The Global Financial Crisis: Why It Happened, and Options for National and International Policy Change

A comparative overview of the crisis and macro-economic policy responses so far

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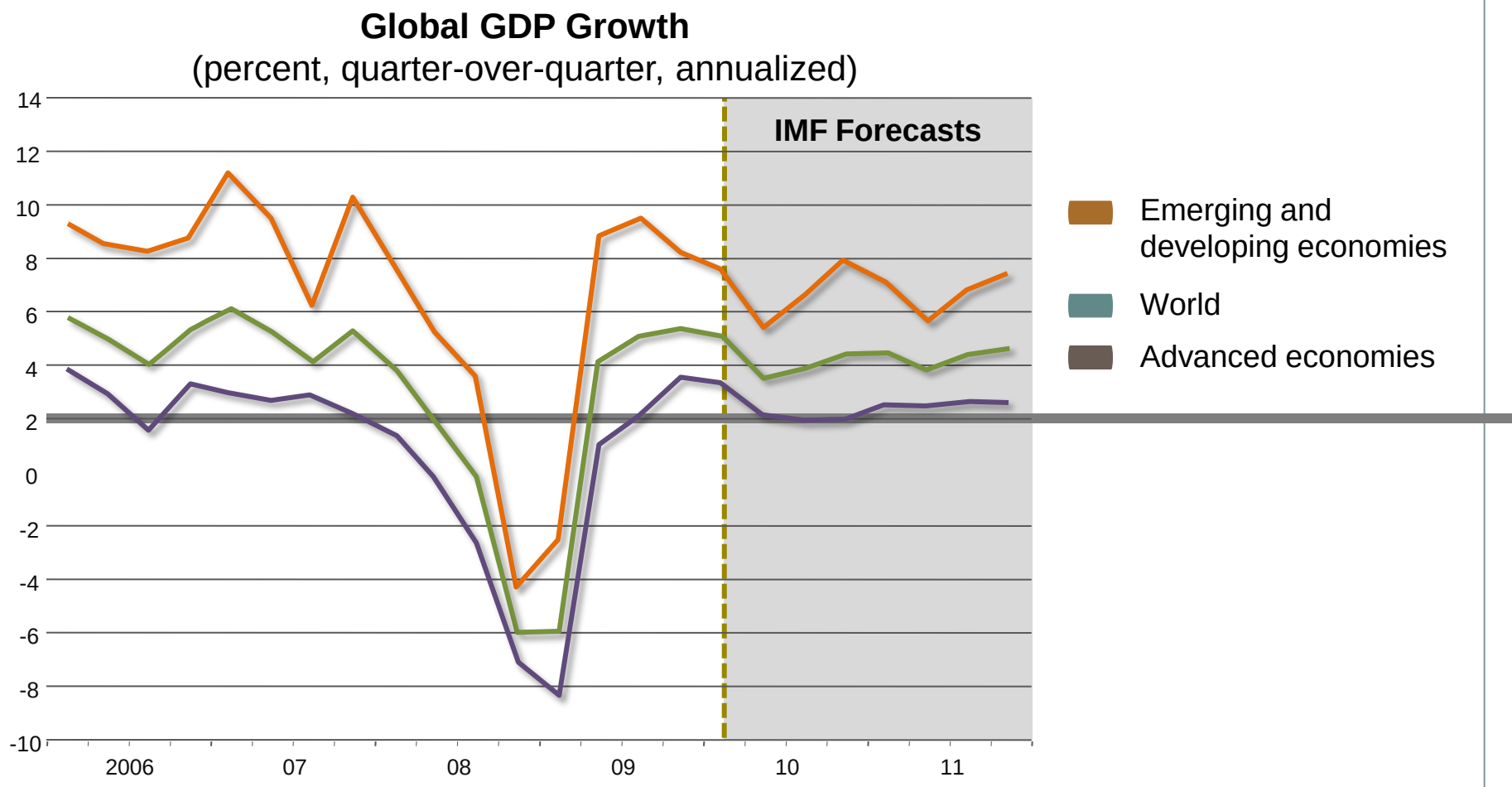
The world is recovering from the great recession, but huge challenges remain

- The impact of the crisis
- How did the crisis start
- Why this recession is different
- Policy Responses thus far
- Policies to sustain the recovery
- Lessons from the crisis

The Crisis—Impact on Growth

Global growth fell sharply during the crisis everywhere in the world



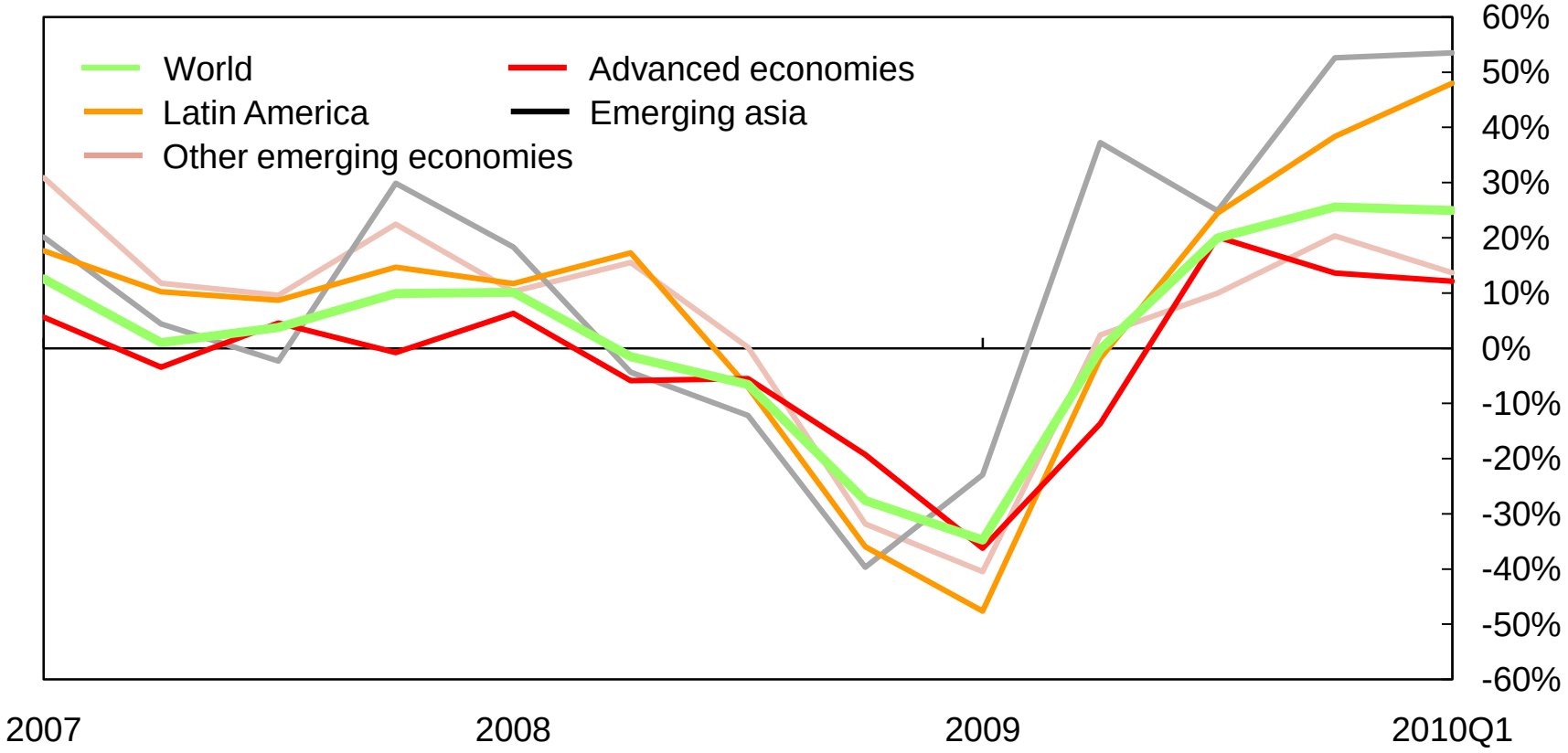
Source: IMF WEO (October 2010).

The Crisis—Impact on Trade

World trade collapsed…

Growth Rate of World Real Imports

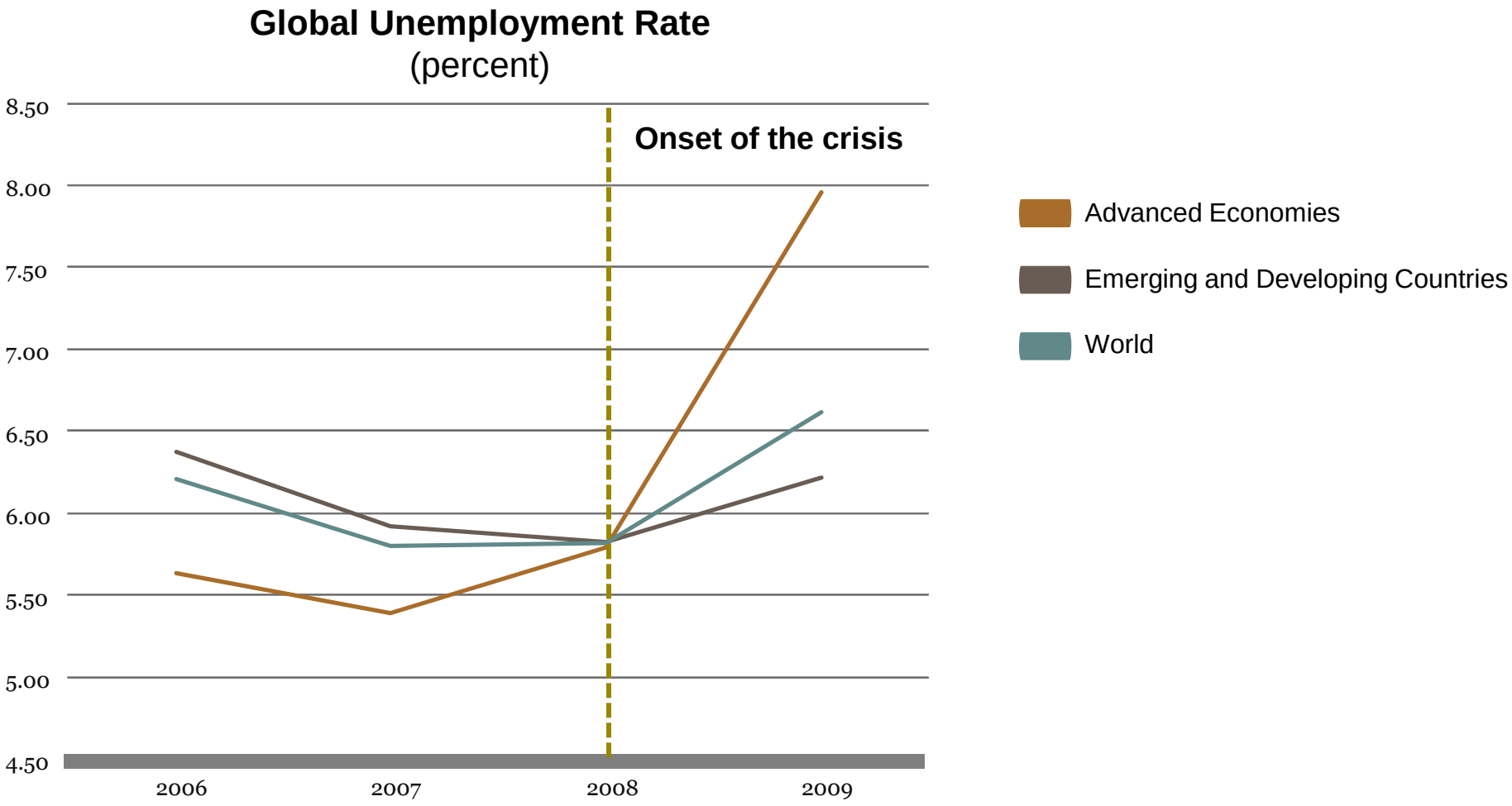
(percent, quarter-over-quarter seasonally adjusted annual rate)



Source: IMF WEO (October 2010).

