Post-financial crisis: How are we doing?

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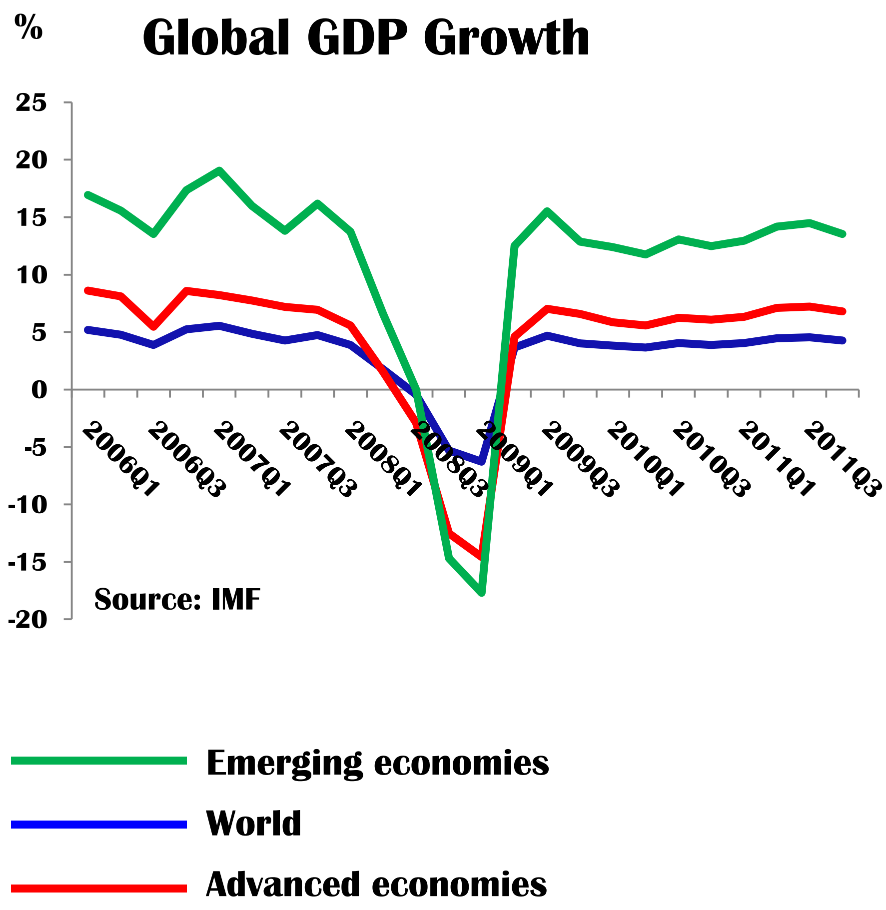
Global economic situation

- Global economy expanding again – pulled up by strong performance in Asian economies
- Recovery evident in financial markets, although conditions still difficult for borrowers
- Pace of recovery slow, mostly led by turn in inventory cycle
- Commodity demand increasing, boosting trade
- Lay-offs likely to continue in advanced economies - low demand, excess capacity, and tight credit

