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Statement by Mr. Kaya, Mr. Benk, Mr. Just, Mr. Marek, Mr. Bayar, and Mr. Mehmedi on World Economic Outlook; Global Financial Stability Report; Fiscal Monitor (Preliminary)
Executive Board Meeting
September 30, 2020

We thank staff for the comprehensive set of reports. The Covid-19 pandemic is a truly transformational event, whose short- and long-term ramifications are defining the entire global economic system. As the human toll from the pandemic continues to mount and the concomitant economic fallout – despite a gradual reopening of economies – persists, authorities across the membership are facing binding policy constraints and difficult trade-offs. Against this backdrop, the flagship reports provide an accurate account of the global economic outlook as well as risks and offer an appropriate set of policy recommendations. Going forward, we would appreciate even more frequent updates, including in an informal format, to help the authorities stay abreast of the developments amidst an exceptional time of stress.

World Economic Outlook

We broadly concur with staff's assessment of the current economic developments and agree with the baseline scenario for the global economic outlook. We take positive note of the signs of recovery as most economies have started to gradually reopen. Nonetheless, resurgence of the pandemic in different parts of the world jeopardizes this nascent recovery as administrative containment measures appear to be reinstated in many economies while individuals continue to avoid contact-intensive economic activity. Therefore, the WEO baseline, which assumes a weakening of growth momentum in the second half of the year, appears sensible. In the absence of a vaccine and/or an effective treatment, social distancing and localized lockdowns will likely continue through and beyond 2021, undermining short-term economic outcomes as well as the longer-term potential through scarring effects. Therefore, the eventual recovery of the world economy hinges critically on the development of clinically proven vaccine(s) and treatments as well as on ensuring their broad-based coverage. The emphasis on multilateral cooperation in this regard is well placed.

We underscore that uncertainty remains a defining feature of the Fall WEO forecasts. In that regard, we see staff's scenario-based approach as quite pertinent. We agree that due to the exceptionally high degree of uncertainty, putting a quantitative assessment on the balance of risks is neither an analytically sound approach nor a useful one, for practical purposes. We therefore welcome the WEO presentation of both positive and negative scenarios as well as the breakdown of the impact of the pandemic on the global GDP. *We wonder whether and how staff in their projections about the impact of a downside scenario, have factored in the effect of a possible discretional policy response, where policy space exists.* Further, as also elaborated in the GFSR, the disconnect between market valuations and underlying economic fundamentals persist, which could amplify the potential adverse market reaction in case of a downside scenario. Thus, we are more concerned about a severe financial tightening – beyond the level implied by staff's scenario analysis - should there be a pronounced loss in confidence and risk appetite.

On the policy responses, we concur that fiscal policy has played a critical role in buttressing the economic recovery, preserving employment, and cushioning vulnerable segments of the population as well as firms from the adverse effects of the crisis. Going forward, as economies reopen, fiscal policy needs to be gradually unwound while retaining targeted social support programs and policies to foster reallocation of resources in the economy. We caution against a premature scaling back of crisis-related measures. We acknowledge the growing trade-off between the need to provide continued support to foster economic activity and the significant build-up of debt across all country groups. Reflecting this, anchoring fiscal policies to credible medium-term programs that would safeguard debt sustainability is crucial. In the interim, we underscore the importance of ensuring the quality of spending, including through prioritizing productivity enhancing, inclusive spending programs rather than wasteful subsidies and expenditures.

Monetary policy stimulus by the major central banks remains necessary to underpin economic activity and financial market sentiment, while safeguarding medium-term price stability. Introducing swap lines within a broad group of central banks, including from major emerging market economies, helped countering earlier bouts of tightening in financial market conditions. We encourage advanced economy central banks to consider widening these swap networks to cover remaining systemic gaps in the international monetary system. Similarly, we appreciate the ECB's targeted longer-term refinancing operations which have eased lending conditions in the euro area and also created some positive spillovers to the periphery. Given the prevailing uncertainty about the course of inflation, central banks need to remain vigilant against incipient inflationary/deflationary pressures to adjust all available tools, as appropriate, to ensure that inflation expectations are well anchored.