The Crisis—Impact on Unemployment

Unemployment rose sharply in developed and developing countries



Source: IMF WEO (April 2010).

The Crisis—Impact on the Wealth

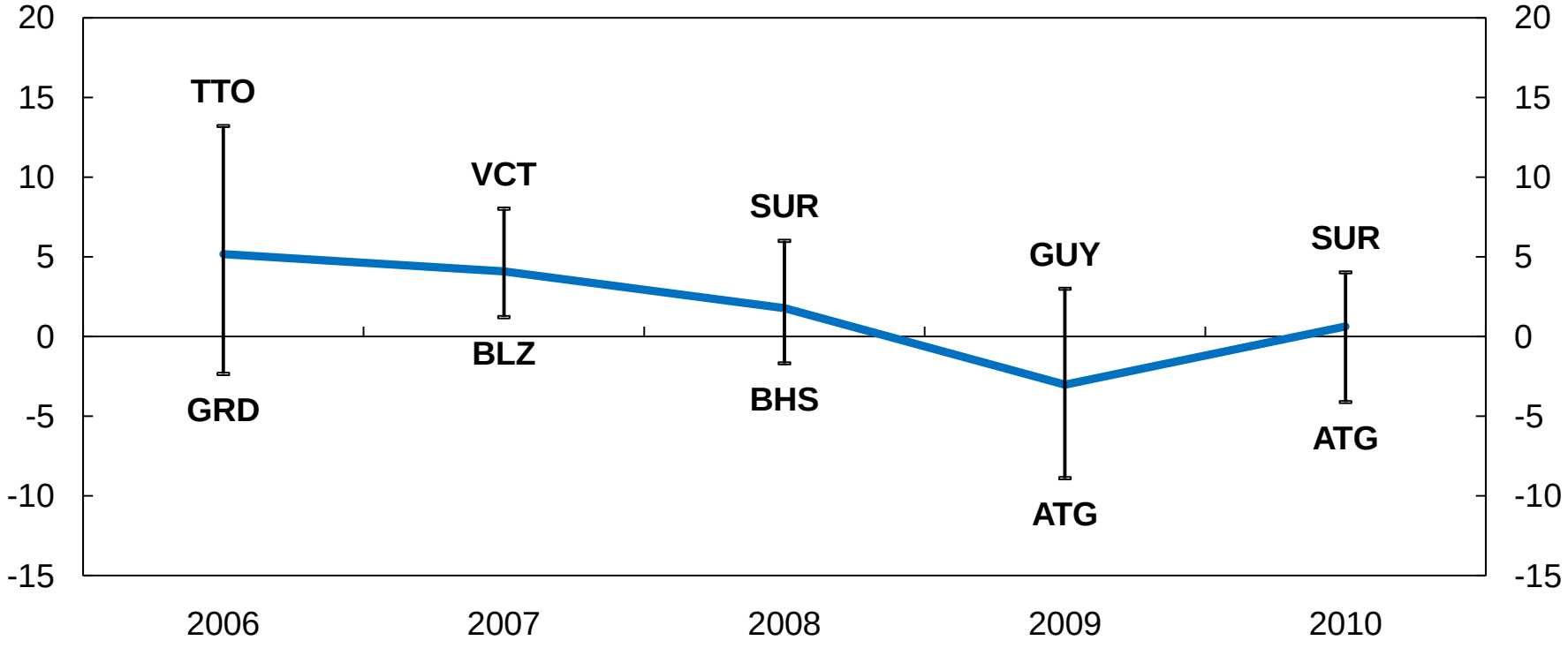
- Wiped out US$2.7 trillion in U.S. originated assets of financial institutions (15½ % of GDP)

- Write-downs on global exposures are estimated at about $4 trillion (7% of GDP)

The Crisis—Impact on the Caribbean

Severe recession followed by a slow recovery of growth…

Caribbean: Real GDP Growth 1/
(annual percentage change)

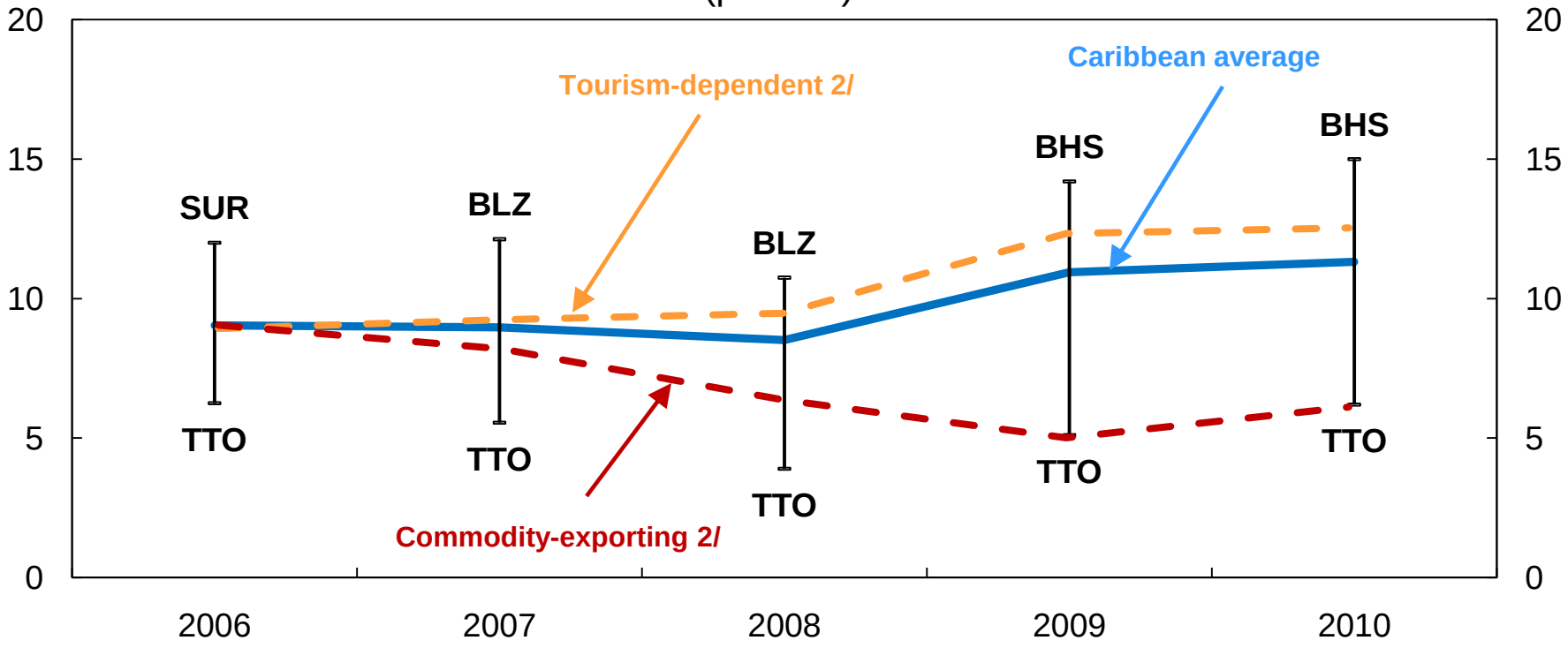


Source: IMF WEO (October 2010).
1/ Caribbean countries include Antigua and Barbuda, Bahamas, Barbados, Belize, Dominica, Grenada, Guyana, Jamaica, St. Kitts and Nevis, St. Lucia, St. Vincent and the Grenadines, Suriname, and Trinidad and Tobago.

The Crisis—Impact on the Caribbean

… higher unemployment…

Caribbean: Unemployment Rate 1/
(percent)

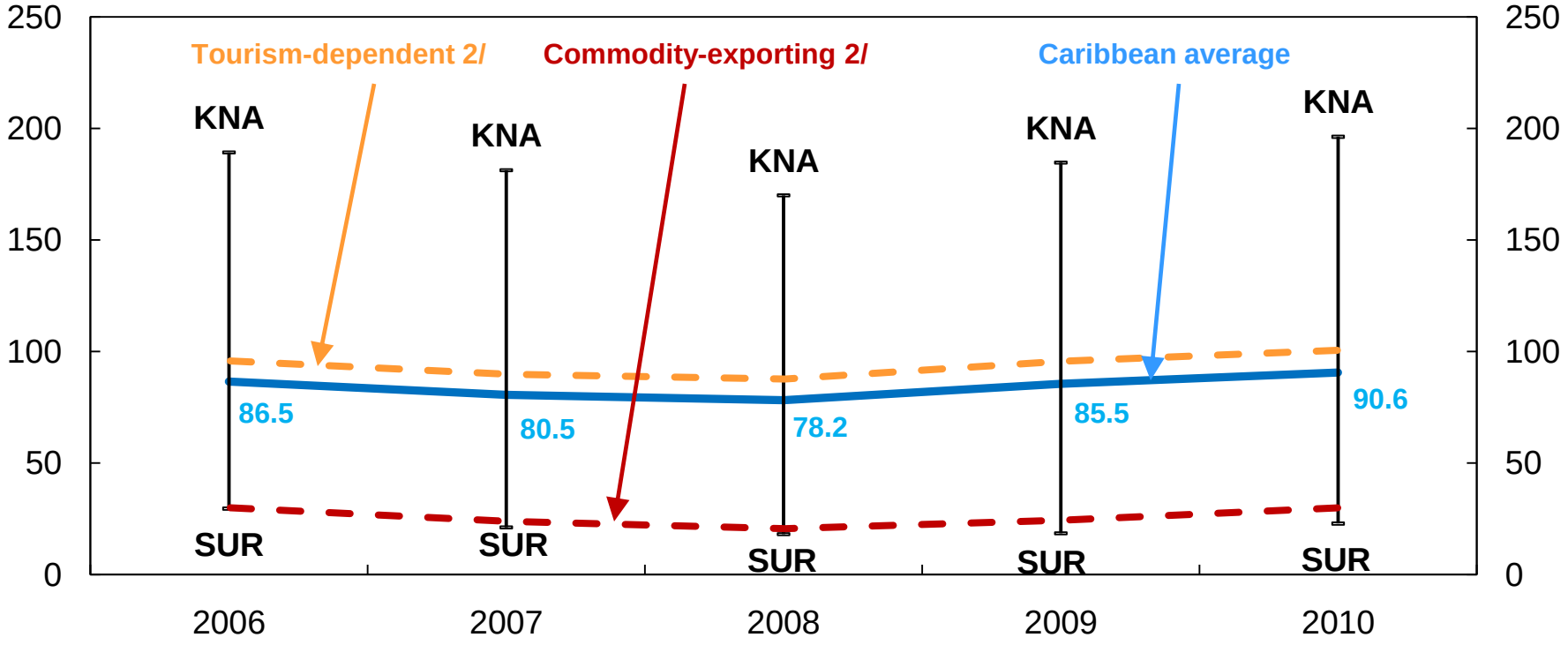


Source: IMF WEO (October 2010).
1/ Caribbean countries include Bahamas, Barbados, Belize, Jamaica, Suriname, and Trinidad and Tobago. Data for Guyana and ECCU countries are not available.
2/ Tourism-dependent countries include all Caribbean countries, except for Suriname and Trinidad and Tobago, which are commodity-exporting countries.

