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**Statement by Mr. Merk, Mr. Fragin, Mr. Sattler, and Mr. Krahnke on World Economic Outlook; Global Financial Stability Report; Fiscal Monitor
(Preliminary)
Executive Board Meeting
March 25, 2021**

We thank staff for an informative set of reports that covers very well the state of the global economy one year into the pandemic. The pandemic triggered a deep global recession, causing massive economic and social disruptions, and setting the fight against global poverty back years. Swift and strong policy responses worldwide, supported by international cooperation, have helped to limit the economic damage, but recovering the lost ground and building back better will be a challenge.

The swift development of vaccines is cause for optimism and will increasingly allow cautious steps towards normality – both in terms of everyday lives and the functioning of the global economy. However, there is still great uncertainty surrounding the future course of the pandemic and its economic repercussions. Access to vaccines needs to be broader and more equitable. Exceptional assistance by governments worldwide will remain indispensable for the time being. Also vital is that all emergency measures are well-targeted and limited in duration without distorting financial and fiscal stability or hindering necessary structural change.

World Economic Outlook

We generally share staff's view on the global economic outlook. The recovery path continues to be dominated by the pandemic and will vary across countries and sectors. We expect global economic activity to accelerate in the second half of 2021, fuelled by a supportive macroeconomic policy mix and easing restrictions on the back of a growing share of the vaccinated population. While AEs are expected to regain much of the ground lost at the peak of the pandemic, GDP levels through 2024 for most countries are very likely to remain well below pre-pandemic projections, reflecting only gradually subsiding economic slack. Many EMDEs (excluding China), on the other hand, tend to have slower rollouts of vaccination campaigns and are more exposed to long-lasting knock-on effects due to constrained scope for policy support. Uneven

availability of vaccines could potentially cause a start-stop rhythm along the recovery path in many countries.

We broadly concur with staff's projection for the euro area. **On Germany, we think that staff's GDP projection is a plausible scenario but forecast uncertainty remains high.** Overall, we expect the recovery to be merely delayed by domestic lockdown measures. Once a sufficient number of people has been vaccinated and lockdown measures are lifted, the economic recovery should resume.

We concur with staff's analysis of the V-shaped recovery in the global manufacturing sector. The relatively robust performance of trade and manufacturing, which no longer experience significant interruptions as seen in the early days of the pandemic, indicate that many businesses have successfully adjusted in recent months and hence appear less sensitive to the stringency of containment measures. *In this context, we would appreciate further comments by staff on the role that supply-side bottlenecks (e.g. containers, semiconductors) might play for the near-term trajectory of global manufacturing.*

We generally agree with staff's assessment of the underlying forces of the broad-based commodity price increases in recent months. However, with respect to the oil market, we consider the sizeable voluntary production cuts by OPEC+ members to be of similar importance as the prospect of the global recovery gaining momentum.

We concur with staff that risks are overall balanced in the near-term but more to the upside further out.

- A strong recovery led by AEs, primarily the US, as well as by China, and the release of pent-up demand amid accelerating vaccination campaigns represent noteworthy upside risks to the global recovery. The same holds true for the impact of (existing and possible additional) fiscal support, including that of the recent package in the US.
- The main downside risk factors include pandemic resurgence from new viral strains and slower vaccination rollout, as well as financial vulnerabilities exposed e.g. by a repricing of financial assets. Concerning EMEs, the impact of tighter financial conditions due to a sudden reassessment of market fundamentals or spillovers from abrupt market adjustments in the US could be considerable, notably in countries with weak fundamentals. Furthermore, higher than foreseen damage to potential output, including from severe setbacks in human capital accumulation, poses significant risks over the medium term.

The policy response should continue to effectively combat the pandemic, sustain economic lifelines of those hard-hit by public health measures and support a sustainable and inclusive recovery.

- **Fiscal support to the real economy needs to be responsive to evolving circumstances, while avoiding premature withdrawal of fiscal support before the health crisis is brought under control and the economic recovery is firmly underway.** The current stage is still marked by extensive government-mandated lockdowns that restrict effective participation in the market process of some sectors. Therefore, continued income replacement to severely affected firms and households seems justified. We agree that an eventual rollback of such fiscal lifelines should be done in a cautious manner avoiding sudden cliff effects. However, there is a strong rationale to

phase-out sectoral support measures when restrictions are lifted and demand picks up. As noted by staff, it is essential even in this crisis phase not to bind future budgetary margins by committing to permanent and inefficient spending outlays, and extraordinary spending needs to be balanced with debt sustainability in cases of limited fiscal space.