Global economic situation

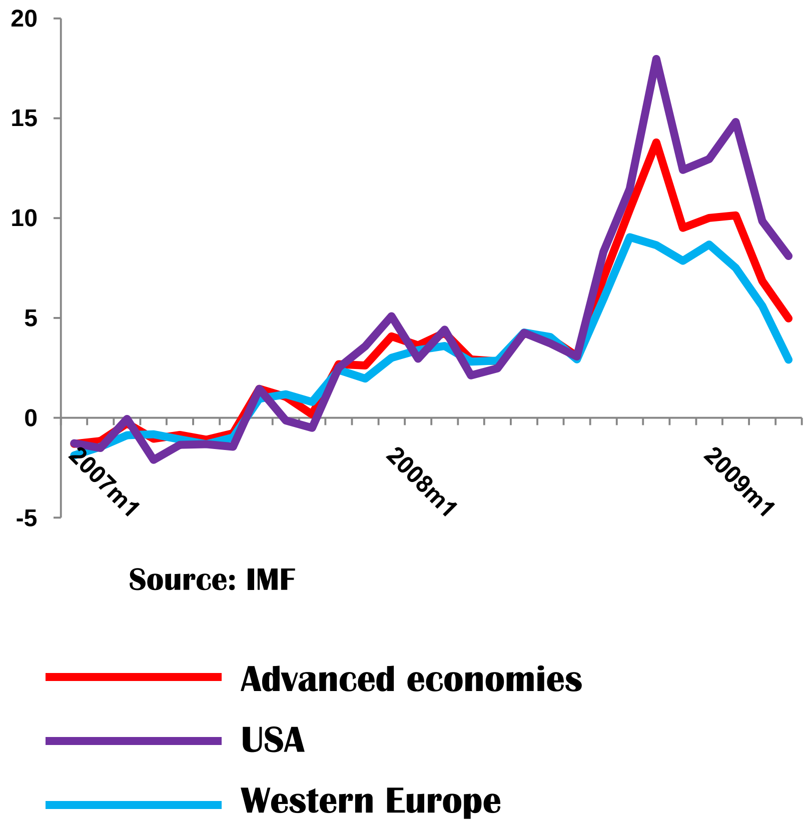


GDP Growth

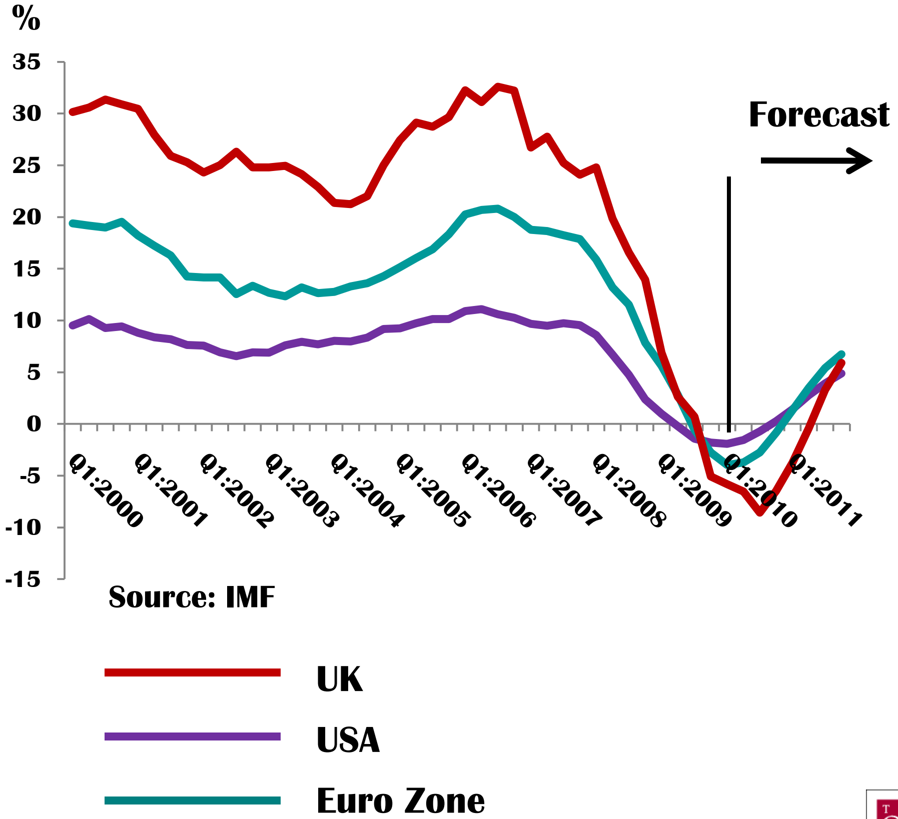
1. Global:
   - -0.8% (2009)
   - 3.9% (2010)
2. Advanced economies
   - -3.2% (2009)
   - 2.1% (2010)
   - US
   - -2.5% (2009)
   - 2.7% (2010)
3. Emerging economies
   - 2.1% (2009)
   - 6.0% (2010)