The Crisis—Impact on the Caribbean

… and a sharp rise of public debt/GDP ratios

Caribbean: Public Debt 1/
(percent of GDP)



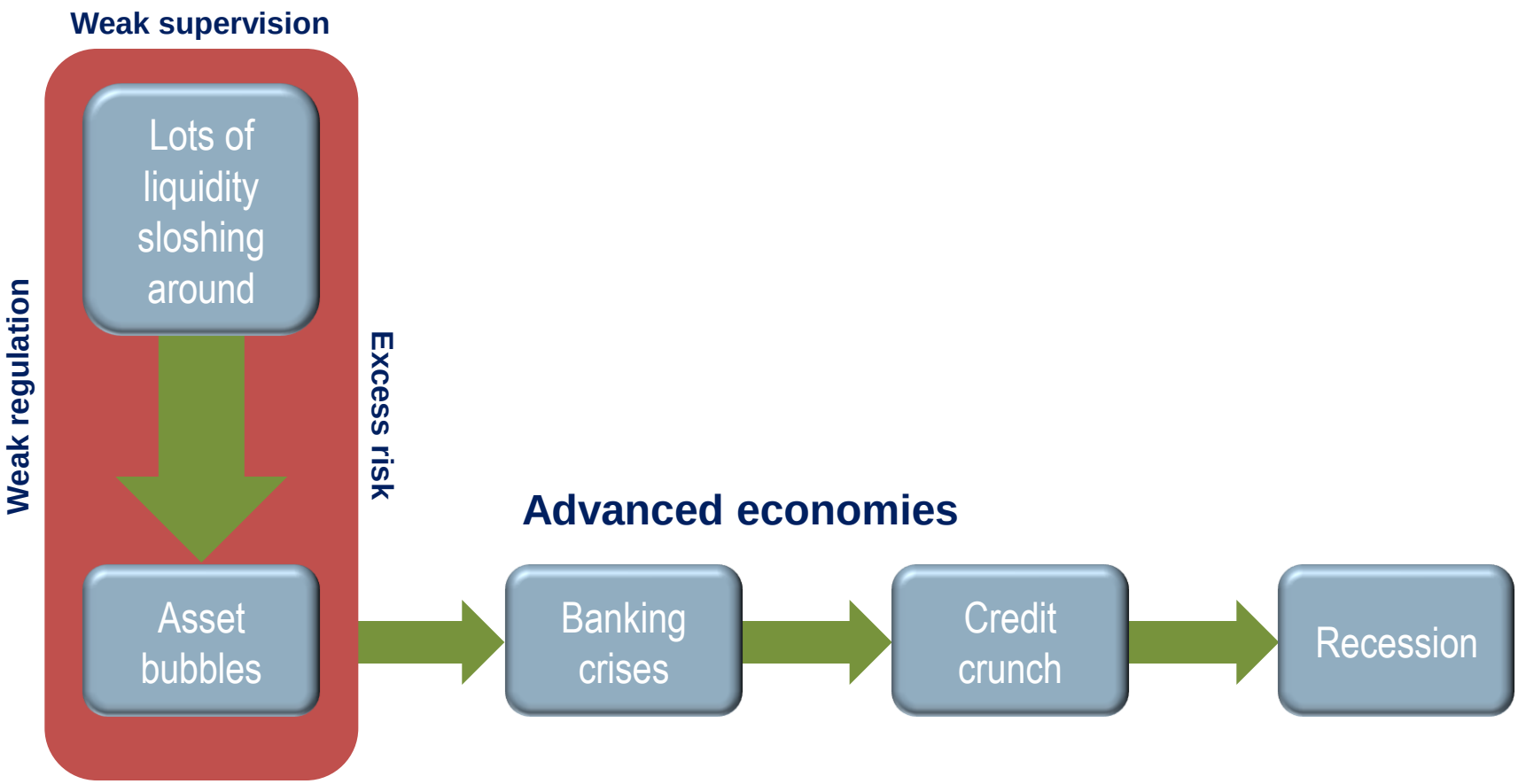
Source: IMF WEO (October 2010).
1/ Caribbean countries include Antigua and Barbuda, Bahamas, Barbados, Belize, Dominica, Grenada, Guyana, Jamaica, St. Kitts and Nevis, St. Lucia, St. Vincent and the Grenadines, Suriname, and Trinidad and Tobago.
2/ Tourism-dependent countries include all Caribbean countries, except for Suriname and Trinidad and Tobago, which are commodity-exporting countries.

What caused the crisis? How did it start?

Let's look at where the crisis began…

In U.S. and European banks

Crisis starts in advanced countries

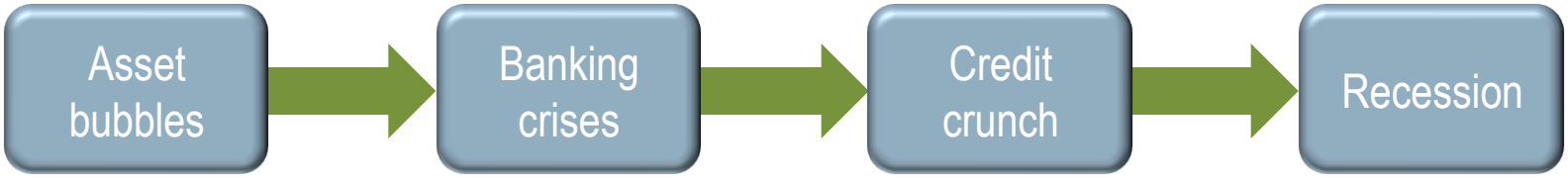


Failure at the policy and supervisory levels

- Market discipline and regulations failed to keep up with innovation and leverage build up.
  - Belief in light-touch regulation based on the assumption that financial market discipline would root out reckless behavior and that financial innovation was spreading, not concentrating risk.
- Macroeconomic policies did not respond to increase in systemic risk.
  - Central banks focused mainly on inflation, not on risks associated with high asset prices and increased leverage.
- Leadership needed at the international level to detect and respond to risks.