- **Emerging from the crisis, investing in support of structural adjustments of our economies and alleviating the uneven impact of the crisis will be imperative.** Improving the composition of public spending, with emphasis on high-quality investments in support of education as well as the green and digital transitions, should feature high on the policy agenda. This should be fostered by credible fiscal frameworks, including commitments to return to compliance with fiscal rules, as noted by staff, and the state scaling back its direct footprint in the economy. It is also worth noting that due to the nature of the crisis and of support measures adopted, interpreting the fiscal stance might be inherently difficult and probably inconclusive, with a tightening not necessarily reflecting a material drag on the economy. However, it will only be possible to determine the precise scope of fiscal consolidation needs once the uncertainty about the further course of the crisis and the long-term consequences on potential growth path become clearer.
- **The level of persistent damage to the economic fabric is so far uncertain and likely masked for the moment by exceptional policy measures.** Expediting reforms to facilitate insolvency and restructuring procedures in conjunction with lowering barriers to entrepreneurs are particularly important to avoid large-scale “zombification” should the number of business failures rise. Persistent scarring is a particular threat in relation to human capital, both through prolonged separation from labour market participation and through the disruption of educational pathways with knock-on effects on lifetime incomes. While hysteresis is potentially lower than in previous crises in many AEs thanks to extensive use of job retention schemes, labour market policies will need to gradually shift course towards supporting effective reallocation of jobs.

We broadly agree on the outlook for inflation as presented by staff. The credibility of monetary policy frameworks remains vital to keep inflation expectations well-anchored, not the least in the current environment of high and rising government debt. We concur that where institutional frameworks safeguarding central bank autonomy are well-established it is unlikely that inflation expectations and inflation will increase rapidly.

We concur with staff that the interest rate of the Federal Reserve represents the main push factor affecting capital flows and that rising US policy rates can have substantial repercussions especially on portfolio flows, depending on the triggers for such a rise. Analysis conducted in the Eurosystem finds significant spillbacks from US and European monetary policy. Thereby, repercussions are somewhat more important for the Fed than for the ECB. However, our analysis confirms staff’s findings that external financial vulnerability in EMEs is very heterogeneous and primarily depends on domestic parameters, supporting the case for sound and prudent policies in EMEs as the first line of defense (Bundesbank, Global Financial Interconnectedness and Spillovers Between G20 Countries, Monthly Report September 2020, p. 53-73).

We agree that special care must be taken by monetary authorities in AEs at the current juncture when communicating their policy stance. Given some EME’s elevated vulnerabilities due to increased financing needs, the limited effectiveness of flexible exchange rates to act as a stabilizing tool and the

increasing importance of outward spillovers from EMEs, it is a shared interest to avoid monetary policy surprises emanating from AEs that might set the stage for currency or financial crises in EMEs. At the same time, sound macroeconomic and financial conditions at home are the best way in which AEs can contribute to external financial stability in EMEs. Monetary policy should therefore focus on price stability at home while keeping in mind possible spillbacks from abroad.

Global Financial Stability Report

Overall, we concur with the GFSR’s analysis of the possible unintended consequences of policy support as well as the potential adverse effects of an asynchronous and divergent recovery on financial stability. The unprecedented policy support may have unintended consequences by creating potential macro-financial stability risk down the road. However, in order to avoid cliff effects, support measures should not be terminated prematurely and simultaneously. Macroprudential policy should act pre-emptively.

We also concur that as long as the path of the pandemic and the economic recovery remain unclear, the banking sector should refrain from dividend distributions. For particularly robust and well-capitalized banks, exceptions should be possible under certain conditions in order to maintain the competitiveness of European banks. Deferring payouts to more certain times is unlikely to harm the wealth position of shareholders but increases resilience of the banking sector in this period of high uncertainty.

We share the view that global coordination is needed when developing macroprudential tools for the non-bank financial sector. In general, new macroprudential tools require careful ex-ante analyses. Tools that strengthen systemic resilience overall should be preferred over potential new tools that might create contagion risks between sectors in the financial system, as for example NBFITools that relocate risks to the banking sector.

We agree that a strong increase in risky assets’ prices in the past few months has raised concerns about high valuations and excessive risk taking. Extensive policy measures have helped to mitigate the impact of the pandemic, but might have contributed to stretched valuations, distortions in implied risk premia, and a rise in vulnerabilities.

We welcome staff’s analysis on emerging markets’ financing needs and capital flows. We agree that despite the recent episodes of rebound, capital flows remain somewhat fragile, as the currently high volatility in emerging market portfolio flows indicates. Emerging markets with weaker fundamentals and limited access to vaccines may be hit hardest by a shift in investor sentiment and tighter global financial conditions. Similar to the taper tantrum, a policy normalization in advanced economies could again lead to a snapback in term premia in emerging markets.

As regards the banking sector, we agree that banks should use capital buffers in case of increasing losses to continue lending to the real economy. Staff predominantly explains the reluctance to use buffers with profitability considerations. At least for the Euro area in general and Germany in particular, extensive fiscal support shielded the financial system from the direct implications of the pandemic and its economic fallout. Insolvencies are still low (even lower when compared to pre-crisis levels) and no significant increase of loan losses has been recorded. As a

result, until now there has been no apparent need for the banking sector to dip into regulatory capital buffers, like the Capital Conversation Buffer. Preliminary results from empirical work (using European or German data) also do not suggest that banks were reluctant to use buffers. However, from a more conceptional angle our analysis suggests that reluctance might also be related to the interplay of various requirements. Binding constraints in other parallel requirements, e.g. the leverage ratio requirement, might render macroprudential buffers ineffective. According to latest surveys, banks are tightening lending standards. While staff emphasizes this as a potential headwind to recovery, it could also be a prudent reflection of rising credit risks and prospective phasing out of support measures.

