ANNEX

IMF EXECUTIVE BOARD DISCUSSION OF THE OUTLOOK, SEPTEMBER 2009

The following remarks by the Acting Chair were made at the conclusion of the Executive Board's discussion of the World Economic Outlook *on September 16, 2009.*

Executive Directors welcomed signs that the global economy appears to be recovering and that financial conditions have improved markedly. Decisive and wide-ranging public interventions in key advanced economies have allayed concerns about systemic financial collapse and a global depression, while stimulative macroeconomic policies have shored up domestic demand across many other economies. Directors observed that emerging and developing countries, notably strong Asian performance, are leading the global recovery, supported by accommodative policies and recent increases in commodity prices.

Directors nevertheless expected the pace of global recovery to be subdued, with activity remaining far below precrisis levels. Downside risks to growth, though receding, remain a concern. First, a key constraint on activity is credit availability, as bank deleveraging is expected to limit the supply of credit for some time. Second, forces driving the current rebound will fade, as fiscal stimulus diminishes and inventory rebuilding gradually loses impetus. Third, consumption and investment are muted by the need to repair balance sheets, as well as rising unemployment, high excess capacity, and financing constraints. All these provide grounds to be cautious about the course of the global recovery.

Directors stressed that the key policy tasks remain restoring financial sector health, while maintaining supportive macroeconomic policies until the recovery is on a firm footing. Directors agreed that, while it is still too early for an exit from extraordinary public interventions and fiscal and monetary stimulus, policymakers need to begin preparing for the exit. The challenge is to calibrate the timing for the unwinding of public support, suited to individual country circumstances, communicating clear, coordinated exit strategies to the public. A premature withdrawal could jeopardize achievements in securing financial stability and economic recovery, while a delayed exit runs the risk of damaging public balance sheets, amplifying inflation prospects, and distorting incentives. Directors underscored the importance of international coordination and the advisory role of the IMF in the design and timing of exit strategies, recognizing that recovery paths differ from country to country.

Directors considered that the key issues facing monetary policymakers are when and how to unwind accommodative conditions, anticipating the impact of the withdrawal of fiscal support. In advanced economies, most central banks can afford to maintain accommodative conditions for an extended period so long as output gaps remain wide. While the rise in central bank liquidity will largely run off naturally as financial conditions improve, it could take much longer to reverse the buildup in illiquid assets on some central banks' balance sheets. Directors noted that central banks have the tools available to absorb reserves as needed to drain liquidity. They thought that the need to remove monetary accommodation is likely to materialize sooner in emerging economies than in advanced economies, although the situation varies across emerging economies. In some emerging economies, warding off risks of new asset price bubbles may also call for greater exchange rate flexibility.

Beyond the short-term horizon, Directors considered that monetary authorities should regularly monitor asset price movements along with other economic developments and, where and when possible, complement changes in policy rates with macroprudential instruments under appropriate circumstances. That said, they recognized that many unresolved practical issues exist regarding macrofinancial linkages, and hence it is too early to draw firm operational conclusions for monetary policy.

Notwithstanding already large deficits and rising public debt in many countries, Directors generally believed that fiscal stimulus needs to be sustained until the recovery is firmly established. They broadly felt that support may even need to be amplified or extended beyond current plans if downside risks to growth materialize, although a few saw very limited fiscal room in major advanced economies. Directors agreed that more progress in putting public finances back on a sustainable path could be achieved by governments' committing to large reductions in deficits and advancing reforms to entitlement systems. The credibility of such commitments could usefully be supported with more robust fiscal frameworks, including suitable fiscal rules and strong enforcement mechanisms that help constrain spending pressures in the upswing.

Directors stressed that completing financial sector repair and reforming prudential frameworks are urgently needed to return to sustained growth and to fully exit from liquidity and credit provision. Renewed efforts to increase bank capital and to cleanse bank balance sheets would help underpin the recovery. Official stress tests provide key diagnostics in order to design appropriate strategies for recapitalization of viable banks and for careful resolution of nonviable banks. In addition, exit strategies need to be clearly articulated to help guide bank restructuring. Public support programs need to be phased out gradually, using well-designed, market-based incentives. Moreover, clarity on new standards for capital regulation, liquidity risk requirements, provisioning, and accounting, and, where possible, resolution strategies are necessary in order for banks to decide properly how to deploy their resources and which business lines are likely to be profitable.

Directors noted that the pace of sustained medium-term growth depends critically on addressing the supply disruptions caused by the crisis and rebalancing the global pattern of demand. While past banking crises have tended to result in appreciable permanent output losses, this need not be the case if appropriate policies are deployed. Beyond the restructuring of financial firms and repair of markets, measures to help facilitate the redeployment of capital and labor are necessary. Countries with significant impediments to growth need to accelerate structural reforms to lift productivity and potential output.

To offset likely subdued domestic demand in deficit economies, many current account surplus economies will need to rely more on domestic demand growth, boosting private consumption, increasing the efficiency of capital allocation, and allowing greater exchange rate flexibility where necessary. Deficit countries must also do their part, tackling impediments to public and private saving, boosting potential output through labor and product market reforms, and improving corporate governance. It will be important for all countries to avoid trade and financial protectionism.

Directors cautioned that rising unemployment will present a major challenge in many advanced economies, while the crisis has been a setback to growth, employment, and poverty-alleviation efforts in many low-income economies. They underscored the need to help the unemployed with income support, strong job intermediation services, education and training, and measures to buffer the impact of income losses from lower wages in response to the shocks. Directors called for continued international support for low-income countries in their efforts to alleviate poverty and maintain macroeconomic stability.