Global economic situation

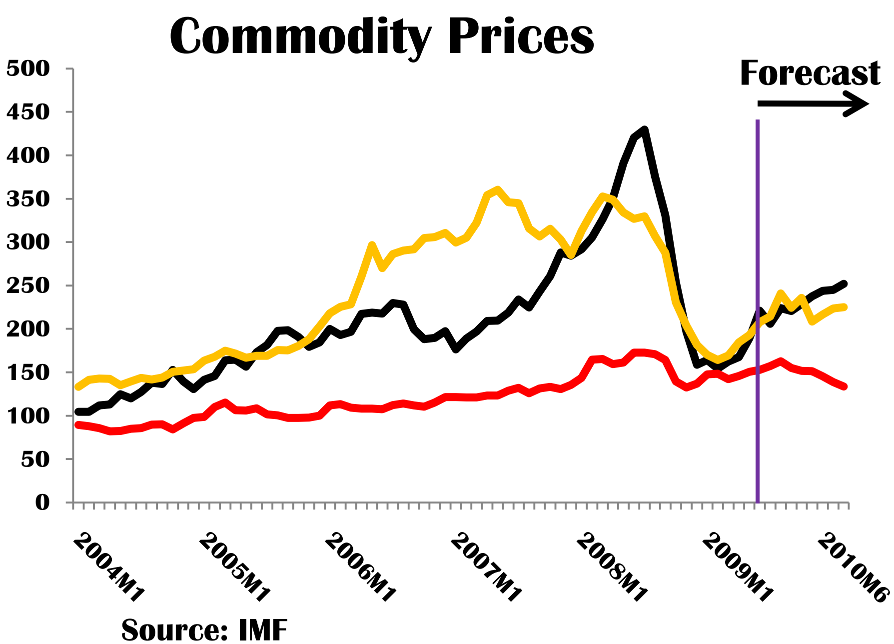
Financial Stress

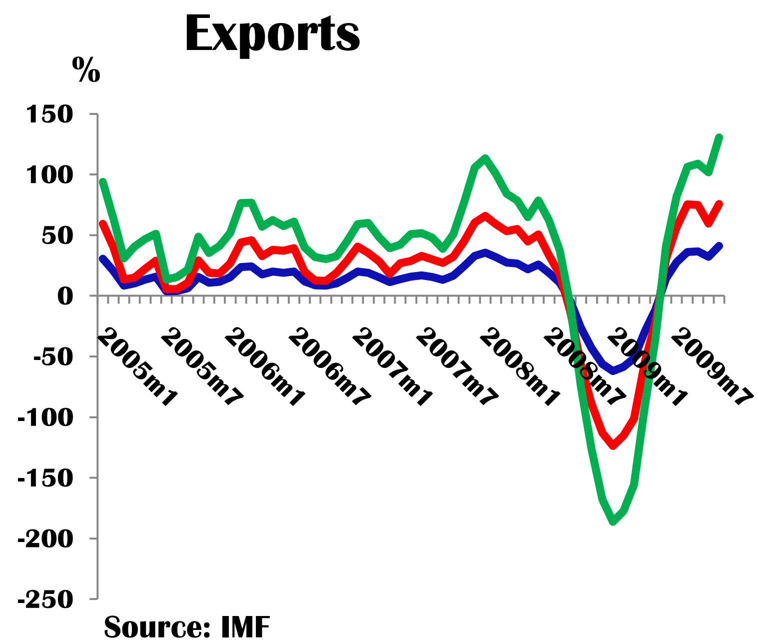


Private Sector Credit Growth



Global economic situation





Energy*

Metals

Agricultural commodities

*Oil price: 2010 - $76/barrel

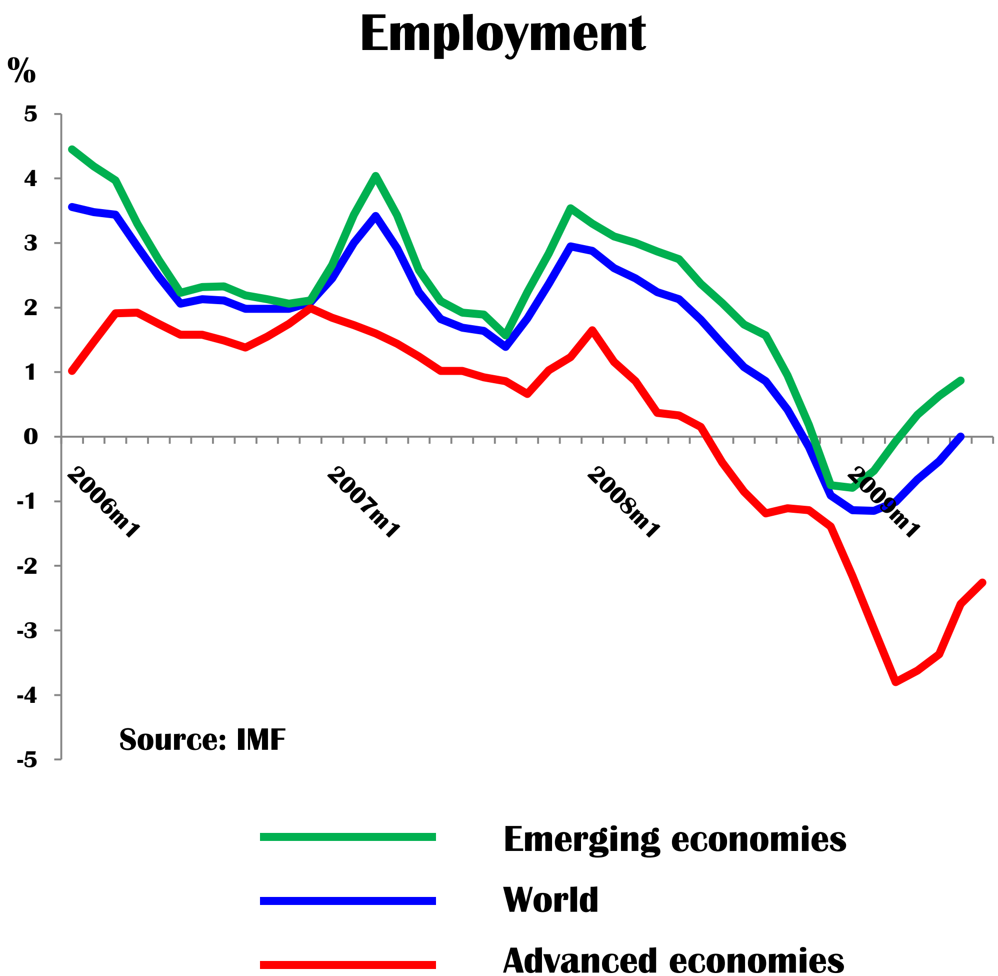