We are deeply concerned about the possibility of the pandemic leaving longer-term scars on potential growth. While the precise effect will vary across economies and sectors, it will reflect a variety of factors, particularly the pressures on sectoral balance sheets, labor market frictions, and the inherent flexibility of countries to undertake a swift and efficient resource reallocation within their economies. Global productivity gains were already sluggish since the Global Financial Crisis and the pandemic is posing renewed pressures in this regard. To that effect, we support staff's emphasis on the policy initiatives that could counteract the drags on productivity growth – including, repairing balance sheets and resolving distressed debt, addressing labor market rigidities and investing in human capital, expediting product market reforms to remove barriers to entry and facilitate resource reallocation, countering undue concentration of market power through effective use of competition policy. We also agree that the crisis presents an opportunity to prioritize new avenues of growth such as information technologies, data-enabled services, medicine and biotechnology, and green investments.

Finally, on a very specific point, we find the wording of a sentence (on page 22, paragraph 3) somewhat disturbing as it suggests that the children schooling from home are more likely to be exposed to violence and exploitation. While recognizing some unfortunate incidents in various parts of the world, we believe that the WEO should refrain from presenting such contentious and categorical propositions - which also do not add much value in terms of advancing the argument.

Global Financial Stability Report

We thank staff for the comprehensive GFSR which provides an in-depth analysis of risks across the main financial market segments and their interconnection with the real economy. The fallout of the COVID-19 pandemic on the financial sector has been largely mitigated by coordinated fiscal, monetary and regulatory response. Depending on the recovery path, it is critical to avoid early policy reversal, and differentiated policy response across jurisdictions is the right way forward. Downside risks in the financial sector were contained owing to massive easing of financial conditions and extensive public policy support. While gradual phasing out of the public and private supporting measures, including loan moratoria, should be pursued in the recovery phase, some jurisdictions facing a more prolonged duration of the pandemic, might need to continue using monetary, regulatory and macroprudential policies to avoid sudden cliff edge effects.

While supervisory authorities should use existing flexibility in financial sector regulation, it is critical to ensure that the gains in the post-GFC regulatory agenda are preserved and in line with the agreed international standards. The relaxation of macroprudential buffers can be encouraged, in line with their regulatory purpose, but their complete depletion must be avoided as the fallout of the pandemic might further weigh on the banking sector's capital position. Jurisdictions in the recovery phase should take gradual steps to withdraw contingency measures and move ahead with regulatory measures distinguishing between liquidity and solvency issues of individual borrowers, to avoid zombification of banks' balance sheets and a rapid increase in non-performing loans. Supervisors should be vigilant regarding the structural transformation in the banking sector and keep abreast of the emerging risks stemming in particular from the ongoing digitalization of banking services as well as risk management and compliance processes. Prudent risk management practices have to be promoted as the low interest rate environment may fuel excessive risk taking. Conducting well-designed stress testing exercises will also be pivotal to monitor banks' resilience to potentially distressed borrowers going forward.

We note that the non-financial corporate sector benefited from substantial public sector measures aiming to relive pressures on their cash-flow, including through commercial loans secured by state guarantees and public sector financial support schemes. Access to capital markets at more favorable terms was facilitated by asset purchase programs deployed by central banks on a large scale, which helped maintain corporate spreads compressed. While this immediate support was warranted to avoid corporate bankruptcies resulting from government-imposed business restrictions, a prolonged pandemic might weigh on the corporates' liquidity position and increase solvency issues. We are concerned that corporate credit quality has already shown signs of deterioration. Solvency developments in the SME sector should also be closely monitored, as their funding conditions are even more constrained compared to large firms, including in terms of access to capital markets funding, lower liquidity buffers and non-diversified revenues. The approach to addressing corporate SME loans should therefore be based on a careful assessment of the SMEs' capacity to repay and customized restructuring.

The disconnect between rising market valuations and economic developments identified in the April 2020 GFSR continues, which might weigh on capital and liquidity position of non-banks. Despite the sharp sell-off at the onset of the pandemic, equity markets have recovered owing to the substantial policy support. We are concerned that equity valuations seem to be at historically high levels in some jurisdictions and a potential abrupt reversal of investor sentiment has therefore been a persisting risk. While asset management funds might increasingly face sudden redemptions resulting in fire sales, insurance companies and pension funds might be incentivized by the extensive central bank capital market purchases to increase their leverage and expand their balance sheets with risky assets. Continued supervisory vigilance is therefore critical to reduce non-banks' asset-liability mismatches and ensure that they can meet their long-term liabilities.
Emerging markets' (EMs) central banks have for the first time engaged in quantitative easing, which helped keep their bond spreads compressed. However, the risk of stretched valuations, and debt distress might become pressing, in particular in those countries already making use of emergency Fund-supported financing and program arrangements, should their public expenditures soar on the back of the prolonged crisis. While the risk of portfolio outflows from the EMs has gradually decreased, rising external debt levels coupled with large rollover needs might further elevate their debt vulnerabilities. Finding the right balance between providing official support and implementing debt restructuring solutions with private creditors will be critical.

