G-20 economies directly hit by banking crises.

Output Losses After Banking Crises

(in percent; deviation from pre-crisis trend)



Source: IMF staff estimates.
Figure reports mean difference from pre-crisis trend (over t-10 to t-3); t-1 normalized to 0; crisis begins at t=0. Shading indicates 90% confidence interval for the mean (orange) and inter-quartile range (yellow).

- *Experience over the last 40 years indicates that output losses in the aftermath of banking crises are both sustained and significant*. As shown in the chart, GDP per capita 7 years after the start of the crisis tends to be about 10 percent lower (on average) compared to pre-crisis trends. However, country experiences vary widely around this, suggesting uncertainty about the impact of the current crisis and an instrumental role for policies. Specifically, past experience shows that growth typically recovers in time, but the varied post-crisis output performance importantly reflects key policy actions.[1]

2. **Repairing the financial system and relying on supportive labor market policies can mitigate the loss of output**. Past experience suggests that reform measures that facilitate resource reallocation, including the capacity to reabsorb displaced labor, tend to mitigate the large disruptive effects of crises on economic activity. To facilitate the reabsorption of displaced workers, labor mobility would benefit from active labor market policies (ALMPs) targeting job search, matching, and training programs. Measures to fix impaired financial intermediation and damaged balance sheets that typically accompany crises also help reduce losses to productivity and, thus, potential output.

---

[1] For detailed analysis, see Chapter 4 of the *World Economic Outlook* (October 2009).

II. REMAKING THE FINANCIAL SYSTEM

3. **The future functioning of the financial system will be a key determinant of global growth prospects.** A healthy and dynamic financial system is crucial for efficient intermediation and innovation, which contributes to economic growth. New regulations and reforms must strike the right balance between rebuilding key financial markets in support of growth, while effectively safeguarding against future threats to financial stability.

4. **Reducing the threat of future systemic crises is an essential element within a framework for sustainable growth**. While plans are being developed to address the major fault lines exposed by the financial crisis—in terms of private incentives and risk management, financial regulations, and prudential oversight—reform momentum must not be lost as market confidence recovers. Challenges to key reforms remain formidable to resolve the deep flaws that led to a build-up of systemic risk. Progress is needed in the following areas:

- *The perimeter of regulation should be broadened to cover all systemically important institutions*. This is crucial to close regulatory gaps, including the transfer of credit risk to key financial institutions who had faced different regulatory requirements.

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

- *Better mechanisms are needed to deal with institutions that are "too big or too connected to fail," but comprehensive solutions are sorely lacking*. Proposals to require systemic institutions to develop resolution plans and to hold supplemental capital to compensate for their larger contribution to systemic risk should help, but preventive measures alone are not sufficient to effectively contain financial fallout if another major bankruptcy were to occur. Stronger crisis resolution mechanisms are also needed. Sound compensation policies (without arbitrary caps) that reward long-term objectives of the firm is also key for maintaining the right incentives to avoid excessive risk taking.

- *International coordination should be strengthened and financial protectionism should be avoided*. This effort will require greater supervisory and regulatory cooperation and convergence across many agencies and jurisdictions. Multilaterally consistent bank-specific resolution frameworks at the national level will be needed to resolve cross-border firms and to counter incentives for beggar-thy-neighbor approaches.

5. **Rebuilding key financial markets on a sounder basis would strengthen growth prospects.** Securitization—where markets remain essentially closed or heavily dependent on public support—needs to be rebuilt to deliver on its promise to transfer and disperse credit risks from the banking system to capital markets. To repair incentive and information

problems that led to the collapse of securitization markets, accounting standards and disclosure should be strengthened all along the chain of intermediation, products should be simplified and standardized, and incentives for issuers and rating agencies should be realigned. Policies are generally moving in the right direction, including to require more "skin in the game" from issuers, but proposals need to be carefully calibrated to avoid stifling market activity. [2]