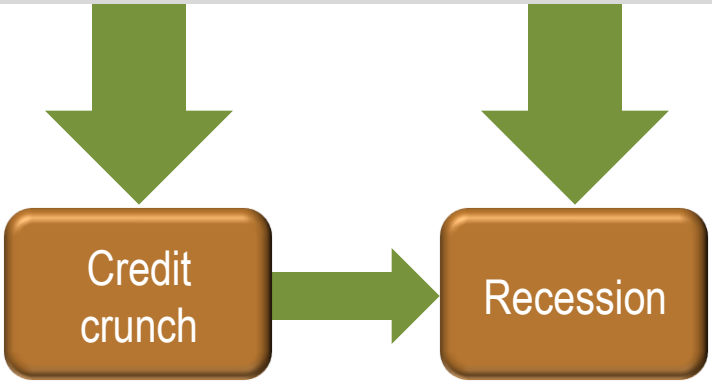
Crisis spreads to emerging economies

Advanced economies



Trade collapsed - Capital flows stopped

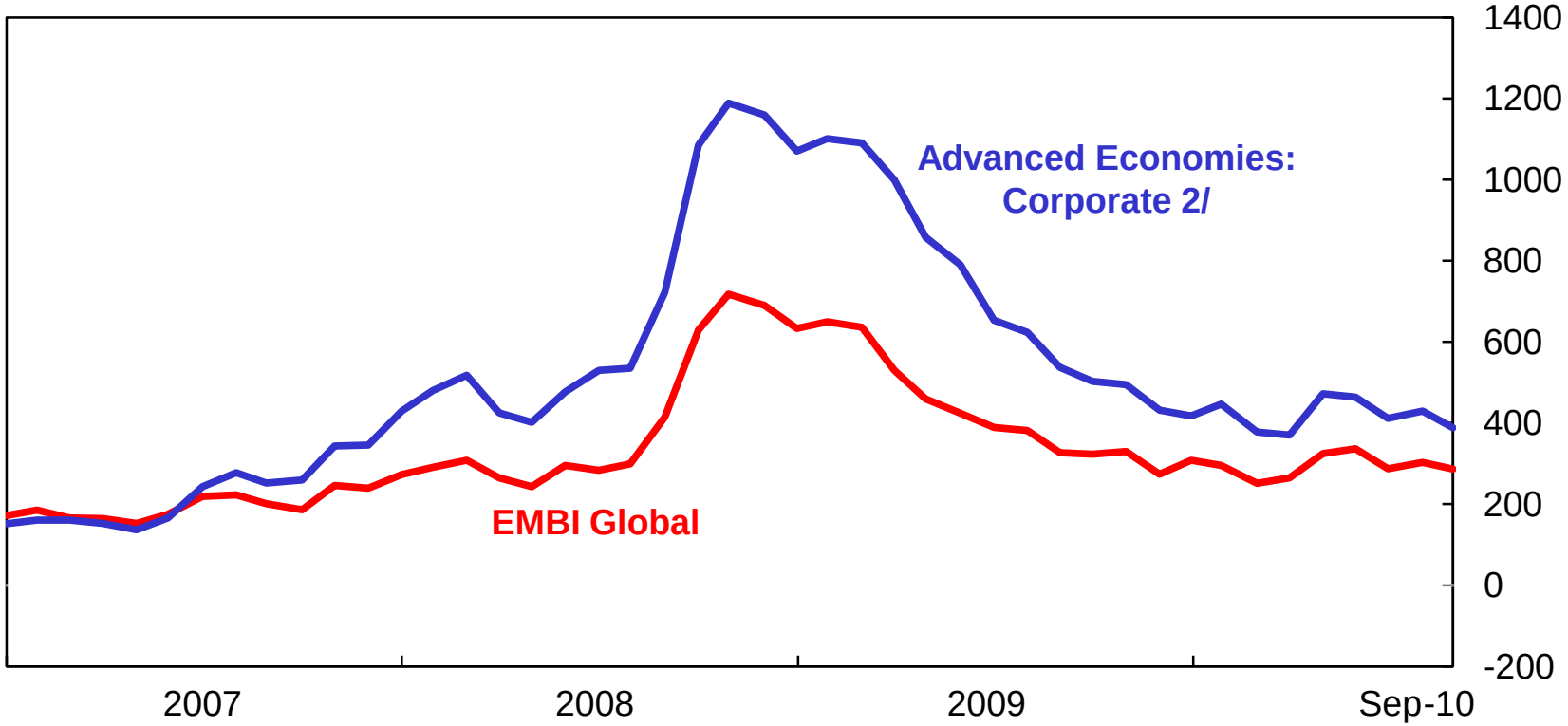
Emerging economies



The Crisis—Contagion to Emerging Economies through Bond Spreads

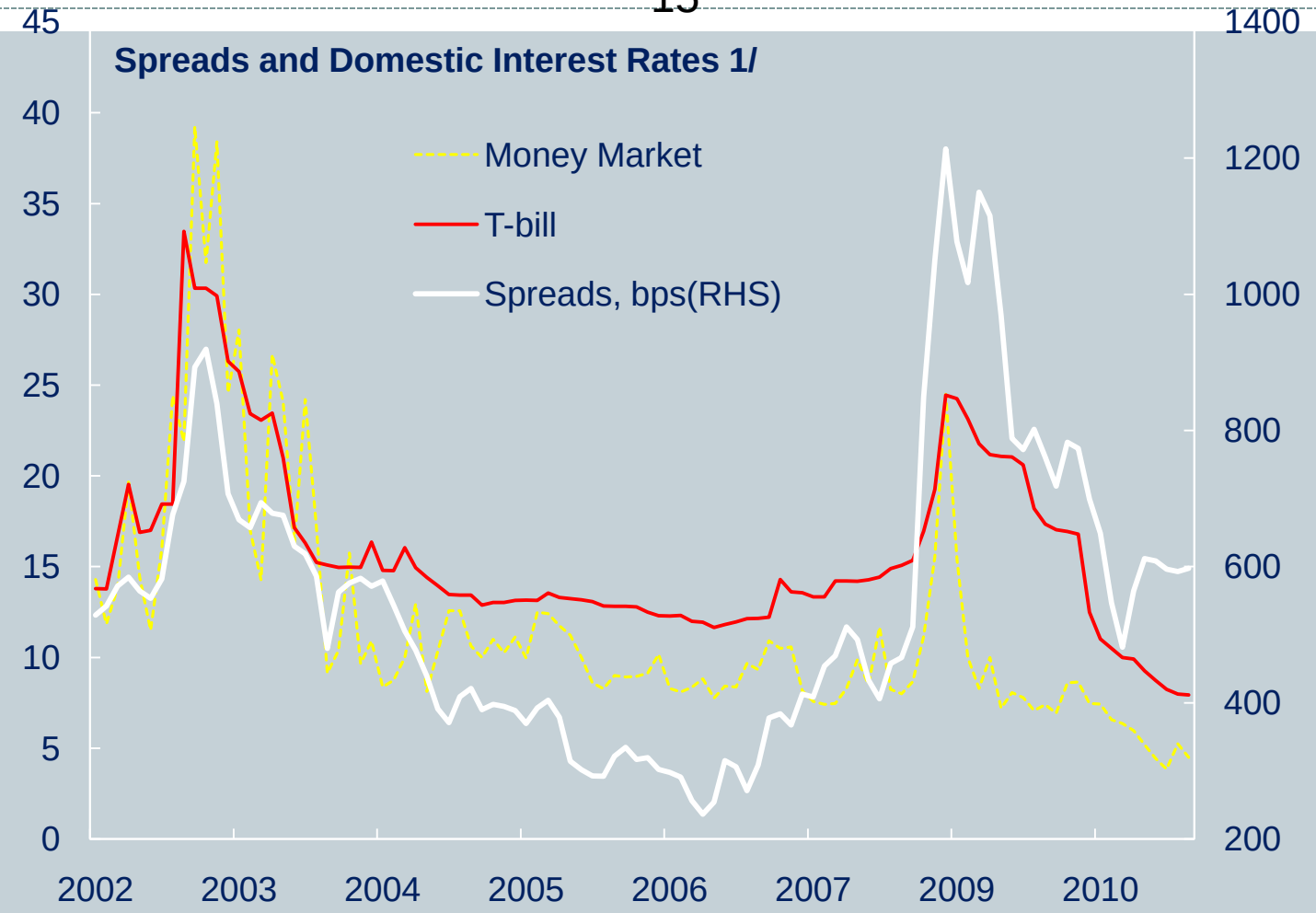
Bond spreads in emerging economies also increased

Sovereign and Corporate Bond Spreads 1/
(basis points)



1/ The sovereign bond spread series for advanced economies is a composite of the five-year U.S. Treasury rate over the effective federal funds rate and the five-year German Bund over the EONIA rate.
2/ Averages of BB-B US, BB-B Euro, and BBB Japan corporate bond spreads.

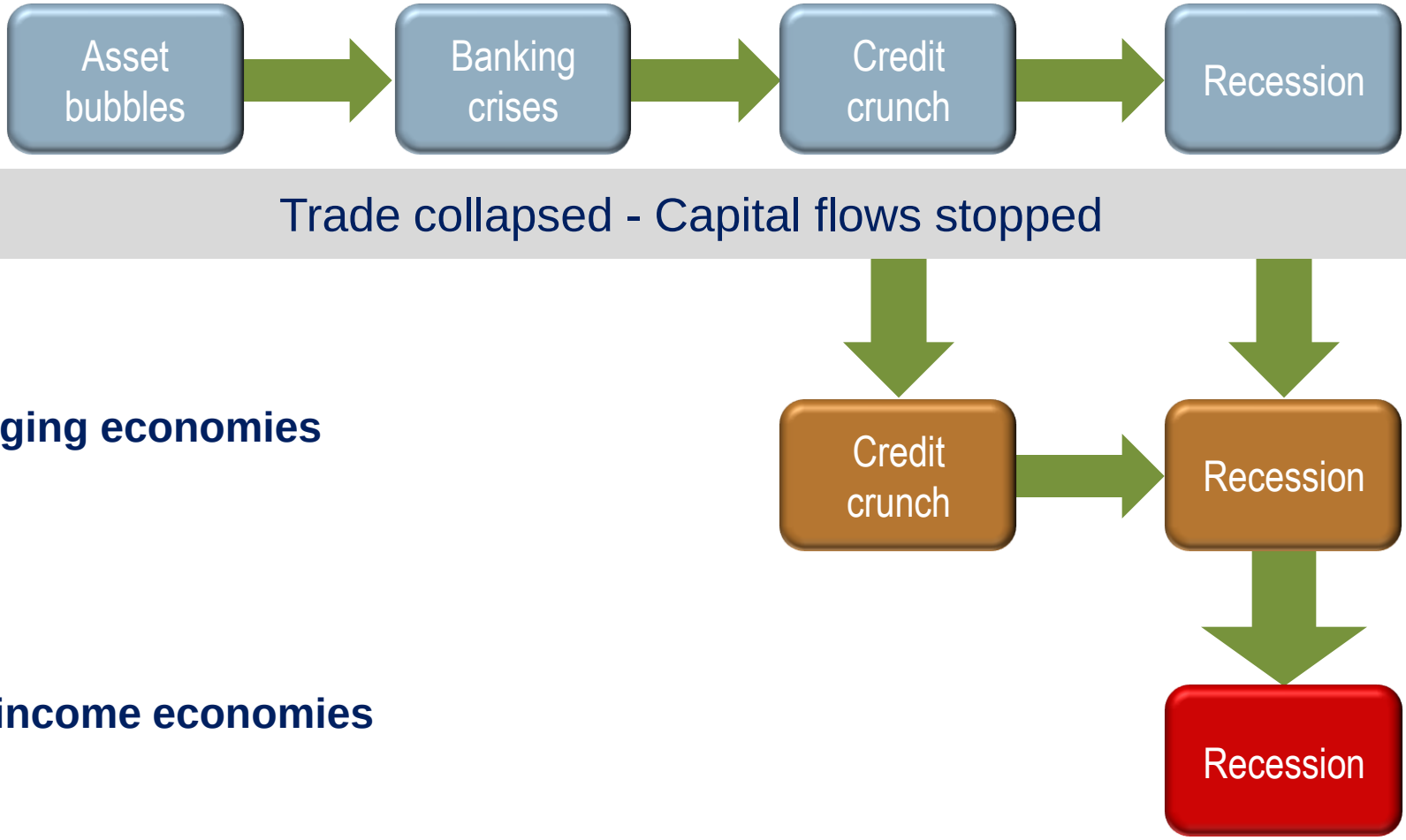
Jamaica: Spreads and Domestic Interest Rates



1/ Spread refers to JPMorgan Central American and Caribbean Index (CACI) Jamaican stripped spread, which is calculated as the spread between a portfolio of Jamaican USD denominated bonds and on-the-run US treasury zero-coupon rate.

