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

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Securing the recovery. The global recovery has been better than expected. The WEO projections see global output expanding by about 4¼ percent in 2010 and 2011. Extraordinary and coordinated policy intervention since the crisis has all but eliminated the risk of another Great Depression, laying the foundation for recovery. Nevertheless, the recovery is proceeding at varying speeds—it is tepid and policy-dependent in many advanced economies, but solid in most emerging and developing economies. Global financial stability has also improved, although stability risks remain. In advanced economies, the credit crisis appears to be bottoming out. Cross-border financial flows from advanced to emerging economies have also rebounded strongly in nearly all regions and this is welcome. How to best deal with these inflows—for example, exchange rate appreciation, macro-prudential tools, reserve accumulation, capital controls—to best avoid excesses and maintain stable growth going forward is a key challenge. The effects of the crisis will linger and concerns about advanced country sovereign risks have risen sharply, threatening to spill over to banking systems and across borders. Overall, the outlook for activity remains unusually uncertain, with downside risks prevailing.

Do Ministers and Governors agree that recovery remains dependent on supportive policies in advanced economies but is more solid in many emerging and developing economies? Where do they see the main risks?

Addressing new fiscal challenges. The key task ahead is fiscal consolidation. Strong fiscal support has helped avoid a collapse in private demand and paved the road to recovery. But the crisis has led to large public debt increases, particularly in advanced economies. This reflects mostly revenue losses from the recession and financial crisis and underlying spending pressures, not the stimulus. As the global economy is recovering again, priorities need to shift toward fiscal consolidation. In particular, many countries urgently need to define and communicate fiscal consolidation strategies. The goal should be to reverse the rise in government debts, not just to stabilize them at post-crisis levels. Lower debts would provide greater room for policy maneuver, contain interest rates, and facilitate adjustments to rising aging-related spending. A major and sustained adjustment is required in primary fiscal balances. The timing and pace of the fiscal consolidation depend on country circumstances, particularly the speed of recovery and the government debt position. Given the still-fragile recovery, most advanced economies should maintain planned stimulus in 2010 and begin tightening in 2011, if the recovery continues to unfold as expected. But countries that are suffering large increases in risk premiums need to start fiscal consolidation now.

What risks do higher deficits and public debt in advanced economies present for the recovery? Do Ministers see constraints on fiscal consolidation? What actions can be taken now to support fiscal sustainability without jeopardizing the recovery?

Repairing and reforming financial sectors. Policies need to buttress lasting financial stability, so that the next stage of the deleveraging process unfolds smoothly and results in a safer, competitive, and vital financial system. Banks need to continue strengthening their capital base and securing stable funding. Swift resolution of nonviable institutions and restructuring nonviable ones is key. Restarting securitization on a safer basis is also essential to support the flow of credit. Also, there must be agreement on the regulatory agenda, where three challenges need to be addressed. First, new rules pertaining to capital and liquidity need to be finalized and implemented, as economic conditions permit. Second, to tackle systemic risks seriously, it is not enough to assign new duties to existing or new regulatory bodies, but also to provide them with the tools to mitigate the systemic risks they observe. Third, a better resolution framework for financial institutions is needed, particularly for institutions active across borders.

How do Ministers and Governors see the progress with respect to reforming financial sectors? How can reform momentum be sustained and reform efforts be internationally coordinated?

Combating unemployment. As high unemployment persists in advanced economies, a major concern is that temporary joblessness will turn into long-term unemployment. Beyond pursuing macroeconomic policies that support recovery in the near term and financial sector policies that restore banking sector health and credit supply to employment-intensive sectors, specific labor market policies could also help limit damage to the labor markets. In particular, adequate unemployment benefits that maintain incentives for job-search are essential to support confidence among households and to avoid large increases in poverty. Education and training can help reintegrate the unemployed into the labor force. Earned income tax credits and similar programs can facilitate wage adjustment and mitigate the effects of wage losses on living standards.

How do Ministers and Governors see prospects for unemployment? How do they see the tradeoff between providing further support to labor markets and increasing fiscal pressures?

Rebalancing global demand. The world's ability to sustain high growth over the medium term depends critically on rebalancing global demand. This means that economies with excessively large external deficits before the crisis need to consolidate their public finances in ways that limit damage to potential growth and demand. Private demand may not be as robust after the crisis as people lower expectations about future incomes, so greater reliance on external demand would help. At the same time, countries with excessively large current account surplus will need to further increase internal demand to sustain growth, as external demand will grow less fast than before the crisis. Exchange rates help facilitate this adjustment. As currencies of countries with excessive deficits depreciate, those of surplus countries must appreciate. This will also help emerging economies with excessive surpluses address the challenge of managing large capital inflows. But exchange rate adjustment is just one part of the package. Rebalancing also needs to be supported by financial sector reform and growth-enhancing structural policies in both surplus and deficit economies.

How do Ministers and Governors see prospects for rebalancing? What part can the IMF play to ensure further progress on this front?