Igniting and Sustaining Global Recovery: Key Macroeconomic Management Challenges[1]

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Abstract

A global economic recovery is expected to be ignited in 2010 but this will be characterized by very different growth trajectories among advanced and emerging economies. The downside risks are formidable. Sustaining this recovery will require skillful macroeconomic management. Exit strategies for fiscal stimulus will need to be carefully timed and credible fiscal consolidation plans need to be designed, implemented and communicated to all stakeholders. Monetary policies that go beyond a narrow focus on consumer price inflation would need to be redesigned and implemented. More effective financial supervision and regulation that incorporate the lessons learnt from the financial crisis must be effected and carefully coordinated with monetary policy. Greater flexibility in exchange rates that would curb global imbalances is needed. Looking ahead, a new social compact would need to be determined to both chart the recovery and sustain long-term growth and employment. The crisis is likely to usher fundamental and far reaching changes in economic decision making.

Key words*: sustainable recovery, monetary policy, effective financial support, exchange rate flexibility, change, currency appreciation, investment push*

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1. Introduction

The turbulence unleashed by the financial crisis of 2008 has been a game changer for the global economy. Strong coordinated countercyclical policy responses by the major global players rescued the world from the abyss of a depression in 2009. In turn, these responses that aggravated structural macroeconomic deficiencies in many countries are already clouding the outlook for a sustainable recovery. In the aftermath of the crisis, the new global economic order that is likely to emerge would be very different from the one that preceded it.

The purpose of this paper is to identify the challenges of macroeconomic management for the post-crisis recovery as individual economies find new moorings and global imbalances are wound down in an orderly manner, in order to sustain global growth with low inflation. Fiscal, monetary, financial regulatory and exchange rate policies will need to be refined and coordinated carefully in order to ensure resilience in the face of turbulence. The lessons learnt in the last two years provide valuable insights in shaping macroeconomic management for the post-crisis period.

The paper begins by describing the disparities in the recovery process among groups of countries followed by an identification of the major downside risks. This discussion of economy-wide issues then should be linked to the problem of global imbalances and the imperative for global cooperation in macroeconomic policy making. Against this context, some of the major challenges of macroeconomic management to ignite and sustain a post-crisis recovery are considered. The paper concludes by highlighting its key messages.

2. Two Faces of the Global Recovery

Against the backdrop of the steep declines in GDP growth in the fourth quarter of 2008 and the first quarter of 2009 across the world, the global economy with a decline in GDP growth of 0.6 percent in 2009 did better than many had expected. In 2009, the advanced economies shrank by 3.2 percent while emerging and developing economies registered GDP

growth of 2.4 percent. At a growth rate of 6.6 percent developing Asia led the pack.

Looking ahead, the latest World Economic Outlook of the International Monetary Fund released in April 2010, forecasts a global growth of 4.2 percent in 2010 and 4.3 percent in 2011. The volumes of world trade and capital flows are expected to improve significantly. However, this recovery in GDP growth will be characterized by widening disparities. Advanced economies are forecasted to grow by 2.3 percent in 2010 and 2.4 percent in 2011. In contrast, emerging and developing economies are forecasted to grow by 6.3 percent in 2010 and 6.5 percent in 2011. Developing Asia is forecasted to roar ahead with 8.7 percent growth in both 2010 and 2011.

The growth performance of 2009 and the forecast for 2010 and 2011 suggest that the anemic recovery of the advanced economies stands in sharp contrast to the V-shaped recovery of developing Asia. Output of the advanced economies is now about 7 percent below the pre-crisis level and the sluggish growth rates forecast suggest that the output gap is likely to persist. In turn, current unemployment rates of around 10 percent are not likely to fall below 8 percent even by the end of 2011. In contrast, the V-shaped recovery in developing Asia is reflected in supply bottlenecks emerging, increases in inflation rates, and asset price bubbles in equity and real estate markets.

The contrasting recovery trajectories of the advanced economies and developing Asia are described as the two faces of the global recovery. This typology is used both to simplify the paper and provide clear-cut key messages.