Low-income countries

Advanced economies



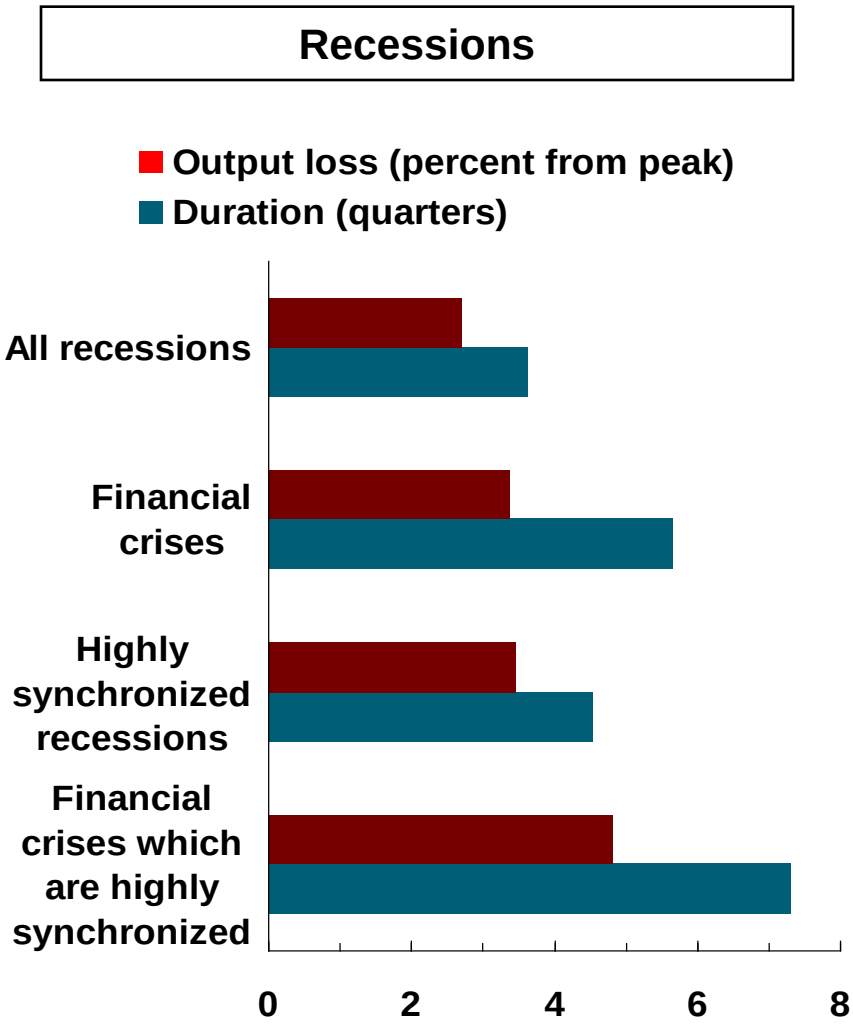
Emerging economies

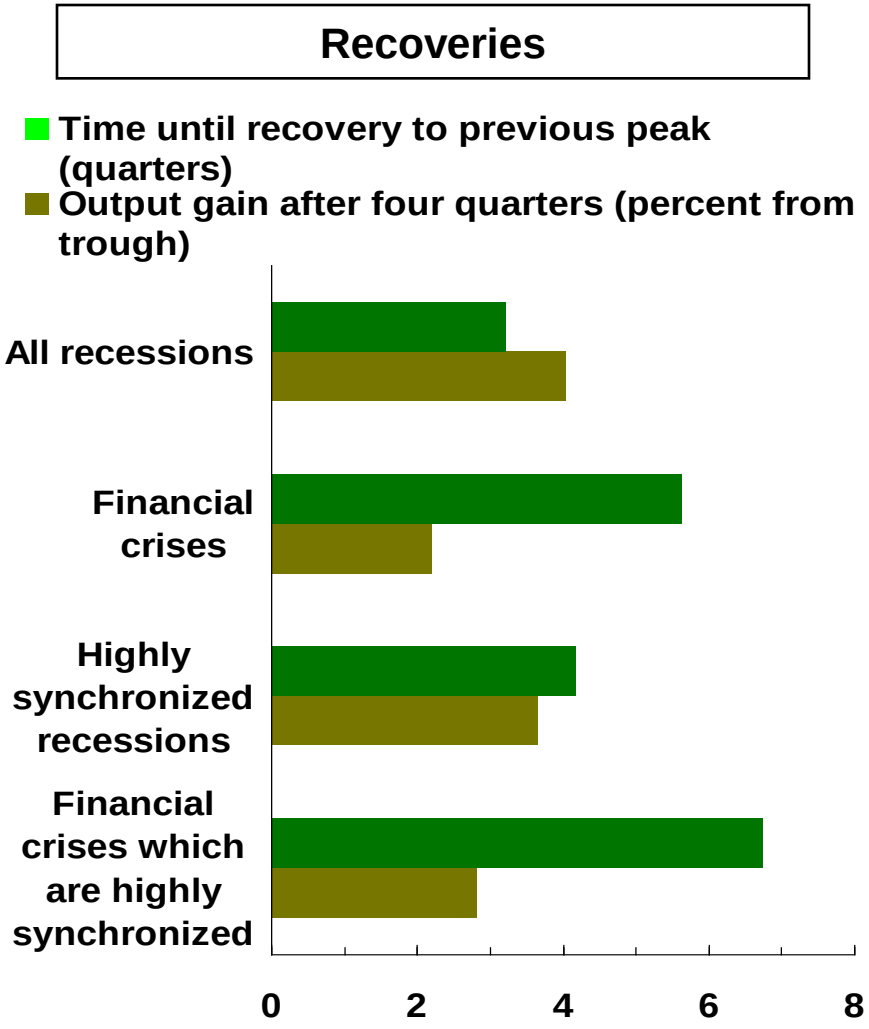
Low-income economies

Why is this recession different?

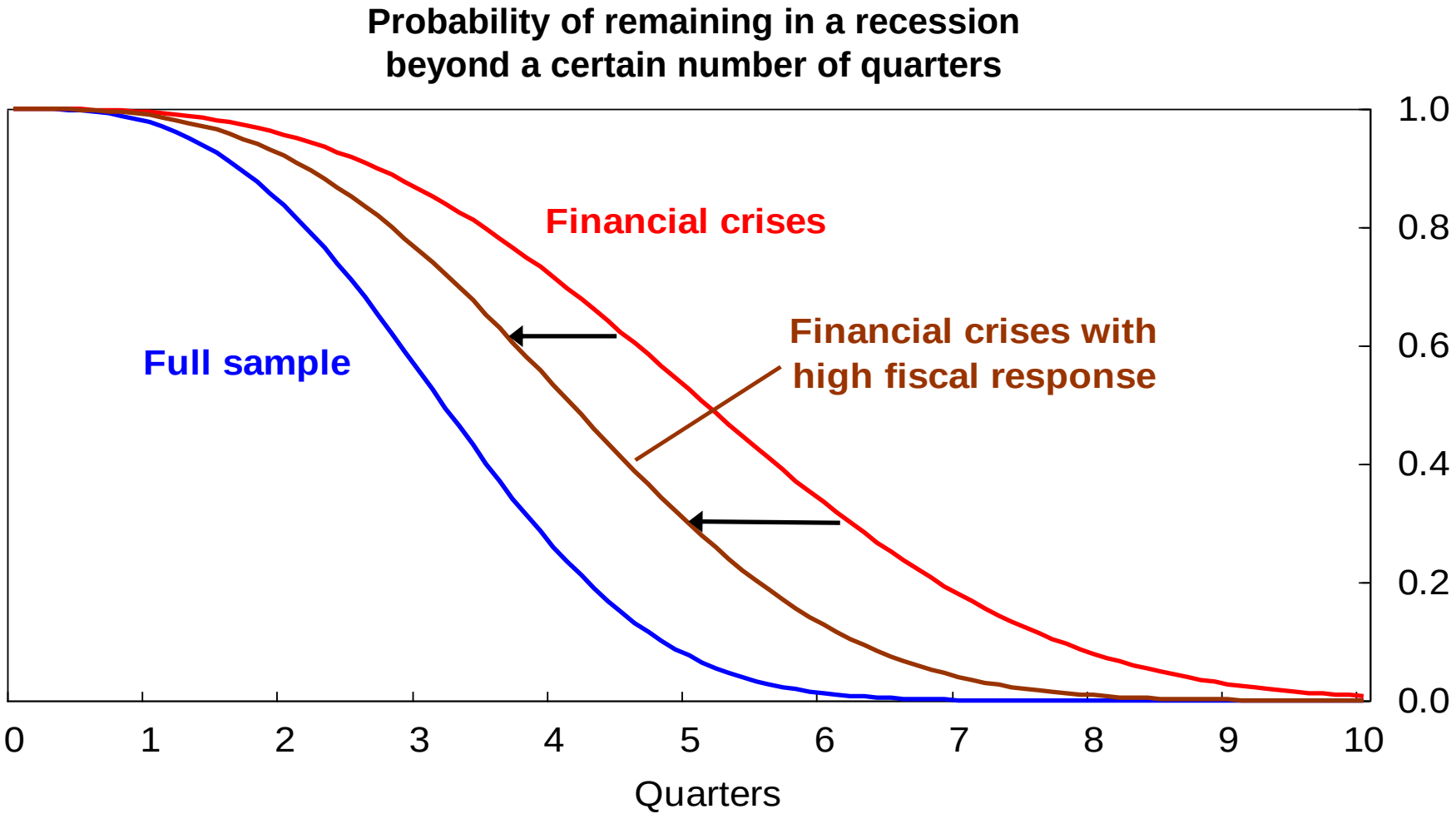
- Recessions associated with financial crises are severe and recoveries from such recessions are typically slow. These features become more pronounced if in addition the recession is global.
- Countercyclical policies are helpful in ending recessions and strengthening recoveries. Their effectiveness depends on the type of recession.

Features of Recessions and Recoveries Depend on the Type of Recession…

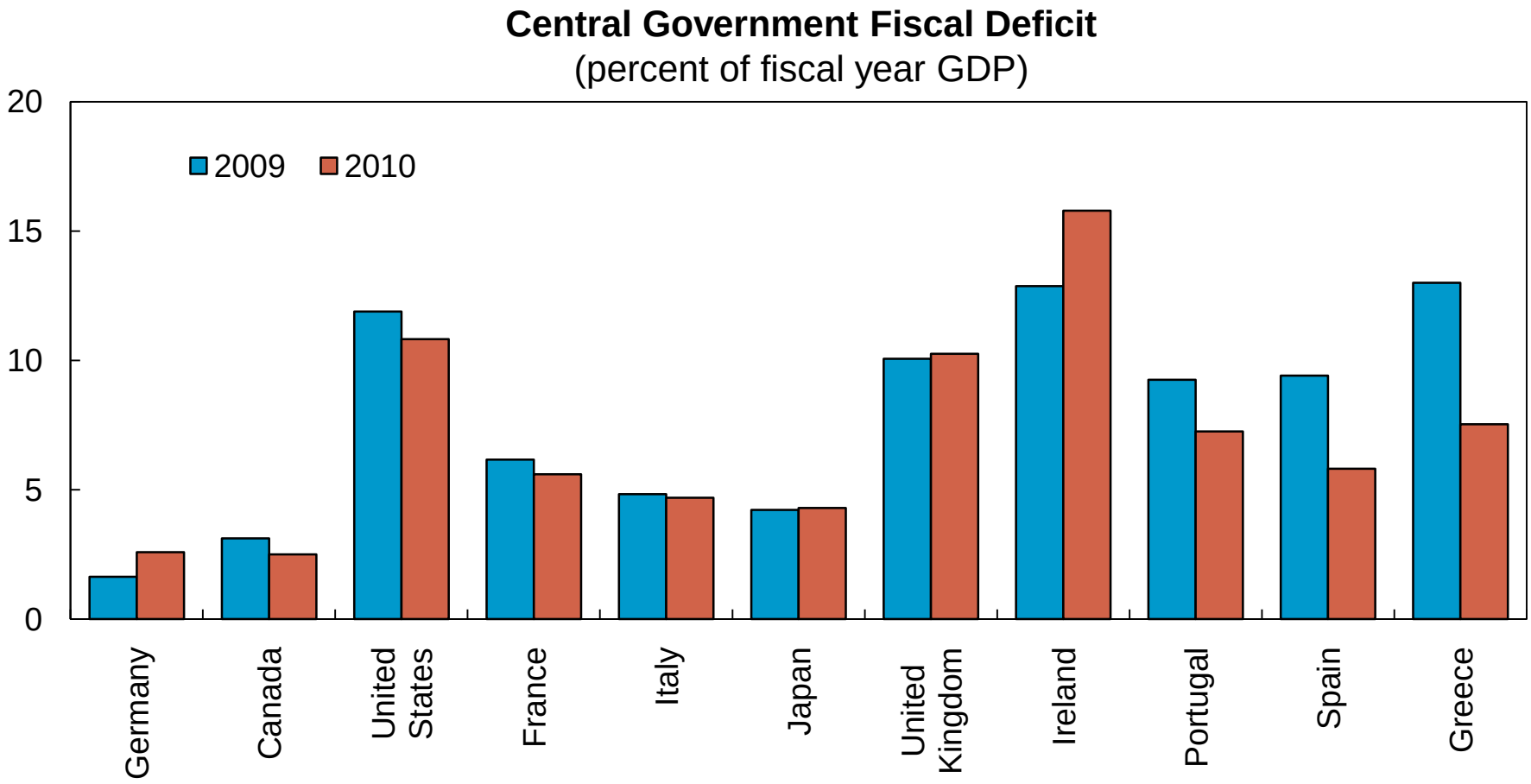




Policies Help Shorten Recessions…
Fiscal Stimulus is Effective in Financial Crises…