2011 - $82/barrel

Emerging economies

World

Advanced economies

Global economic situation



Public policy

- **Policy critical in cutting adverse feedback loop between financial and real sectors**
- ***Monetary policy*:**

- rise in output gap has reduced inflation

- interest rates virtually at zero, and central banks committed to keeping rates low

- various measures used to ease financial conditions – "quantitative easing"

- hard to unwind if markets remain illiquid

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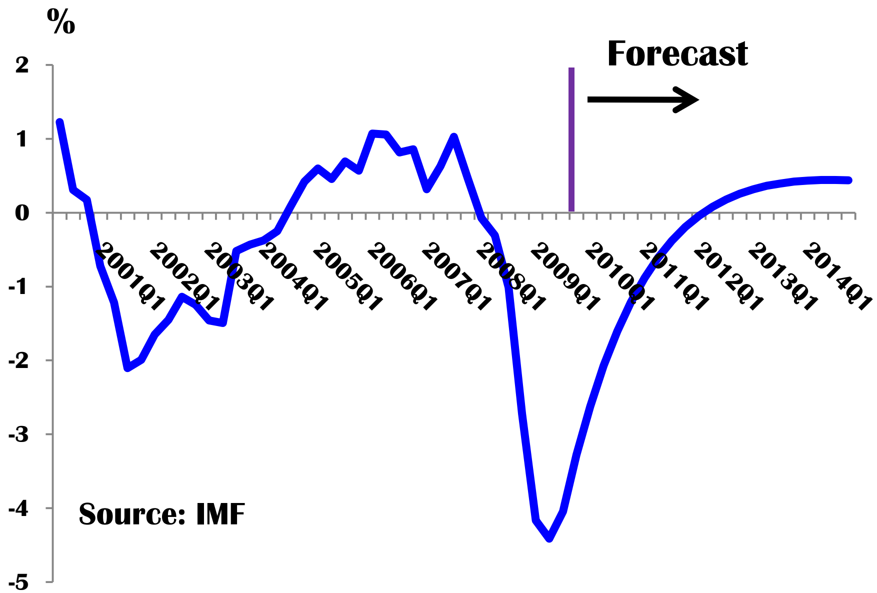
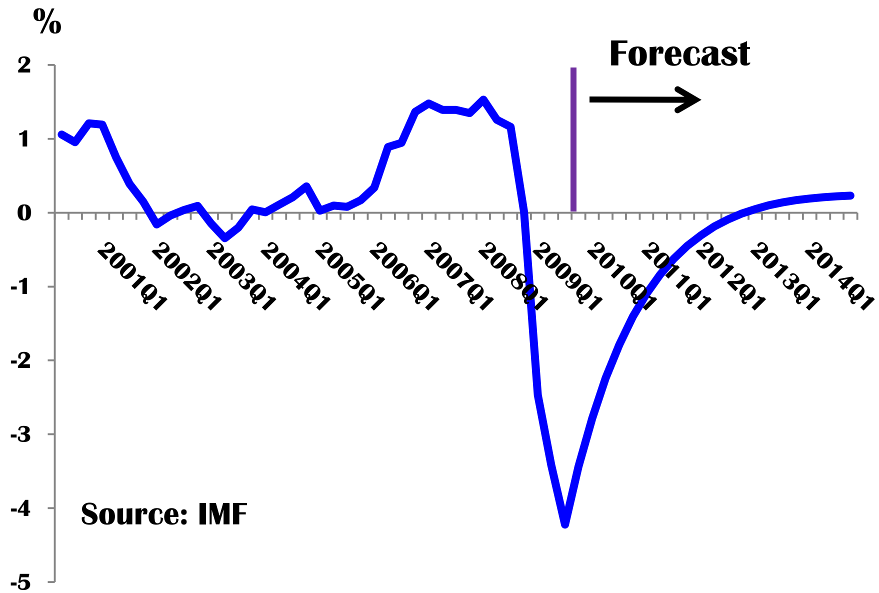
Output gaps

