Overview of the economic chapters

Chapter I

The financial crisis has left policymakers with a daunting legacy, especially in industrial countries. In setting policies, they must adopt a medium- to long-term perspective while they cope with the still fragile and uneven recovery. Households have only just begun to reduce their indebtedness and therefore continue to curb spending. Extraordinary support measures helped to contain contagion across markets, preventing the worst. But some measures have delayed the needed adjustments in the real economy and financial sector, where the reduction of leverage and balance sheet repair are far from complete. All this continues to weigh on confidence. The combination of remaining vulnerabilities in the financial system and the side effects of ongoing intensive care threaten to send the patient into relapse and to undermine reform efforts.

Macroeconomic support has its limits. Recent market reactions demonstrate that the limits to fiscal stimulus have been reached in a number of countries. Immediate, front-loaded fiscal consolidation is required in several industrial countries. Such policies need to be accompanied by structural reforms to facilitate growth and ensure long-term fiscal sustainability. In monetary policy, despite the fragility of the macroeconomy and low core inflation in the major advanced economies, it is important to bear in mind that keeping interest rates near zero for too long, with abundant liquidity, leads to distortions and creates risks for financial and monetary stability.

Fundamental reform of the financial system must be completed to put it on more stable foundations that would support high sustainable growth for the future. Above all, reform should produce more effective regulatory and supervisory policies as part of an integrated policy framework. A new global framework for financial stability should bring together contributions from regulatory, supervisory and macroeconomic policies. Supported by strong governance arrangements and international cooperation, such a framework would promote the combined goals of financial and macroeconomic stability.

Chapter II

While some emerging market economies are in danger of overheating, GDP in most advanced economies is still well below pre-crisis levels despite strong monetary and fiscal stimulus. The rapid increase of government debt raises urgent questions about the sustainability of public finances.

Banks have increased their capital buffers, and profits have been boosted by a number of temporary factors. But banks still remain vulnerable to further loan losses. As recent disruptions in funding markets have shown, banks can face significant refinancing pressures when sentiment turns adverse. Although banks in the crisis countries have made some progress in repairing their balance sheets, this process is far from complete. Efforts to restructure and strengthen the financial system should continue.

Central banks cut policy rates sharply during the crisis in order to stabilise the financial system and the real economy. Those essential cuts, reinforced by unconventional policy measures to address financial market malfunctioning, helped to forestall an economic meltdown. But there are limits to how long monetary policy can remain expansionary. Low interest rates can distort investment decisions. The financial stability risks that could arise from a prolonged period of extremely low policy rates also need to be very carefully weighed. An extended period of such low policy rates can encourage borrowers to shorten the duration of their debts, facilitate the increased leverage of risky positions and delay necessary balance sheet adjustments. While policymakers can and should address such risks with other tools, they may still need to tighten monetary policy sooner than consideration of macroeconomic prospects alone might suggest. Chapter III

Emerging market economies (EMEs) are recovering strongly and inflation pressures there are rising. Given low policy rates in the major financial centres, many EMEs are concerned that their stronger growth prospects could attract destabilising capital inflows, leading to currency appreciation. Some continue to keep policy rates low and resist exchange rate appreciation by conducting large-scale intervention in foreign exchange markets. Such policies tend to be associated with a sizeable expansion in bank balance sheets, rapid credit growth and asset price overshooting. The risks of domestic overheating thus increase. To promote more balanced domestic and global growth, some EMEs could rely more on exchange rate flexibility and on monetary policy tightening. In addition, prudential tools have an important role to play in enhancing the resilience of the financial system to domestic and external financial shocks. In contrast, while capital controls may have a limited and temporary role, they are unlikely to be effective over the medium term. Chapter IV

The level of public debt in many industrial countries is on an unsustainable path. Current budget deficits, partly cyclical but also swollen by policy responses to the crisis, are large in relation to GDP. And expenditures related to ageing populations are set to increase considerably over the next few decades. Recent events in Greece and other southern European countries have shown how quickly investors' doubts about the sustainability of public finances in one country can spill over to others. In addition, high levels of public debt may lower long-term economic growth and ultimately endanger monetary stability. Chapter V

These risks underscore the urgent need for credible measures to reduce current fiscal deficits in several industrial countries. Tackling the long-term fiscal imbalances requires structural reforms aimed at boosting the growth of potential output and containing the future increase in age-related expenditures. Such measures may have adverse effects on output growth in the short term, but the alternative of having to cope with a sudden loss in market confidence would be much worse. A programme of fiscal consolidation – cutting deficits by several percentage points of GDP over a number of years – would offer significant benefits of low and stable long-term interest rates, a less fragile financial system and, ultimately, better prospects for investment and long-term growth.

Chapter VI

The crisis revealed that some business models of financial firms were seriously flawed. For a long time, financial firms earned comparatively low returns on assets but used high leverage to meet targets for returns on equity. They also took full advantage of cheap short-term funding. This strategy made their profits more volatile, especially during periods of market stress. Since the crisis, investors have become more discriminating in their treatment of financial firms, rewarding those with more prudent and resilient models. The priority of policymakers now is to incorporate in the regulatory framework the stronger standards being imposed by the marketplace. Higher-quality capital, lower leverage and more stable funding should buttress the sector's future resilience. This need not undermine medium-term profitability, particularly if restructuring continues and excess capacity is progressively eliminated. In addition, more sound business models should restrain funding costs, thus contributing to strong, stable and sustainable performance in the sector.

Chapter VII

The stability of the financial system is undermined by distorted incentives and procyclical feedback effects. Macroprudential policy, which broadens the perspective of traditional prudential policy, can readily strengthen the resilience of the financial system to procyclicality by adapting conventional prudential tools. Countercyclical capital buffers, for example, can be built up when credit growth rises above trend during a boom, and released during the downturn. Other measures such as ceilings on loan-to-value (LTV) ratios for mortgage lending can act as automatic stabilisers because they will bind more during a boom when banks typically seek to expand property loans by accepting high LTV ratios. Such approaches could help to restrain credit and asset price excesses and thus mitigate the build-up of systemic financial vulnerabilities.

Addressing procyclicality is closely linked to traditional macroeconomic stabilisation policy. A more resilient financial system complements countercyclical monetary and fiscal policy, helping address threats to financial stability in the downturn. That said, monetary policy does need to lean more against the build-up of systemic financial vulnerabilities during the boom. That can be done by lengthening the policy horizon, thereby promoting long-term price stability more effectively.