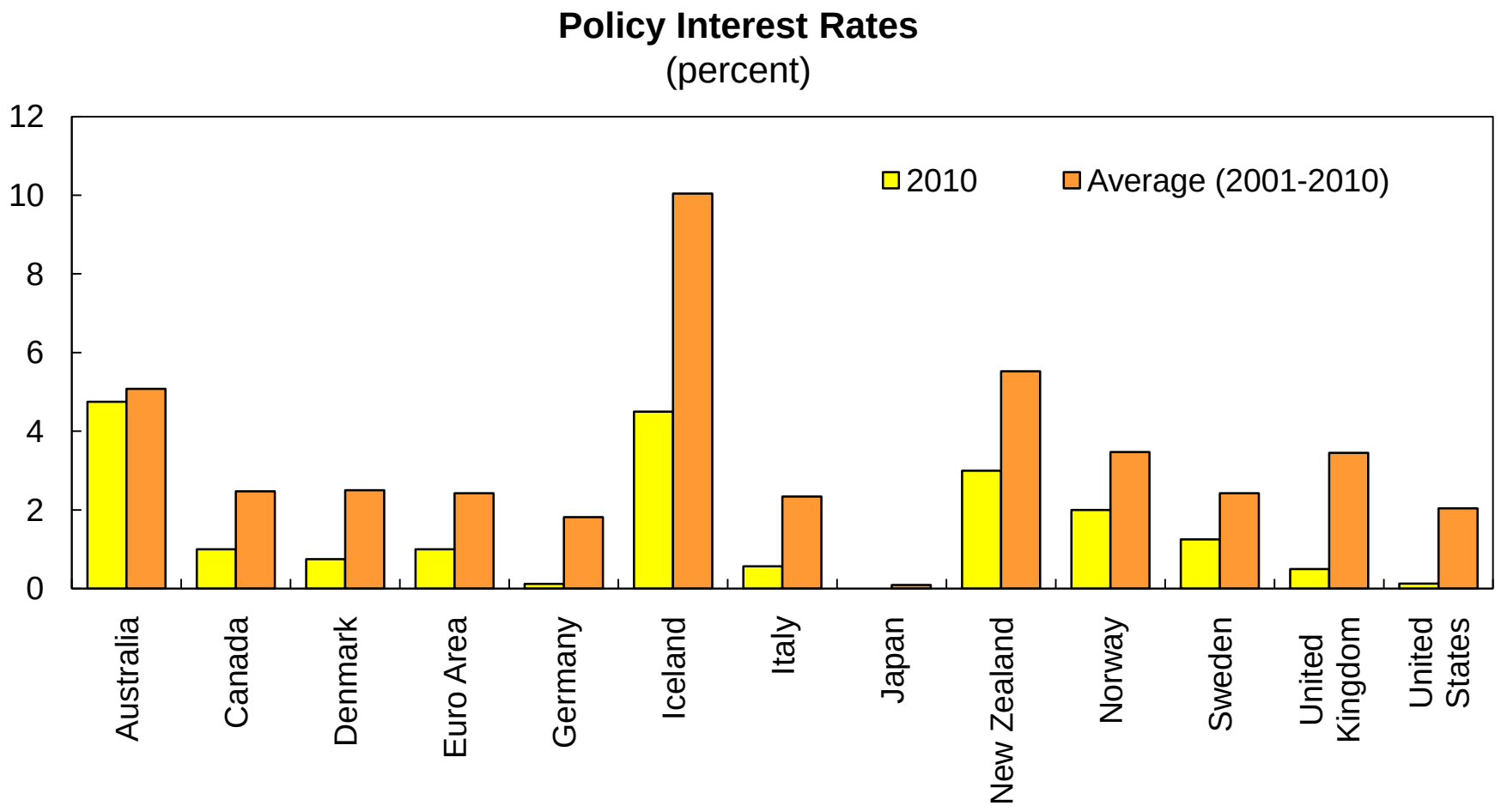


Most countries implemented a fiscal stimulus to respond to the crisis



Source: IMF WEO (October 2010).

To sustain the recovery, central banks have kept policy rates at historically low levels

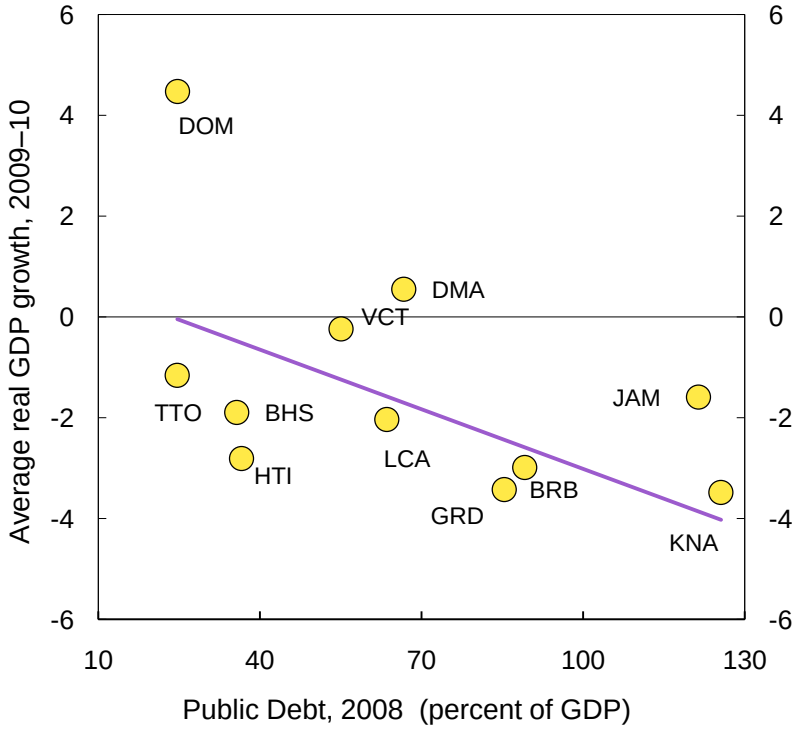


Source: Haver Analytics, Inc.

In the Caribbean, high public debt/GDP ratios have weakened growth and narrowed the fiscal space

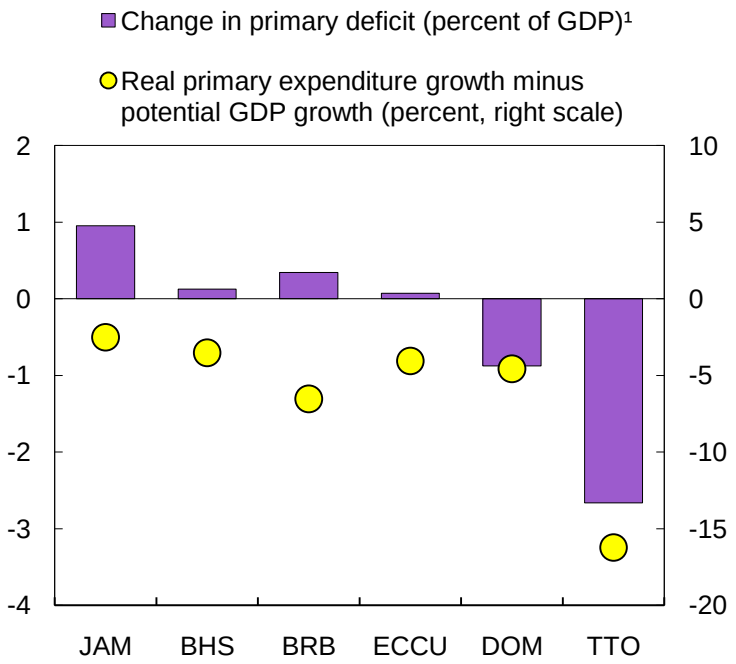
Growth has been weaker in countries with higher debt levels...

Public Debt Burden and Real GDP Growth



... where fiscal space remains constrained.

Change in Primary Deficit and Primary Expenditure Growth, 2010

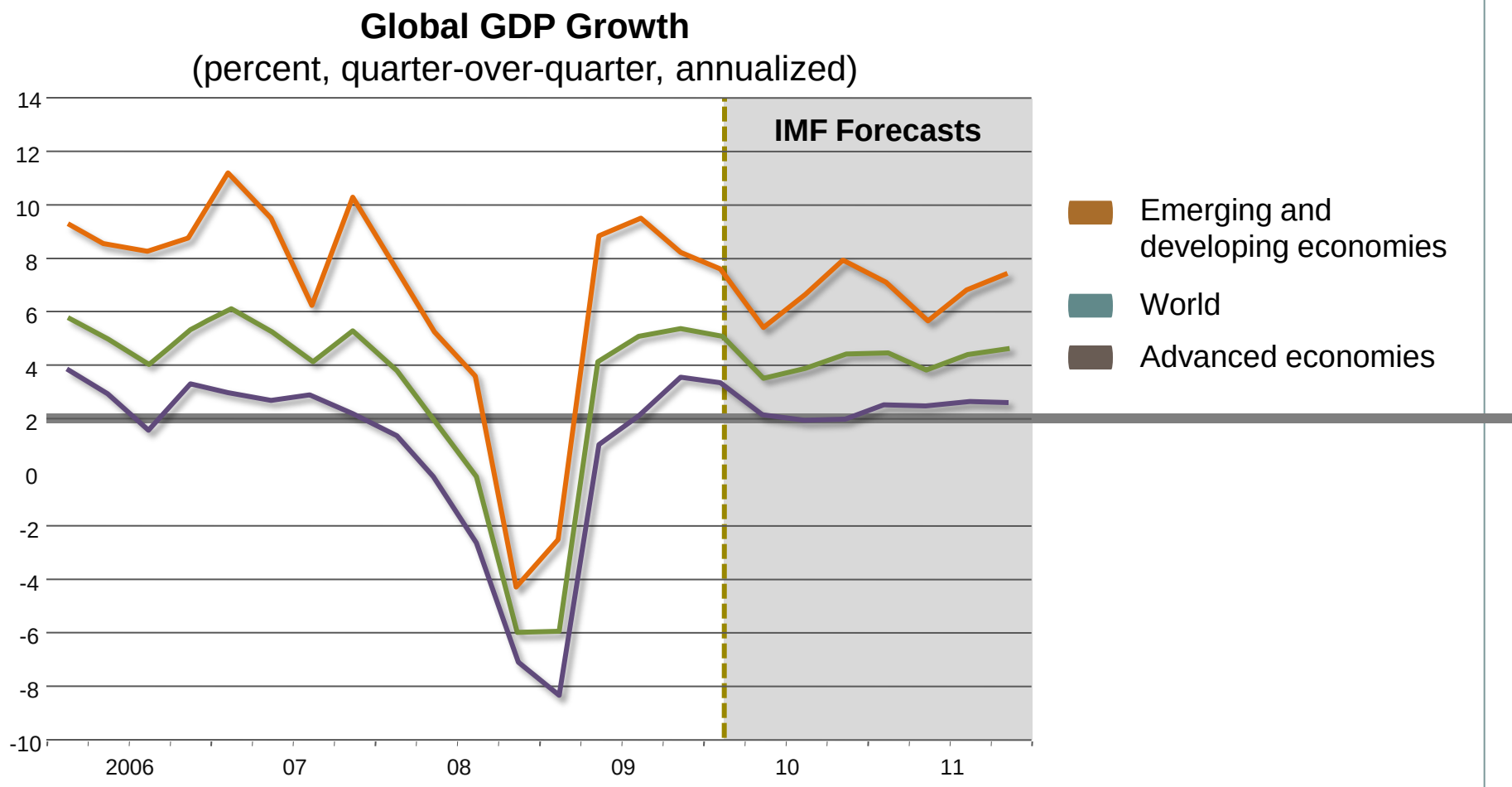


Policy Response in the Caribbean

- Some central banks followed an accommodative monetary policy and lowered the policy rate as U.S. rates declined.
- Financial sector legislative and supervisory frameworks were strengthened:
  - Intensified monitoring of financial institutions (FIs).
  - Broadening the regulatory perimeter to include nonbank FIs.
  - Liquidity facilities provided to avoid the contagion from CLICO.
- Short-term fiscal stimulus (constrained by scant fiscal space):
  - Temporary decrease of hotel/payroll taxes and/or lower cost of electricity and energy contingent on maintaining employment.
  - Aggressive tourism marketing efforts.
  - Temporary employment and training programs, and extension of unemployment benefits.
- IMF programs.

Two–speed recovery is underway

As before the crisis, EMEs are growing much faster than advanced economies



Source: IMF WEO (October 2010).