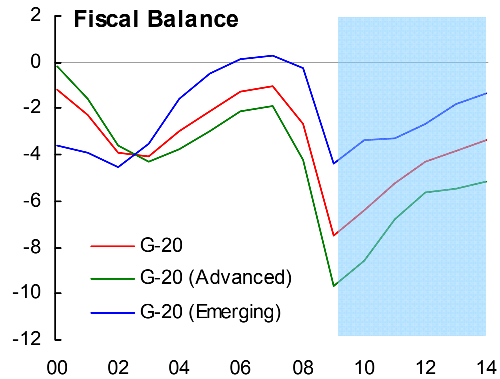
III. Global Rebalancing and Policy Challenges

6. **Required balance sheet repair after the crisis needs to be accompanied by a shift in the sources of global demand to sustain growth**. Several G-20 economies face a lengthy period of substantial balance sheet adjustment—particularly in countries with large public and external deficits and affected by large credit and housing booms and busts. Specifically:

- *As the recovery takes hold, public sector accounts will need to be consolidated considerably to achieve fiscal sustainability, restraining public demand*. Following exceptional public actions taken to stabilize the financial system and to support aggregate demand, substantial efforts over many years will be needed to reverse the deterioration of budgetary positions and place public debt onto sustainable trajectories, particularly in the many economies with high public debt.[3] The amount of adjustment needed would be even larger if growth is weaker over the medium term. This adds to the enormous fiscal burdens related to population aging—which dwarfs the costs incurred from the crisis— and will require major entitlement reform to safeguard public finances.

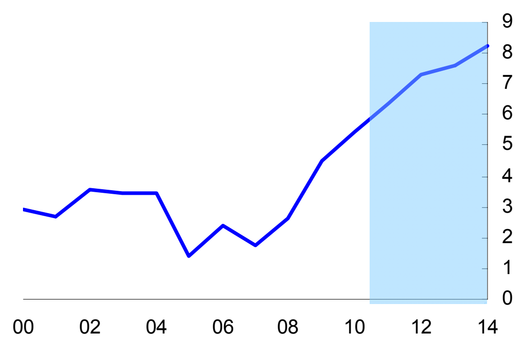
- *Household balance sheets will also need to be strengthened, implying higher private saving*. In the United States, household debt remains at historic highs, while financial and housing wealth have suffered steep losses, alongside

Outlook for Public Finances
(Percent of GDP)



Source: IMF, World Economic Outlook.

U.S. Household Savings Ratio
(Percent of disposable income)



Source: IMF, World Economic Outlook.

---

[2] For detailed analysis, see Chapter 2 of the *Global Financial Stability Report* (October 2009).

[3] For a detailed discussion of exit strategies and fiscal adjustment, see *Global Economic Prospects and Policy Challenges*, IMF Surveillance Note for the G-20 meeting of Ministers and Deputies, September 3-4, 2009.

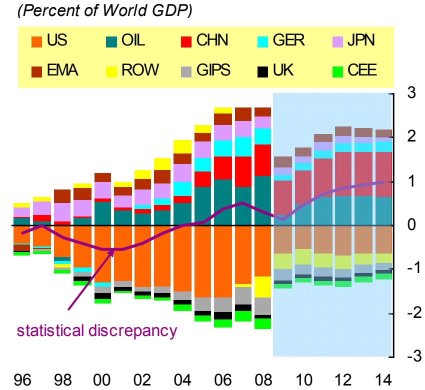
weaker growth prospects and rising unemployment. Moreover, perceived macroeconomic and financial risks are higher. This indicates that the recent sharp recovery in U.S. household saving rates will need to be sustained or even extended. Other advanced economies—e.g., United Kingdom, Ireland, and Spain—and some emerging economies (especially in Europe) will also need to see significant consolidation of household finances in the wake of major housing and credit busts.

- *Repair in public and private sector balance sheets imply shifts in the underlying pattern of saving and investment.* Specifically, higher saving (net of investment) and smaller current account deficits are likely among many G-20 advanced economies. Similar adjustment patterns are likely in much of emerging Europe, amid tighter external financing conditions.

