JOINT FOREWORD TO *WORLD ECONOMIC OUTLOOK* AND *GLOBAL FINANCIAL STABILITY REPORT*

Prospects

Even with determined steps to return the financial sector to health and continued use of macroeconomic policy levers to support aggregate demand, global activity is projected to contract by 1.3 percent in 2009. This represents the deepest post–World War II recession by far. Moreover, the downturn is truly global: output per capita is projected to decline in countries representing three-quarters of the global economy. Growth is projected to reemerge in 2010, but at 1.9 percent it would be sluggish relative to past recoveries.

These projections are based on an assessment that financial market stabilization will take longer than previously envisaged, even with strong efforts by policymakers. Thus, financial conditions in the mature markets are projected to improve only slowly, as insolvency concerns are diminished by greater clarity over losses on bad assets and injections of public capital, and counterparty risks and market volatility are reduced. The April 2009 issue of the *Global Financial Stability Report* (GFSR) estimates that, subject to a number of assumptions, credit write-downs on U.S.-originated assets by all holders since the start of the crisis will total $2.7 trillion, compared with an estimate of $2.2 trillion in the January 2009 *GFSR Update*. Including assets originated in other mature market economies, total write-downs could reach $4 trillion over the next two years, approximately two-thirds of which may be taken by banks. Overall credit to the private sector in the advanced economies is thus expected to decline during both 2009 and 2010. Because of the acute degree of stress in mature markets and its concentration in the banking system, capital flows to emerging economies will remain very low.

The projections also assume continued strong macroeconomic policy support. Monetary policy interest rates are expected to be lowered to or remain near the zero bound in the major advanced economies, while central banks continue to explore unconventional ways to ease credit conditions and provide liquidity. Fiscal deficits are expected to widen sharply in both advanced and emerging economies, on assumptions that automatic stabilizers are allowed to operate and governments in G20 countries implement fiscal stimulus plans amounting to 2 percent of GDP in 2009 and 1½ percent of GDP in 2010.[1]

The current outlook is exceptionally uncertain, with risks still weighing on the downside. A key concern is that policies may be insufficient to arrest the negative feedback between deteriorating financial conditions and weakening economies in the face of limited public support for policy actions.

Policy Challenges

The difficult and uncertain outlook argues for continued forceful action both on the financial and macroeconomic policy fronts to establish the conditions for a return to sustained growth. Whereas policies must be centered at the national level, greater international cooperation is needed to avoid exacerbating cross-border strains. Building on the positive momentum created by the April G20 summit in London, coordination and collaboration is particularly important with respect to financial policies to avoid adverse international spillovers from national actions. At the same time, international support, including the additional resources

[1]The Group of 20 comprises 19 countries (Argentina, Australia, Brazil, Canada, China, France, Germany, India, Indonesia, Italy, Japan, Mexico, Republic of Korea, Russia. Saudi Arabia, South Africa, Turkey, United Kingdom, and United States) and the European Union.

being made available to the IMF, can help countries buffer the impact of the financial crisis on real activity and limit the fallout on poverty, particularly in developing economies.

Repairing Financial Sectors

The greatest policy priority for ensuring a durable economic recovery is restoring the financial sector to health. The three priorities identified in previous issues of the GFSR remain relevant: (1) ensuring that financial institutions have access to liquidity, (2) identifying and dealing with distressed assets, and (3) recapitalizing weak but viable institutions and resolving failed institutions.

The critical underpinning of an enduring solution must be credible loss recognition on impaired assets. To that end, governments need to establish common basic methodologies for a realistic, forward-looking valuation of securitized credit instruments. Various approaches to dealing with bad assets in banks can work, provided they are supported with adequate funding and implemented in a transparent manner.