Two-Speed Recovery

- EMEs buoyed by an accommodative policy stance and plentiful inflows of foreign capital. Instead of worrying about unemployment, risks relate to possible overheating.
- In advanced countries, growth remains too weak to bring down unemployment. Large output gaps and weak balance sheets in households and banks are holding back credit growth and private demand.
- In Caribbean, growth projected to turn positive but subdued. Tourism grew in 2010 and expected to continue in 2011.
- Downside risks: (1) financial stresses and fiscal sustainability—in the Euro area in particular; (2) lack of progress on credible m-t fiscal consolidation plans in advanced economies; (3) high commodity and food prices.

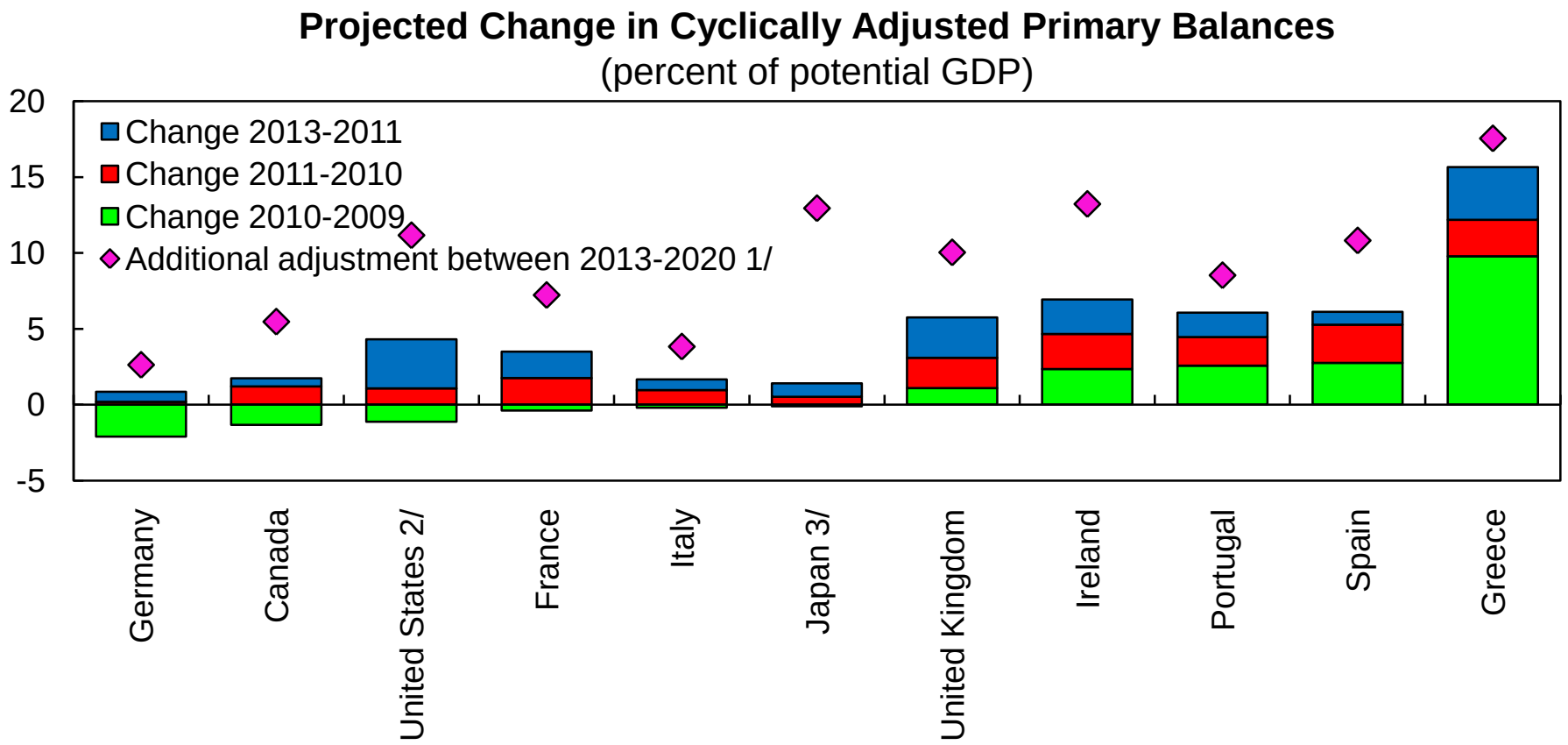
What can be done to foster the recovery?: A consistent policy framework

- Accommodative monetary policy and continued support for banks to support credit and demand.
- Repair and reform financial systems.
- Medium-term fiscal consolidation plans, including to build credibility and new room for policy maneuver.
- Structural reforms and exchange rate flexibility to boost domestic demand in key EM.
- Employment promotion and protect the most vulnerable.

Financial sector repair and reform need to accelerate

- Recapitalize/resolve banks.
- Repair markets for securitized assets.
- Re-establish market discipline.
- Implement regulatory reform with a broader and more global view (broaden the regulatory perimeter and foster cross-border coordination among regulators).

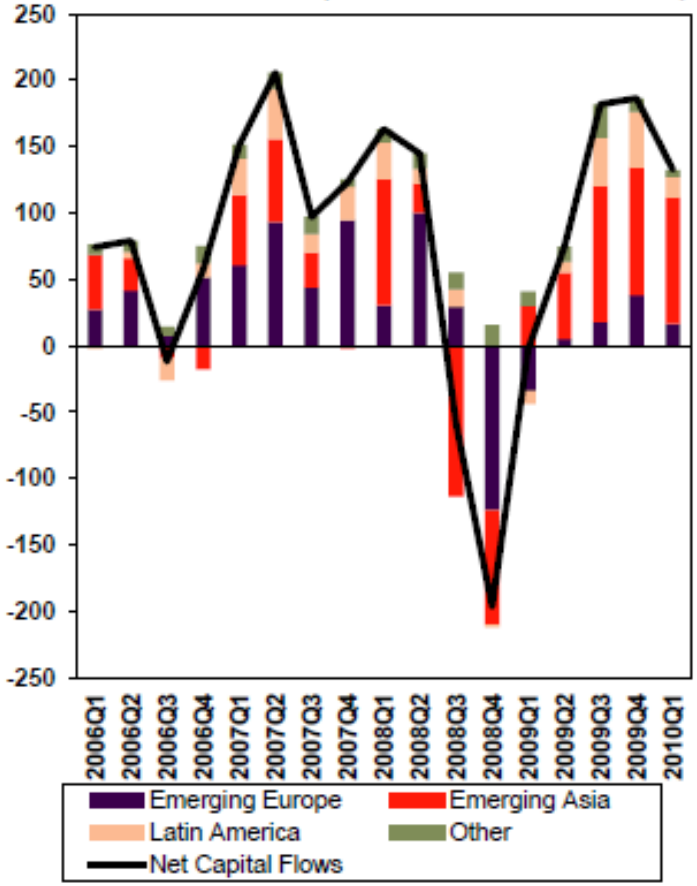
Over the medium-term, fiscal plans are urgently needed



Source: FAD staff estimates.
1/ In percent of GDP; distance from blue bar reflects required additional fiscal adjustment relative to 2010-13; adjustment to be sustained between 2020–30 to reduce public debt to prudent levels.
2/ Structural primary balance.
3/ Excluding financial sector support recorded above the line.

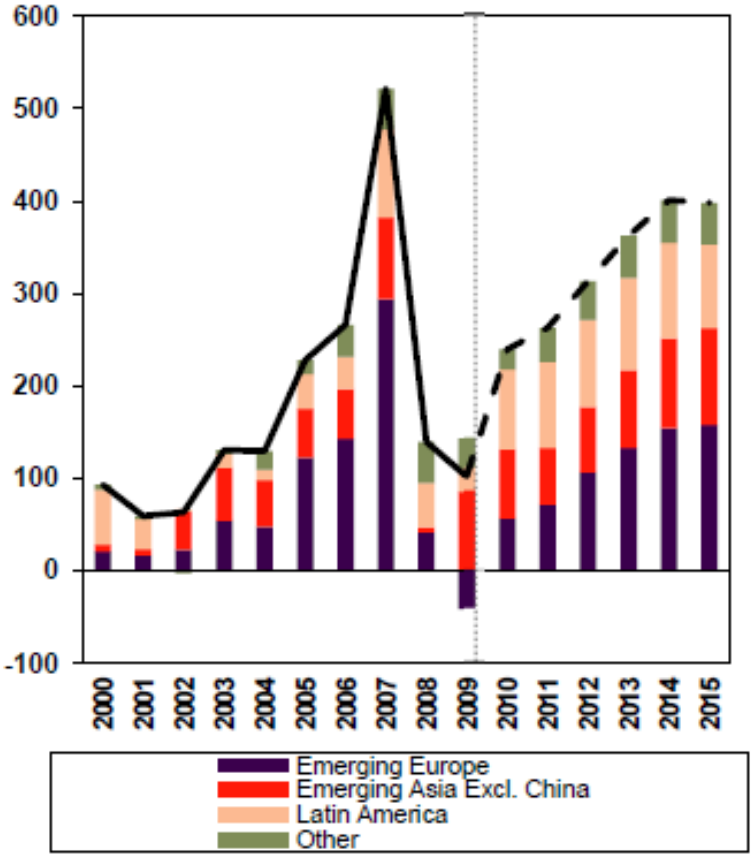
Expansionary policies in advanced countries pose policy challenges for EMEs: Soaring capital flows

Net Quarterly Capital Flows into EMEs, 2006Q1-10Q1 *(billions of US dollars)*



Source: International Financial Statistics.

Net Annual Capital Flows into EMEs, 2000-2015 *(billions of US dollars)*



Dealing with inflow surges: Exchange rate flexibility and capital controls

- Fiscal and monetary stimulus policies are leading to capital inflow surges in emerging economies.
- Macro and prudential policies can help deal with the downsides of inflow surges (appreciation and inflation).
  - Macro policy space (especially exchange rate) must be exhausted before imposing capital controls.
  - Capital controls and prudential measures should target specific risks.
    - Prudential measures when flows intermediated through the regulated financial institutions.
    - Capital controls when flows by-pass regulated financial institutions.

Foster employment and protect the most vulnerable

ILO/IMF collaboration (Oslo Conference 9/2010)

- The crisis will not be over until unemployment falls.
- Growth is essential for employment, but it is not enough.
- Job creation must be a priority.
- Specific policies are needed to protect the poor and the vulnerable (social protection floor).
  - Programs to subsidize short-term work and on-the-job training.
  - Unemployment benefits.
  - Job subsidies.
- Focus on policies for employment-creating growth

What are the main lessons for policy makers on the macroeconomic level?

- Monetary policy should respond to the buildup of systemic risk (focus on macro-financial stability).
- Fiscal policy should be put on a stronger footing in good times (to open up fiscal space for countercyclical fiscal stimulus in bad times).
- While international capital flows are on the whole beneficial, global imbalances have to be addressed.