US – Output Gap



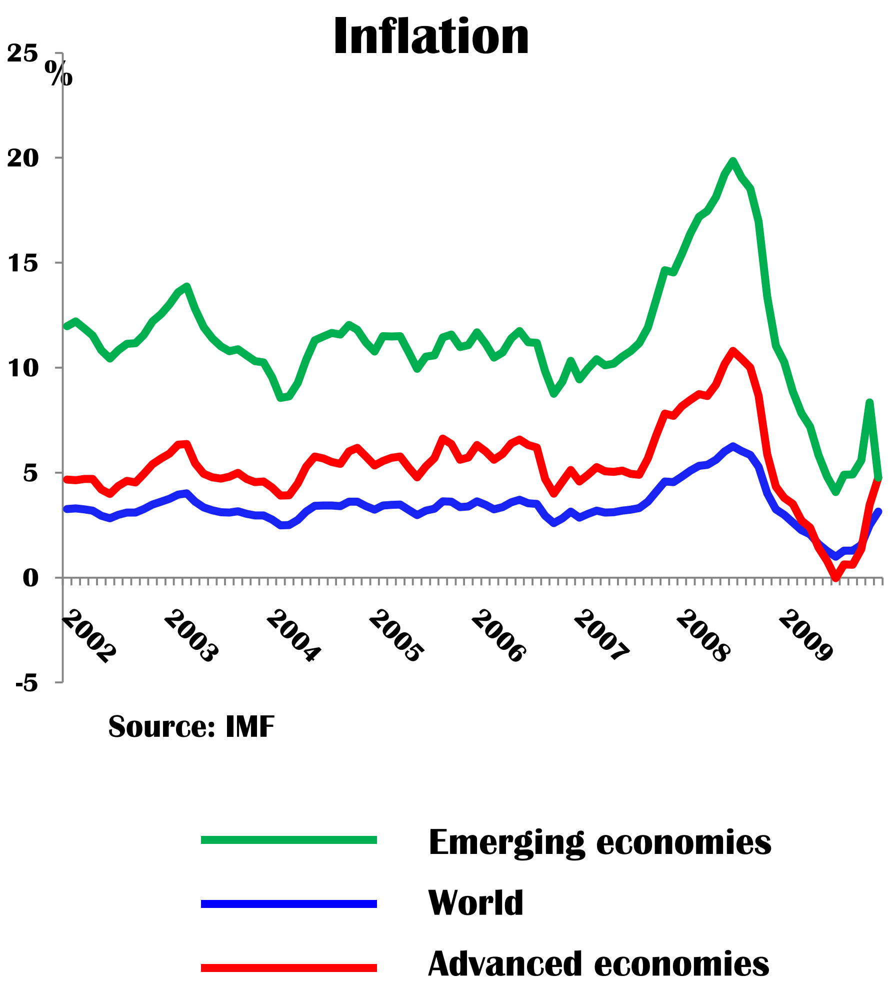
Euro area – Output Gap



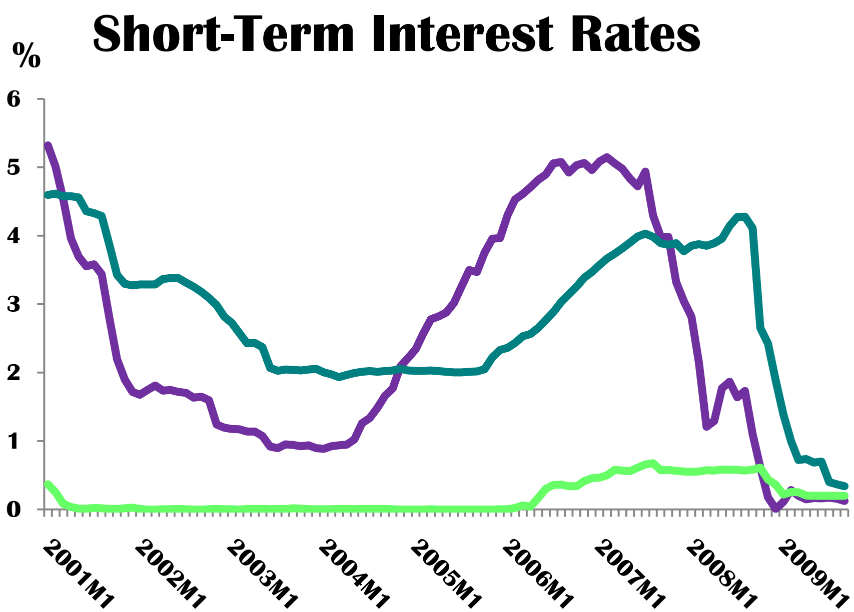
Output gap*

*Actual GDP growth – potential GDP growth

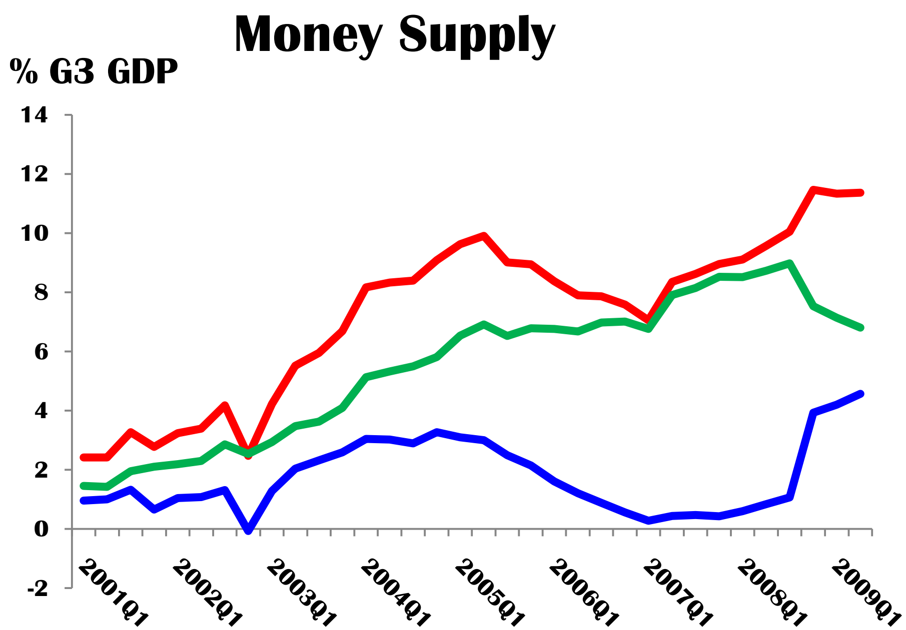
Global economic situation



Monetary policy



Source: IMF

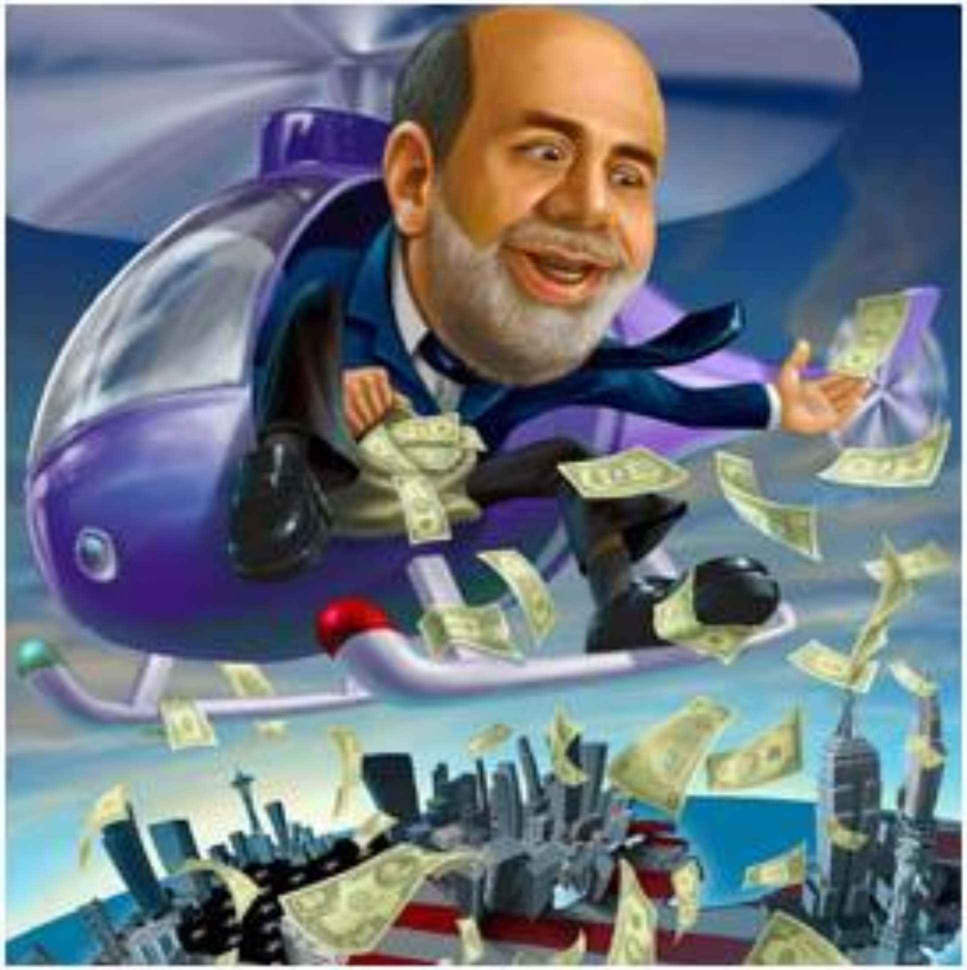


Source: IMF

US
Euro area
Japan

Base money + reserves
Reserves
Base money

"Helicopter Ben!"



“Mervyn’s Monetary Magic!”

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Public policy

- ***Fiscal policy:***

  - provided major stimulus in both advanced and emerging economies

  - expansion largest in advanced economies, estimated to boost G20 GDP by 1% in 2009

  - public debt rising fast, especially in advanced economies (110% of GDP by 2014)

  - fiscal deficits will contract as recovery improves cyclical components of budget