The expected rise in global public debt above 100 percent is worrying. We note that advanced economies (AEs) will experience larger increases in debt in 2020 than EMs due to their funding constraints. However, in the recovery phase both AEs and EMs will need to adopt medium-term consolidation strategies and address the issue of contingent liabilities, resulting from the extensive support programs for the corporate, banking and household sectors. Declining fiscal space also weighs on the sovereigns' capacity to engage in the potential recapitalization of distressed banks, therefore sound recovery and resolution plans are instrumental to avoid disorderly bank failures.

Fiscal Monitor

Staff appropriately analyses how fiscal policies have played a key role, as part of swift and concerted government responses across the membership, to mitigate the health and economic impact of the coronavirus crisis. We also appreciate the roadmap for fiscal policies during the different phases of the pandemic to better navigate lockdowns and reopening and to facilitate structural transformation to adjust to the new post-pandemic economy.

The massive and unprecedented fiscal policy support undertaken since the start of the COVID-19 crisis, with AEs and large EMs accounting for the bulk of the global fiscal policy response, has saved lives and livelihoods, supported vulnerable people and firms, and mitigated the fallout on economic activity. We take note of staff's conclusion that the outcomes would have been much worse without the public health and fiscal measures put in place. However, while the measures have been large and timely, they were also taken at the expense of targeting and governments should be fully cognizant of the unintended consequences of some of the implemented fiscal measures which could delay the necessary labor and sectorial reallocation, which in turn are critical for the recovery.

While fiscal support has been necessary to contain the spread of the disease and restore confidence, the fiscal response coupled with the sharp contraction in output and government revenues has pushed public debt levels close to 100 percent of GDP in 2020 globally, the highest ever. As policies that address health risks contribute to the restoration of confidence and trust, fiscal policy should therefore remain supportive and flexible where fiscal space exists, and countries should use their fiscal spaces efficiently. With 47 percent of low-income countries deemed at high risk of debt distress or already in debt distress and with debt vulnerabilities remaining elevated in many EMEs, fiscal risks should be properly contained, and debt sustainability ensured. To this end, it is critical that fiscal costs are properly assessed, disclosed, mitigated, and embedded in the budget processes and medium-term fiscal frameworks. At the same time, it is essential that countries carefully monitor and mitigate the sizable fiscal risks stemming from a potential protracted economic downturn, volatile financing conditions, commodity price movements, and contingent liabilities. With the COVID-19 pandemic inflicting a huge economic toll on LICs and overwhelming their weak health systems, we underscore that ramping up public health expenditures is the number one priority despite the limited fiscal space and vulnerable debt positions. Aid, grants, and concessional emergency financing by development partners and multilateral financial institutions for the health sector and other priority spending is essential, also with a view to ensure that fiscal positions do not deteriorate to unsustainable levels. Concurrently, ensuring that LICs have access to vaccines and treatments as soon as they become available is critical.

We welcome and agree with the proposed fiscal roadmap for the recovery, attuning fiscal measures and strategies to the three phases of the pandemic and ensuring that fiscal policy remains flexible. As most countries have partly or fully reopened, we concur that fiscal measures should remain targeted and countries with fiscal space could undertake job-intensive public investment while ensuring proper public investment management. Once the pandemic is under control, supporting the recovery will entail rebuilding fiscal buffers and strengthening debt sustainability while implementing measures which ensure a more inclusive and greener growth, including through investments in health, education, digital transformation and green projects while increasing income taxation, and strengthening social protection.

We appreciate the focus of the FM's Chapter 2 on the appropriate role of public investment in fostering the post-pandemic recovery, including the assessment on the fiscal multipliers in the COVID-19 crisis and recovery. We take note of the four steps needed to be taken immediately by countries, (i) the focus on capital maintenance of existing infrastructure; (ii) reviewing and reprioritizing active projects, (iii) creating a pipeline of projects, and (iv) starting planning for the development priorities stemming from the crisis. To this end, we underscore the importance of strengthening public investment management practices and governance, including through addressing shortcomings in the selection and appraisal process. We concur that investment priorities should include improving healthcare systems, addressing climate change risks and facilitating the transition to a low-carbon economy, and expanding digital infrastructure. In addition, training and re-skilling of displaced workers to support resource reallocation should be pursued.