As the Caribbean recovers from the global crisis, it faces significant challenges going forward

Promoting growth

- Energy and infrastructure
- Human capital development
- Competitiveness
- Diversification

Fiscal sustainability

- Reducing debt-to-GDP ratios
- Creating fiscal space to allow for countercyclical policy

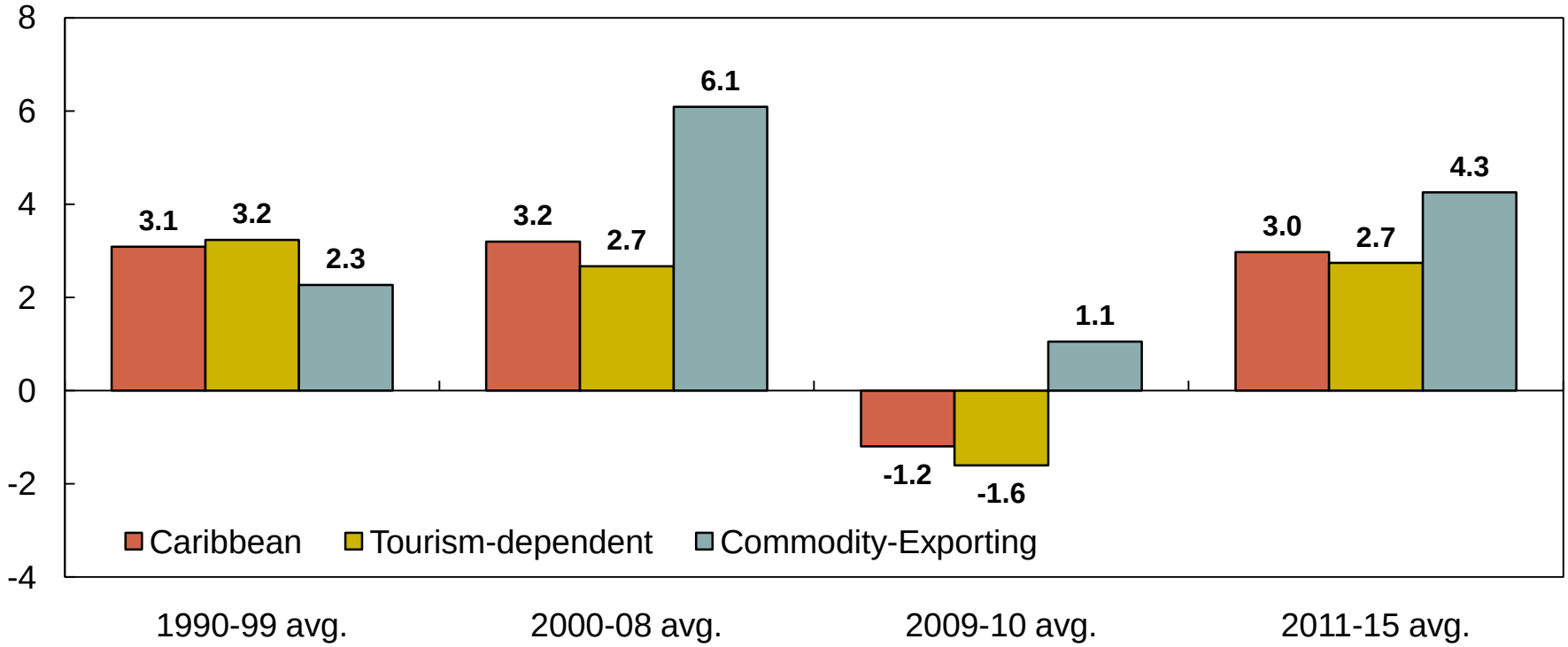
Financial sector

- Strengthening regulations, particularly for nonbank FI
- Resolving CLICO

Climate change

Reforms to boost growth are needed: In absence of reforms, growth is projected to be lower than in the past

Caribbean: Real GDP Growth 1/ 2/
(annual percentage change)



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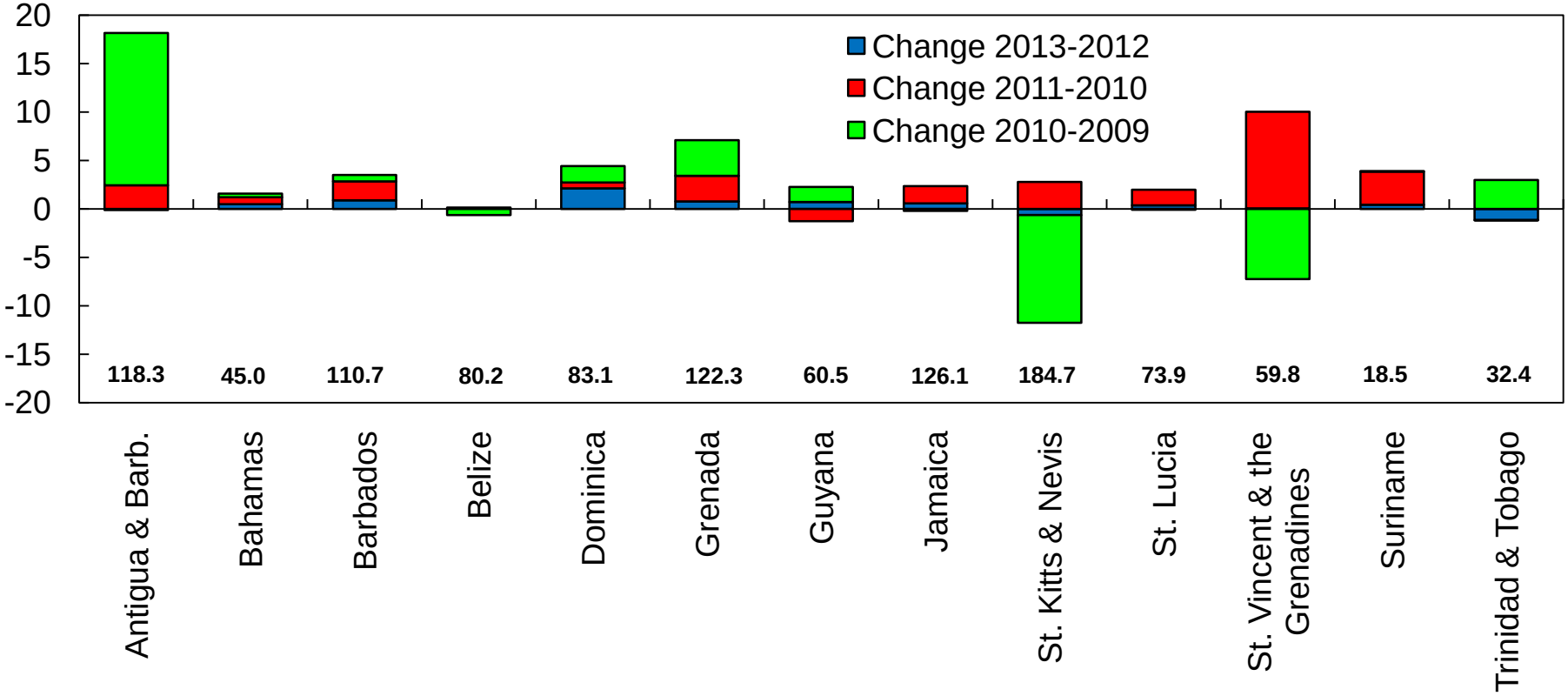
2/ Tourism-dependent countries include all Caribbean countries, except for Suriname and Trinidad and Tobago, which are commodity-exporting countries.

Medium-term fiscal plans are urgently needed

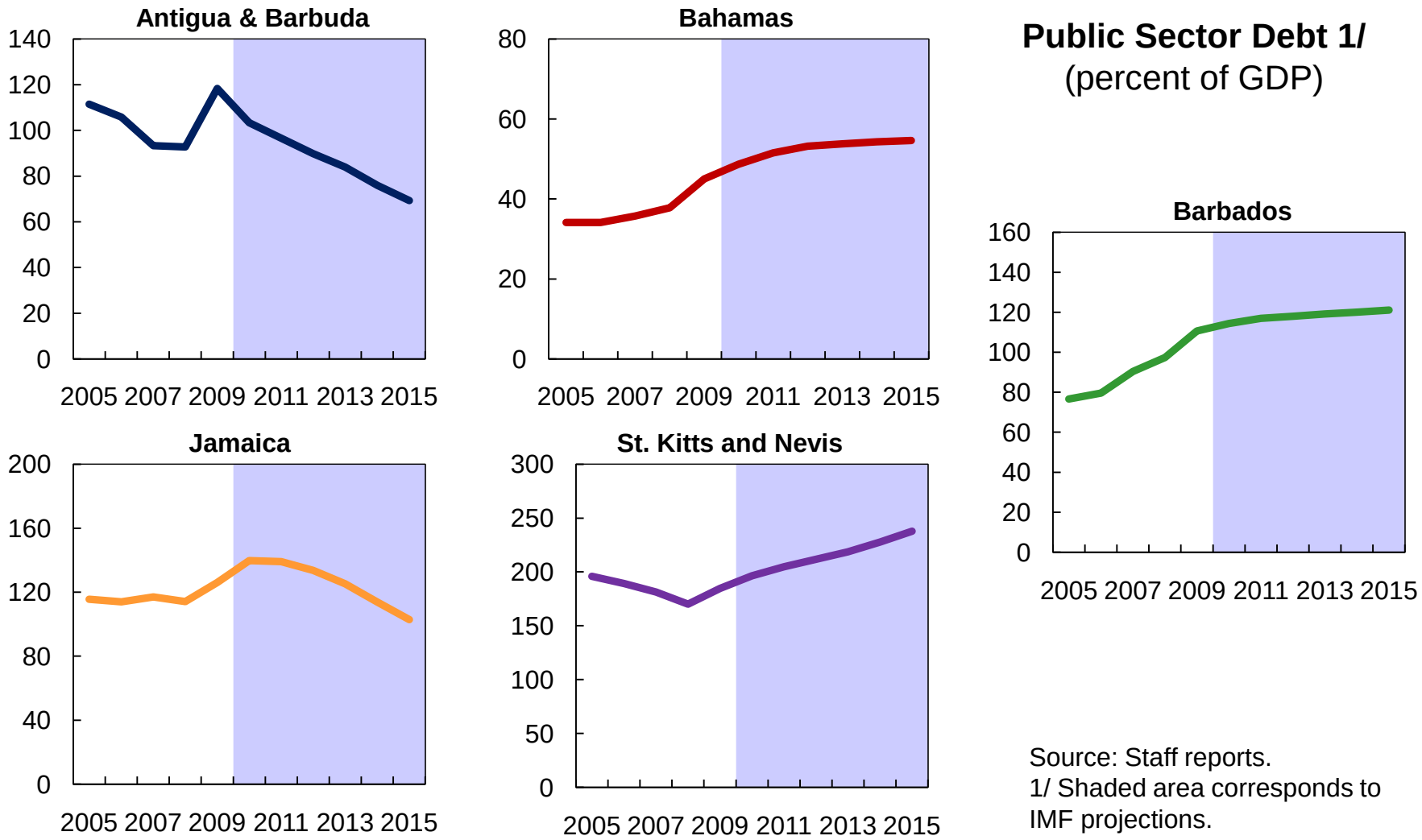
Caribbean: Projected Change in Cyclically Adjusted Primary Balances
(percent of potential GDP)



Source: WHD staff estimates.
1/ Numbers next to the country names refer to 2009 public sector/central government debt as a percent of GDP.

If no additional measures are taken, debt-to-GDP ratios will continue to rise

Public Sector Debt 1/
(percent of GDP)



Source: Staff reports.
1/ Shaded area corresponds to IMF projections.

Financial Sector

- Strengthening the financial sector requires:
  - Upgrading the legislative and supervisory framework for:
    - Commercial banks.
    - Nonbank financial institutions.
  - Intensifying monitoring and on-site inspections, and more frequent reporting.
  - Consolidated supervision of conglomerates.
  - Agreements and closer collaboration for cross-border supervision.
- Urgent resolution of CLICO.
  - A transparent resolution process.
  - Minimize fiscal costs and contingent liabilities.

Thank You