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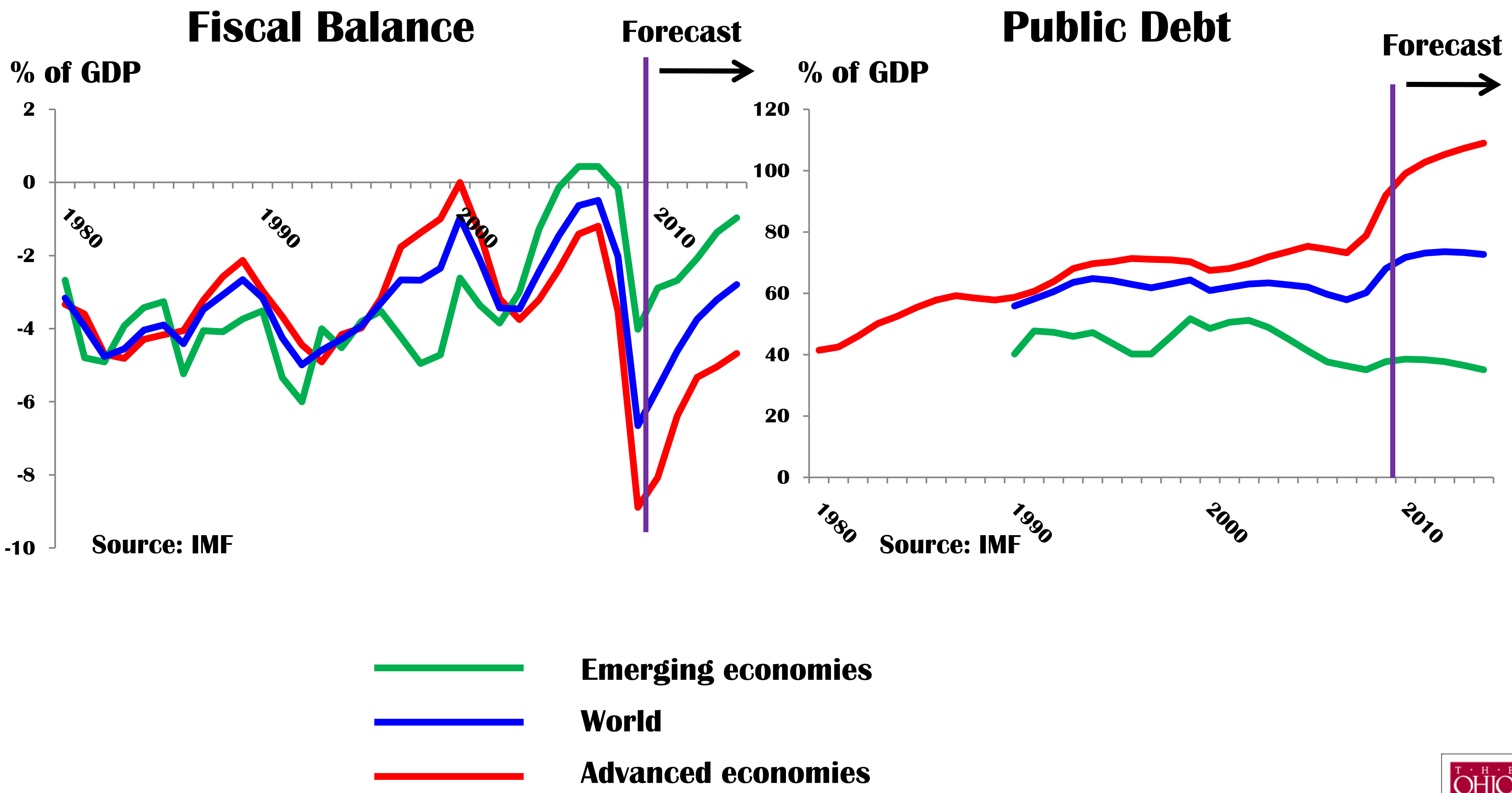
Fiscal policy



Public policy

- ***Financial policy:***

  - most governments provided deposit and debt guarantees – low cost and easy to implement

  - programs to recapitalize financial institutions have typically met with public skepticism

  - G20 economies have put in less than 6% of GDP

  - capital remains short of that necessary to forestall further bank deleveraging – potential drag on recovery

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Rebalancing world economy

- Trade deficits in countries such as US, matched by surpluses in emerging economies such as China, who also own large part of US public debt ($895 billion at end of 2009)
- Adjustments required in global demand

  - economies with trade surpluses need to increase domestic consumption

  - required to offset lower demand and higher savings rates in economies that have run trade deficits

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Risks to sustained recovery

- Key risk is that recovery stalls, and deflation becomes entrenched – could be triggered by too early exit from accommodative monetary policy
- Other risks include:

  - central banks have to tighten monetary policy by more than expected to deal with inflation

  - large increases in public debt could unsettle global bond markets

  - pressures for trade protection may build with increased unemployment

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Short vs. medium-term objectives

- **Need to map course between unwinding support policies too soon/leaving them in place too long**
- ***Monetary Policy*:**

- in advanced economies, central banks can afford to maintain liberal monetary policy for a while

- once output gap narrows, and inflation becomes a concern, policy will need to be tightened

- inflation-targeting perhaps too narrow - more emphasis on macro-prudential tools needed

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Short vs. medium-term objectives

- ***Fiscal Policy*:**

  - stimulus needs to be sustained until economic recovery on firm footing

  - but need to address long-term fiscal balances at some point by committing to deficit reductions

  - long-term increase in debt will place pressure on interest rates as recovery occurs, possibly crowding-out private investment

  - may also eventually cause flight from bonds

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Short vs. medium-term objectives

- ***Financial Policy*:**

  - restructuring financial firms is key for normal lending to resume, i.e., toxic asset cleanup

  - exit strategies need to be clearly articulated

  - three key financial reforms necessary:

  (a) perimeter of regulation needs broadening

  (b) counter-cyclical frameworks required

  (c) international regulatory convergence