The major reasons for the trajectory of the recovery are identified. At the broadest level, two outstanding features of 2009 when the global economy was at the brink of depression in the first quarter stand out. First, at the G-20 level there was strong coordination of countercyclical monetary and fiscal policies across a very broad spectrum of major economies. Second, at the national level, monetary and fiscal policies were carefully coordinated to significantly enhance their synergies.

Together, the precipitous decline in private demand was compensated by a sharp increase in public demand to avert a depression and ignite a recovery.

Turning to the two faces of the expected recovery in 2010 and 2011, the anemic recovery in advanced economies is due to a variety of reasons. In the United States, household consumption which currently accounts for 70 percent of aggregate demand is expected to slow-down as households repair their balance sheets through raising saving rates. In Europe, credit supply is likely to be limited as banks which play a key role in financial intermediation repair their balance sheets. Deflation continues to haunt Japan and higher real interest rates could snuff out a hesitant recovery.

The V-shaped recovery in developing Asia will largely be fuelled by domestic demand. Household consumption is expected to be buoyant because of confidence in macroeconomic performance, expectations of rising wages and an increase in employment. The fiscal stimuli of 2009 that resulted in a pick-up in public investment in infrastructure will be accompanied by renewed private sector investment in infrastructure which is expected to lead to steady and sustainable returns. The sharp increase in the volume of world trade forecast for 2010 at about 7 percent from a decline of about 11 percent in 2009 will provide a boost to exports from developing Asia.

While the two faces of the global recovery and the major underlying causes have been described, an important consideration for the disparate nature of the recovery is the preconditions that existed in these two groups at the end of 2007. An understanding of these preconditions is essential for the magnitude and nature of the macroeconomic challenge in terms of fiscal, monetary, and exchange rate policies that would need to be coordinated to ignite and sustain a global recovery. Two events significantly influenced the establishment of these preconditions.

First, the bursting of the dot com bubble in the United States in 2001 led to a prolonged period of accommodation of monetary policy in order to facilitate an economic recovery. In hindsight, lowering interest rates was sensible, but persisting with low rates for a long period was a

mistake. These low rates did not trigger inflationary pressures because of cheap manufactured imports from China. The early 2000s also saw growing trade and current account surpluses in China.

Growing global imbalances that are attributed to a savings glut in developing Asia with capital moving from the impoverished South to the industrialized North were becoming worrisome. A disorderly unwinding of the global imbalances with severe crisis in the global capital and currency markets were deemed as the most important systemic risks. Low interest rates accompanied by financial deregulation set up the conditions for a perfect storm with asset bubbles in the equity and real estate markets. The real estate bubble was fed by credit frenzy where both households and financial institutions took on enormous risks. The banks and financial institutions repackaged their risky assets into collateralized debt obligations with high ratings and sold them worldwide including in the United States. With the beginning of a recession in 2007 and the lapse of the first two years of low mortgage rates after which mortgage holders would have to pay steeper interest rates, borrowers defaulted on a big scale. This was the beginning of the subprime crisis that quickly led to a liquidity freeze as holders of the collateralized debt obligations could not unload them. In September 2008, the collapse of major financial institutions like Lehman Brothers and the bailout of AIG triggered a tailspin in financial markets worldwide. Holders of subprime assets made losses totaling over 2 trillion dollars. The counterpart of financial sector deregulation on the fiscal side was significant income tax, corporate tax and estate tax cuts in a situation of steeply rising defense and war expenditures. As long as growth was strong, deficits and servicing of growing public debts were manageable. But as the global economic and financial crisis deepened, the vulnerability on the fiscal side became evident.

To sum up, in the industrialized countries in general and in the United States in particular, the advent of the crisis was characterized by accommodative monetary policy, expansionary fiscal policy characterized by chronic fiscal deficits and rising public debt, and loose

financial regulation and supervision. There was complacency that technology driven productivity improvement and the Asian savings glut had created conditions where conventional economic wisdom at the macroeconomic level no longer applied.