We concur with the staff’s findings on corporate vulnerabilities and share the assessment regarding the solvency risks of small and medium enterprises. We also agree with the assessment regarding the importance of involving private lenders when allocating public support to firms. Private sector expertise can be particularly valuable when assessing the viability of firms. However, we recommend a cautious approach with respect to the conclusions drawn from the analysis. The coverage of the European non-financial business economy is very small. This limitation could be made more transparent in the text, possibly by an appropriate disclaimer.

As staff rightly accentuates, increasing debt levels in the non-financial corporate sector are a cause of concern. Extensive policy measures have shielded the financial system from a wave of corporate insolvencies and corresponding losses. While the flow of credit meeting the liquidity demand of the real economy was mostly unimpaired, this has come at the cost of higher indebtedness in parts of the corporate sector. The current situation is challenging for macroprudential policy, as it must deal with a potential materialization of risks without losing sight of a further build-up of vulnerabilities. We agree that based on sound empirical analyses the macroprudential toolkit could be expanded to include nonbank financial intermediaries.

We concur with the view that the COVID-19 shock is likely to reinforce structural changes, impacting CRE in the medium term. As in other countries, we also observe in Germany that certain CRE segments like retail, hotel, and office have been the most affected by the COVID-19 shock, while others have rather profited (e.g. logistics space). However, up to now the pandemic has not yet caused strong price declines on the German CRE market in contrast to those observed for the EU as a whole.

In line with staff’s findings, we agree that it is important to ensure an adequate CRE risk provisioning by banks and other financial intermediaries with the aim to strengthen their financial resilience against future market adjustments and a possible increase in NPLs once fiscal support measures are phased out. While the banking channel is the most relevant channel for shock transmission in case of a significant deterioration in CRE markets, the role of NBFIs, especially real estate investment funds has grown. The exposure of insurance companies to CRE investments has increased over time, but is still moderate in relation to their assets. In our view, appropriate macroprudential instruments for CRE loans would need to reflect diverse CRE financing structures. In addition, as credit growth rates are already slowing in reaction to the COVID-19 shock, one should take into consideration that introducing macroprudential measures at such a point in time could restrict financing for the real economy in a procyclical way.

Fiscal Monitor

We welcome the fiscal policy analyses and recommendations of the IMF Fiscal Monitor 2021.

The stabilization of aggregate demand was one important goal of fiscal stimulus to counteract the economic impact of the pandemic. As most countries relied on debt financing of stimulus packages, fiscal policy stances were expansionary, thus cushioning the adverse effects of the pandemic shock. In Europe, we agree with staff that efficient use of Next Generation EU can stimulate economic recovery and facilitate the ongoing digital and ecological transformation of the economy.

We agree with the assessment that targeted and transformative public investment should be an important element of the economic policy stance. This will not only help achieve important SDGs, but will also increase future growth potentials and contribute to debt sustainability. In the current environment, public investment is expected to have significant multipliers. As a result, public investment is a crucial ingredient for strong and sustainable growth after the pandemic.

We agree with the assessment that a swift vaccination of our societies offers the best chance to overcome the pandemic. We agree that fiscal policy must remain flexible and supportive of health systems, vulnerable households, viable firms, and the economic recovery, until we make enough progress towards sufficient inoculation of our societies. We subscribe to the strategy of continuously monitoring the pandemic and economic situation, targeting fiscal measures to the specific needs. In any case, fiscal policy should remain supportive until the pandemic subsides and economic recovery has sufficiently gained momentum. As the IMF analysis points to spillovers of COVID-19 related policy measures, countries with ample fiscal space should pursue a prudent approach when deciding about exit strategies for fiscal support. We must avoid potential cliff effects in case fiscal support would be withdrawn too early.

Higher fiscal deficits and debt levels worldwide are the results of the internationally coordinated policy response, which was necessary to cushion the economic downturn. While the expansive policy stance is the right course of action in the crisis, and which should not be abandoned prematurely, we have to be aware of debt sustainability in the medium and long term. In times of economic upswing, it will be key to take the necessary actions to ensure debt sustainability and rebuild fiscal buffers. In this respect, one possible way forward would be to make progress on unresolved issues in international taxation, in particular regarding base erosion and profit shifting. We welcome the support of the IMF for a political agreement on the G20/OECD Base Erosion and Profit Shifting project, which will be important to avoid harmful tax competition and unilateral measures.

On Chapter 2, we agree with staff that inequality is a critical topic. We concur with the view that improvements in education, health and early childhood development are crucial factors for progress. Staff could make its call to align distributive choices better with people's preferences more prominently. An important contribution would be deeper country-specific analysis, including possibilities to tackle tax evasion. **We underline the importance of better incorporating inclusive growth and inequality in the Fund's surveillance, including within the Comprehensive Surveillance Review.**