7. **Following the crisis, the recovery in many advanced economies will need to depend more on net exports, matched by less dependence elsewhere**. With damaged balance sheets and interests rates at the floor, domestic demand in countries directly hit by the crisis will be constrained for some time. This suggests that countries such as the United States will need to rely more on foreign demand and higher net exports to support growth. As the counterpart, lower net exports are needed elsewhere to reallocate the pattern of global demand and to sustain the global recovery. For example, emerging economies (notably, in Asia) would have to become less reliant on export-led growth and more reliant on domestic demand. Advanced economies such as Japan and Germany, as well as oil exporters, could also support rebalancing through desirable reforms that strengthen growth prospects from domestic sources.

Global Imbalances

(Percent of World GDP)



Source: IMF staff estimates.

8. **Factors that may impede this rebalancing would need to be addressed**. Global imbalances have narrowed sharply after the crisis, reflecting some painful corrections and cyclical factors (see chart).[4] However, imbalances—based on current policy trajectories—are projected to widen again, signaling the need for further underlying adjustment. A number of distortions keep saving high in key surplus countries; and problems with the international monetary system continue to prompt self insurance in some countries through large reserve accumulation, especially after the crisis.

[4] As shown in the chart, US and UK current account deficits and those in other advanced countries (Greece, Ireland, Portugal, Spain (GIPS)) and emerging Europe (CEE) have narrowed sharply, as credit and housing booms have turned to busts. Germany (GER) and Japan's (JPN) external surpluses have noticeably narrowed, alongside falling exports and manufacturing; while surpluses have diminished for oil exporters (OIL). Emerging Asia (EMA)—notably, China—has seen less adjustment in its external positions.

9. **Successful rebalancing of global demand will thus require more forceful action, including structural policies in both advanced and emerging economies**. Rapid progress toward fixing the financial system is essential to support productivity and growth in advanced economies. In addition:

- *Given weaker growth prospects in key trading partners, emerging Asia (notably, China) should step up structural efforts*. This includes financial reforms to improve access to credit for smaller enterprises and households to boost domestic spending. Recent signs have been encouraging. Also, strengthening social safety nets, as well as pension and healthcare systems, are instrumental for reducing precautionary saving.

- *Structural reform efforts to boost productivity in the non-tradables sector in key surplus countries could enhance domestic growth prospects and facilitate a shift in demand toward the domestic economy*. Major advanced economies with sizeable external surpluses and lagging productivity in key sectors (notably, Germany and Japan) stand to gain. In emerging Asia, where services have tended to fall behind manufacturing in terms of productivity catch-up, reforms aimed at liberalizing service services would also be beneficial.

10. **Exchange rate appreciation in key surplus countries and depreciation in deficit countries may be needed.** To facilitate adjustment in those economies that need to rely less on external demand and to maintain output at potential, exchange rate appreciation would encourage a shift in productive resources from tradable to nontradable sectors. Stronger currencies (in real terms) would also boost purchasing power and consumption in key surplus countries. As the counterpart, depreciating currencies in major deficit countries would facilitate adjustment away from domestic demand toward net exports. To promote greater exchange rate flexibility in some countries, strengthened country insurance and multilateral liquidity provision could help limit incentives for reserve accumulation that, along with inflexible exchange rates, has been a feature of export-led growth strategies in the past.

11. **Joint implementation of policies in key surplus and deficit countries to advance rebalancing would strengthen global growth prospects**.[5] Staff analysis suggests that strong pursuit of these policy actions would bolster global growth and promote gradual movement towards rebalancing in current account positions. Unsuccessful or misguided polices present a downside risk, where rebalancing is limited and growth is lower. With slow progress on key policies (including repair of the financial system) and a drift toward protectionist measures, growth could be appreciably lower.[6]

---

[5] The main policies for rebalancing are consistent with recommendations and policy plans highlighted in the Multilateral Consultations on Global Imbalances. See http://www.imf.org/external/np/pp/2007/eng/062907.pdf .

[6]See *Global Economy Beyond the Crisis—Challenges Over the Medium Term*, IMF Surveillance Note for the G-20 Meetings of Ministers and Deputies, September 3-4, 2009.