Second, developing Asia is considered. After a long period of strong growth from the mid 1970s to the mid 1990s, the defining event was the 1997-1998 Asian financial crisis. The tsunami that swept through Asia brought developing Asia to its knees and wiped out decade long gains in less than 2 years. A mismatch of currency and maturity in capital flows which went into risky investments laid the stage for the crisis. When debtors were unable to service their debts, instant capital flight occurred. Central Banks in protecting their fixed exchange rates exhausted their reserves. Banks which were the intermediaries between the foreign creditors and domestic debtors collapsed. This was fundamentally a foreign currency liquidity crisis and a financial sector crisis. South-East and North-East Asian countries turned to the International Monetary Fund for financial assistance which was provided with strong conditionalities. Except is Malaysia which introduced capital controls and did not seek IMF assistance, all governments that took IMF assistance were driven out.

Surprisingly, developing Asia recovered quickly and by 2000 was back on a moderately high growth path, lower than in the pre-crisis period but higher than what could be expected from such a financial tsunami. The lessons of the crisis were internalized by governments across the region. Central Banks were given more leeway in pursuing monetary policy with inflation targeting. Bank supervision was strengthened and the banking sector made significant improvements in risk management. Fiscal policy returned to a more prudent and responsible stance in most of developing Asia. Greater flexibility in exchange rates became the norm. In short, the 1997-1998 Asian financial crisis prepared developing Asia to take the 2008 global financial crisis in its stride.

3. Downside Risks Facing the Recovery

Significant downside risks could affect the outlook for global economic recovery. Some of these risks emanate from the macroeconomic and financial preconditions that preceded the 2008 – 2009 global crisis and the macroeconomic countercyclical policy measures taken in 2009 to avert a depression.

First, the fiscal stimuli in major advanced countries resulted in fiscal deficits that were about 9 percent of GDP. These cannot be sustained as they add greatly to preexisting public debt. Debt to GDP ratios are forecasted by the IMF to rise from 65 percent to over 100 percent by 2014. Average public debt as a percentage of GDP rose from about 75 between 2008-2009 to 95 in 2010 for the United States and from 160 to 220 for Japan. Greece, Spain and Portugal find themselves in a similar predicament. Sustainability concerns and the likelihood of more issuance of public debt in the near future have unnerved financial markets that have resulted in sharp increases in spreads on sovereign debt. For example, the yield spread above the 10 year German bond for Greece rose from 300 basis points on 10 January to 600 basis points on 17 March and to 965 basis points on 7 May 2010. The ongoing crisis in Greece and the looming crises in Portugal, Spain, Ireland and Italy indicate the severity of the crisis engulfing the Euro zone and the possibility of contagion that could affect the advanced economies. Preliminary estimates suggest that liquidity support to these countries range from €500 to €1000 billion. Further, while the European and North American banks could absorb a loss on their Greek assets, some of these banks could be severely affected if the contagion spreads to Portugal and Spain. The risk of contagion from Greece, Portugal and Spain presents a clear and present danger to the banking system in the advanced economies that could lead to a credit squeeze from a slowly recovering financial system.

In the industrialized countries, anemic GDP growth, excess capacity, high unemployment, hesitant private sector consumption and investment, all suggest that the withdrawal of fiscal stimulus could lead to a double

dip recession if they were confronted with new shocks. On the other hand, sustained levels of high public sector deficits will invite the wrath of the financial markets. The very recent experience of Greece, Portugal, and Spain in their public sector issuance of bonds after their credit ratings were downgraded and market doubts on their fiscal consolidation plans is sobering. Aggregate demand compression agreed by Greece to restore fiscal suitability in a defined time period suggests that Greece will not return to pre-crisis GDP levels till after 2015.

The sharply increasing fiscal deficits and public debts pose a major risk to financial stability. New issuance of public debt would crowd out growth of private sector credit owing to higher interest rates. With the re-pricing of sovereign debt, both financial institutions and growth would be adversely affected.

Second, while anemic growth, high unemployment and underemployment, and lowered expectations will crimp household consumption in the near term, it is highly likely that households in industrialized countries will repair their balance sheets by reducing indebtedness and raising savings rates over the medium-to long-term. This will lower long-term growth rates. Further, there is a risk that if unemployment levels persist for a long period of time, the growth of potential output will suffer permanent damage.