Bank recapitalization must be rooted in a careful evaluation of the prospective viability of institutions, taking into account both write-downs to date and a realistic assessment of prospects for further write-downs. As supervisors assess recapitalization needs on a bank-by-bank basis, they must assure themselves of the quality of the bank's capital and the robustness of its funding, its business plan and risk-management processes, the appropriateness of compensation policies, and the strength of management. Viable financial institutions that are undercapitalized need to be intervened promptly, possibly utilizing a temporary period of public ownership until a private sector solution can be developed. Nonviable institutions should be intervened promptly, which may entail orderly closures or mergers. In general, public support to the financial sector should be temporary and withdrawn at the earliest opportunity. The amount of public funding needed is likely to be large, but the requirements will rise the longer it takes for a solution to be implemented.

Wide-ranging efforts to deal with financial strains in both the banking and corporate sectors will also be needed in emerging economies. Direct government support for corporate borrowing may be warranted. Some countries have also extended public guarantees of bank debt to the corporate sector and provided backstops to trade finance. Additionally, contingency plans should be devised to prepare for potential large-scale restructurings if circumstances deteriorate further.

Supporting Aggregate Demand

In advanced economies, room to further ease monetary policy should be used forcefully to support demand and counter deflationary risks. With the scope for lowering interest rates now virtually exhausted, central banks will have to continue exploring less conventional measures, using both the size and composition of their own balance sheets to support credit intermediation.

Emerging economies also need to ease monetary conditions to respond to the deteriorating outlook. However, in many of those economies, the task of the central bank is further complicated by the need to sustain external stability in the face of highly fragile financing flows and balance sheet mismatches because of domestic borrowing in foreign currencies. Thus, although central banks in most of these economies have lowered interest rates in the face of the global downturn, they have been appropriately cautious in doing so to maintain incentives for capital inflows and to avoid disorderly exchange rate moves.

Given the extent of the downturn and the limits to monetary policy action, fiscal policy must play a crucial part in providing short-term support to the global economy. Governments have acted to provide substantial stimulus in 2009, but it is now apparent that the effort will need to be at least sustained, if not increased, in 2010, and countries with fiscal room should stand ready to introduce new stimulus measures as needed to support the recovery. However, the room to provide fiscal support will be limited if such efforts erode credibility. In advanced economies, credibility requires addressing the medium-term fiscal challenges posed by aging populations. The costs of the current financial crisis—while sizable—are dwarfed by the impending increases in government spending on social security and health care for the elderly. It is also desirable to target stimulus measures to maximize the long-term benefits to the economy's productive potential, such as spending on infrastructure. Importantly, to maximize the benefits for the global economy, stimulus needs to be a joint effort among the countries with fiscal room.

Looking further ahead, a key challenge will be to calibrate the pace at which the extraordinary monetary and fiscal stimulus now being provided is withdrawn. Acting too fast would risk undercutting what is likely to be a fragile recovery, but acting too slowly could risk inflating new asset price bubbles or eroding credibility. At the current juncture, the main priority is to avoid reducing stimulus prematurely, while developing and articulating coherent exit strategies.

Easing External Financing Constraints

Economic growth in many emerging and developing economies is falling sharply, and adequate external financing from official sources will be essential to cushion adjustment and avoid external crises. The IMF, in concert with others, is already providing such financing for a number of these economies. The G20 agreement to increase the resources available to the IMF will facilitate further support. Also, the IMF's new Flexible Credit Line should help alleviate risks for sudden stops of capital inflows and, together with a reformed IMF conditionality framework, should facilitate the rapid and effective deployment of these additional resources if and when needed. For the poorest economies, additional donor support is crucial lest important gains in combating poverty and safeguarding financial stability be put at risk.

Medium-Run Policy Challenges

At the root of the market failure that led to the current crisis was optimism bred by a long period of high growth and low real interest rates and volatility, together with a series of policy failures. These failures raise important medium-run challenges for policymakers. With respect to financial policies, the task is to broaden the perimeter of regulation and make it more flexible to cover all systemically relevant institutions. Additionally, there is a need to develop a macroprudential approach to both regulation and monetary policy. International policy coordination and collaboration need to be strengthened, including by better early-warning exercises and a more open communication of risks. Trade and financial protectionism should be avoided, and rapid completion of the Doha Round of multilateral trade negotiations would revitalize global growth prospects.

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