Third, the damage to the financial system will take a long time to repair. In industrialized countries, the banking system is still plagued by assets that are toxic and all the losses have not yet been written down. A significant amount of short-term funding will need to be refinanced over the next two years under difficult conditions aggravated by the unwinding sovereign debt crisis in Europe. A sound financial system is a precondition for credit to flow in adequate volumes to both households and firms to sustain a robust recovery which is so essential to reduce unemployment.

Fourth, while global imbalances have declined in 2009, the US and the UK continue to have large structural current account deficits while China, Germany, Japan, and the oil exporting countries continue to run large current account surpluses. The current account deficits indicate

deficits in the private sector or the public sector or both. Consequently, unless global rebalancing occurs, the balance sheet problems of the private and public sectors would persist.

Fifth, an orderly unwinding of global imbalances will require the current account surplus countries to demonstrate more flexibility in their exchange rate policies. Developing Asia in general and China in particular must make the necessary changes in their currency regimes. If China does not let its real exchange rate appreciate, other emerging economies would be resistant to their currencies appreciating. Under these conditions, given near zero interest rates and no significant increase in net exports, the US would be forced to persist with fiscal stimulus and continue with its large current account deficits. The sharply increasing public debt of the US and the persistence of chronic global imbalances could well lead to a disorderly unwinding of global imbalances with catastrophic consequences to the anemic recovery of the advanced economies.

Sixth, the V-shaped recovery witnessed in 2009 that is forecasted to continue in 2010 and 2011 in developing Asia is already adding inflationary pressures. The prospects for higher growth and monetary tightening are causing significant capital inflows and increasing the likelihood of asset price bubbles in both the real estate and equity markets. The volatility in short-term capital inflows is disruptive and reversal in outflows could be seriously destabilizing as vividly experienced during the 1997 – 1998 Asian financial crisis. These short-term inflows have already resulted in currency appreciation in some South and South-East developing economies thereby undermining their export competitiveness. The risks of currency appreciation that is not coordinated, asset bubbles and Dutch disease are significant for developing Asia.

The downside risks facing both advanced economies and developing Asia feed into each other in a highly interdependent world. Carefully conceived, timely and coordinated responses at the macroeconomic and

financial levels would be needed to chart a course for a sustainable global recovery.

4. Strategies for a Sustainable Recovery

In terms of response to these challenges, at the recently held World Bank/ IMF Spring Meetings in Washington DC, two very different strategies are emerging. First, the IMF is advocating a global rebalancing with advanced economies pursuing fiscal consolidation, higher private sector savings, and currency depreciation to propel net exports sharply higher. In contrast, emerging and developing economies should increase consumption and hence lower savings. Current account surplus countries should let their currencies appreciate and thereby lower their net exports. The IMF views this approach to result in a win-win situation through which global rebalancing would result in a sustainable global recovery.

Second, the World Bank has questioned the IMF approach on how the emerging economies would pay for increased imports from the advanced economies if they reduced their savings rates. Instead, the World Bank advocates an alternative approach where investment should be given a sharp push in developing countries to lead to improvements in productivity and higher growth trajectories through which they would import more investment goods with the capacity to pay for the imports from advanced economies. This is the basic rationale for the World Bank's recent advocacy of the creation of multiple growth poles with developing economies emerging as growth drivers of the global economy as captured in its "Modernizing Multilateralism for a Multi-Polar World".

The World Bank strategy to promote multi-polar growth to reduce global imbalances and promote sustainable global recovery is a desirable long term goal. Significant reforms are needed in developing economies to substantially improve or augment risk adjusted returns to capital without which private domestic and foreign investment would simply not occur. Public sector investments are seriously constrained by both the paucity of fiscal resources and in-house capacity to design and

implement bankable projects. For example, the Islamic Development Bank's ongoing study on infrastructure diagnostics in Indonesia identifies serious institutional constraints led to few and poorly prepared bankable projects. As a result, neither public nor private investment has occurred in infrastructure in the last decade in sufficient volumes to sustain high growth experienced in neighboring countries. Implementing the World Bank strategy would first have to overcome serious absorptive capacity constraints in developing countries. In this regard, the example of China which undertook a massive infrastructure investment program under its stimulus program in 2009 is an exception and definitely not the rule.

The two strategies proposed by the World Bank/ IMF are raised for two reasons. First, a major rethinking is underway in the post-crisis world. The structural shifts being witnessed in the manner in which the global economy functions will lead, through a process of trial and effort, for many alternative strategies to be tried and tested before a new model emerges. The tabling of these two strategies is the initiation of this process. Second, the two strategies explicitly recognize the shift from a uni-polar to a multi-polar global economic order. In the twenty-first century, new growth poles will emerge in all continents. The establishment of the G-20 as a substitute for the G-7 constitutes the beginning of this process at the global institutional level.

5. Macroeconomic Management Challenges in the Post-Crisis World

In the two faces of the recovery, the advanced economies are considered first. The failures within the financial system led to the crisis of 2008 and not from the long awaited disorderly unwinding of global imbalances. However, the risks from a disorderly unwinding remain. The trigger for the crisis was the credit freeze resulting from the collapse of the financial system in the latter part of 2008. While very rapid monetary accommodation and unconventional liquidity injection followed in advanced economies, the crippling of the financial system meant that credit flows to both households and firms to be frozen. Fiscal stimuli on

a massive scale starting to the second quarter of 2009 averted a depression. A collapse in private demand was countered by fiscal pump priming. The challenge now is to avert a spiraling of public debt to unsustainable levels as is now happening in Greece through well timed and sequenced fiscal consolidation. This is necessary to ensure that the recovery in its nascent stages is not derailed but at the same time reassures financial markets through the design and implementation of credible and transparent medium-term fiscal consolidation plans.

But this is easier said than done. Political will is the key to fiscal consolidation. A combination of public expenditure reduction and an increase in public revenues is required. An increase in public revenues in a time of anemic growth will require new taxes which could derail the recovery. A cut in public expenditures where the share of non-discretionary spending is high requires difficult political economy considerations to be tackled head on under very trying conditions. Long-term gain will require short-term pain. The danger of deferring difficult decisions on expenditures reduction is that a country will be faced with a Greece like predicament in the short to medium-term or a lingering malaise faced by Japan which has experienced very low growth rates and near deflationary conditions for nearly two decades. In advanced economies, until Governments and people acknowledge and accept that there is always the trade-off between guns and butter famously drilled into the minds of students attending their first class in economics by noble laureate Samuelson and they cannot have more of both, fiscal consolidation will occupy centre stage in the policy debate without concrete action to rein in fiscal deficits and rein in public debt. This is a part of a major shift that will have to occur in the post-crisis world.

While Europe has traditionally had relatively high levels of unemployment, a prolonged period of high unemployment at 8-9 percent in the United States will be a new post-crisis phenomenon. While more efficient functioning of labor markets and wage flexibility would be required in Europe, social protection and safety net policies and programs for the unemployed would need to be revisited and revised in

the US. While there would be fiscal implications, protecting and training workers for defined time periods would facilitate a recovery.

High levels of unemployment and underemployment, low levels of capacity utilization and productivity improvements seen prominently in the United States suggest that inflationary pressures are likely to be muted. As a result, the accommodative monetary stance of central banks with short-term interest rates in both nominal and real terms at historical lows could continue over 2010 and 2011. This monetary stance will be important especially in countries that pursue meaningful fiscal consolidation.

A precondition for accommodative monetary policy to affect the real sector of the economy is the repair of the financial system. Regulatory and supervisory reforms are needed in the financial sector to avoid the excesses of the early 2000s that led to the creation of the asset bubbles prior to the crisis. Clean up of the balance sheets of the financial institutions, introduction of better risk management policies and practices, and injection of more capital would together establish the preconditions for credit to the real sectors to flow in volumes that are required for the recovery. The urgency of rapidly restoring and strengthening the balance sheets in the financial sector has increased sharply as Governments would find it politically and financially to provide bailouts to fragile institutions even if they are too big to fail. The increased sovereign risks in Europe also cast a shadow of the ability of Governments to come to the assistance of banks. Given the increased downside risks, unexpected shocks emanating from within countries or from outside must be guarded against by the financial institutions.

Concerns on debt sustainability, sovereign risks, prolonged accommodative monetary policies, and anemic recovery are already affecting currency markets in terms of exchange rate volatility as well as capital flows to countries that offer higher expected returns. The currency volatility among the major advanced economies is likely to persist depending on the nature and magnitude of unexpected shocks and market expectations. An event that is likely to have a major impact on

currency markets is the timing of the decision of the US Federal Reserve Board to end its policy of near zero short-term interest rates.

Macroeconomic management in developing Asia in the post-crisis world is considered next. As indicated, the Asian financial crisis of 1997-98 led to the adaption of prudent and conservative fiscal, monetary, and exchange rate policies. As a result, countries in developing Asia could confront the global financial crisis with a stronger set of initial macroeconomic conditions than the advanced economies. The countercyclical response was swift and large. There was sufficient fiscal space and monetary policy was tight till September 2008 as developing Asia faced strong inflationary pressures compounded by food price inflation. Countries like India and China unleashed large fiscal stimulus packages accompanied by steep decreases in interest rates. The resulting V-shaped recovery in 2009 sets the stage for macroeconomic management in the post-crisis period.

The most important lesson of the global financial crisis for developing Asia is the continued validity of prudent and conservative macroeconomic management accompanied by financial market stability. These have been the hallmarks of developing Asia in the aftermath of the 1997-98 Asian financial markets. This macroeconomic stance that has led to macroeconomic stability and high and stable growth for a decade needs to be continued.

The pick-up in household consumption and private investment that has accompanied the V-shaped recovery suggests that developing Asia is ready for the phased withdrawal of the fiscal stimulus. Medium-term fiscal consolidation plans need to be designed and implemented. On the expenditure side, the focus must be on cost-effective public investment, social expenditures and subsidies that are targeted and with minimum leakages, and a check on non-discretionary expenditures. Executed properly, these measures would be both growth and equity enhancing. Turning to the revenue side, the tax net needs to be widened, the tax regime made more transparent and non-distortionary to improve the business and investment climate. There is scope for improvements in tax administration in most of developing Asia. Smarter and better

Governments, not bigger Governments are needed to ensure fiscal discipline. Sound institutions and good governance are essential. A rapid rebuilding of fiscal space is essential for developing Asia to be equipped to deal with future crises.

The guiding principle of Central Banks in most countries in developing Asia has been to target inflation and manage inflationary expectations. While the framework for monetary policy in terms of inflation targeting continues to be sound, an important lesson of the global financial crisis is the need to monitor and check asset bubbles. For this, as is so obvious from the very recent experience of advanced economies, financial regulation and supervision need to be strengthened.

In addition to targeting inflation, monetary policy in developing Asia needs to contribute towards asset market stability. Policy measures focusing on asset markets need to be redesigned and implemented. In order to detect and check asset bubbles through policy interventions, a financial authority is needed for the supervision and regulation of the financial sector.

Two institutional issues would need to be addressed. First, should the financial authority address the issue of asset bubbles established inside or outside the Central Bank? Second, independence in monetary policy formulation and in financial regulation and supervision from outside interference provides the best prospects for success in containing price inflation and curbing the emergence of asset bubbles.

In the post-crisis period, developing Asia will need to revisit and revise its exchange rate policies. To understand, the nature and magnitude of the change required, we need to go back to the 1997-98 Asian financial crisis. In its aftermath, developing Asia on the precautionary motive rapidly built up a massive reservoir of foreign exchange reserves that greatly exceeded what was deemed prudent even under the most conservative assumptions. Undervalued exchange rates, export-led growth and investment of reserves in US Treasury bonds fuelled two outcomes. First, they contributed to the build-up in global

imbalances. Second, undervalued currencies were a disincentive to household consumption.

These outcomes need to be reversed, as good global citizens; developing Asia should contribute to the orderly drawdown of global imbalances that are keys to sustain a strong global recovery. Also as responsible governments, the fruits of growth and prosperity should translate into higher household consumption and economic welfare.

Developing Asian countries should allow for the orderly appreciation of their economies. Exchange rates must be allowed to adjust and reflect market fundamentals. Flexibility in exchange rates would enable developing Asia to absorb external shocks more efficiently as well as increase flexibility in the use of monetary and fiscal policies.

Strengthened emphasis on macroeconomic policy prudence, continued good prospects for growth, and exchange rate flexibility that would most likely cause currencies to appreciate in developing Asia vis-à-vis currencies of advanced economies would attract a flood of capital inflows that would lead to further currency appreciation. In order to address this issue, selective capital controls targeted at 'hot money' that is destabilizing will become necessary. Even the IMF concurs on this.

In both advanced economies and developing Asia, a return to conventional wisdom on the imperative for prudent and conservative macroeconomic management accompanied by strengthened financial regulation and supervision is required. This will not only hasten a sustainable recovery but will also strengthen the ability of countries to navigate recurring crises.

6. Conclusion

The global financial crisis of 2008 has inflicted substantial losses and caused significant pain across the world. Yet, the crisis also presents an opportunity and a wake-up call which if grasped will facilitate a sustainable and strong global economic recovery. Learning from the crisis to do better in the future will be important.

In a highly interdependent world of trade, financial, and capital flows, the crises has demonstrated the need for macroeconomic coordination at various levels. First, the G-20 in close cooperation with the multilateral financial institutions carried out a massive fiscal stimulus which was instrumental in igniting the 2009 recovery. Second, the market driven financial and capital flows which significantly determine the access to and the cost of credit for countries are highly sensitive to expectations. This is vividly demonstrated by the effects of a €750 billion loan-guarantee deal agreed by the European Union and the International Monetary Fund on 9 May 2010. This initiative was to calm market fears that the debt crisis in Greece would not spread to other highly indebted countries like Spain and Portugal. The announcement of the deal led to a decline in yield spread for Greece from 965 basis points on 7 May to 436 basis points on 10 May. Managing market expectations through coordinated, decisive and swift action among multilateral, regional and national institutions is a critical lesson of the ongoing crisis. Third, there is a need for coordination between fiscal, monetary and exchange rate policies within economies for countercyclical action during both downturns and upturns.

The global crisis has demonstrated that current account deficits, budget deficits and the level of national debt do matter for all countries. High levels of external debt as in Greece suggest that the backlash of financial market discipline can cripple economies. A strong case is made for a return to traditional values and conventional wisdom in macroeconomic management. Over the medium-term, a focus on macroeconomic prudence is required to ensure growth with stability. Further, sound macroeconomic management will ensure that countries have the fiscal and monetary space to fight future crises which are certain to occur with the uncertainty arising from the form, magnitude and timing of new crises.

In order to sustain the global recovery, the adoption of credible medium-term fiscal consolidation plans that are communicated quickly and transparently to people and the markets is advocated. Monetary

policy that targets price inflation must be coordinated with financial regulation and supervision that monitors the evolution of asset bubbles and decisively checks them. Flexibility in exchange rates particularly by those countries that have persistent current account surpluses is essential to facilitate an orderly unwinding of global imbalances and is so essential to sustain a recovery.

In doing better with less, the expectations of the population on what public goods and services they could expect would need to change. In reining fiscal deficits, public expenditures would need to decline but become more efficient. A new social compact between governments and the population would need to be assured as austerity measures would have no credibility and no political support if the burden of pain is not equitably shared. Institutions would need to be reformed, better governance ensured and the plague of corruption transparently addressed.

These reforms at the institutional level are essential for the big bang approach that has advantages. When countries get into crisis, it is advisable to endure the pain early. Short-term pain early will result in early medium-term gains. The big bang approach uses crises as opportunities to drive home hard political choices.

Finally, prudent macroeconomic management and thereby managing market expectations is a precondition to igniting growth in the short-term and sustaining it in the medium-term. Prudent macroeconomic management would need to be combined with flexible microeconomic policies to enhance firm level productivity and competitiveness that would boost long-term growth which in turn would generate productive and decent employment opportunities that could be sustained. While the journey to global recovery has begun, there are miles to go before a destination can be glimpsed.

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