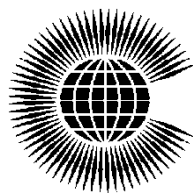


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Global Economic Crisis: Current Issues for Discussion

Paper by the Commonwealth Secretariat

Commonwealth Secretariat
Marlborough House
London SW1Y 5HX

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TABLE OF CONTENTS

	Page
1. INTRODUCTION	1
2. MACROECONOMIC POLICY RESPONSE – AN OVERVIEW	2
2.1 Fiscal Policy	2
Figure 1 – Fiscal Balance as % of GDP	3
2.2 Monetary Policy	3
Figure 2 – Policy Interest Rates.....	4
Figure 3 – Policy Interest Rates in Developing Regions	4
3. FISCAL POLICY CONSIDERATIONS	5
3.1 Does the Government have the fiscal space to pursue expansionary fiscal policy? .	5
3.1.1. <i>Existence of flexibility in Advanced Countries</i>	5
3.1.2 <i>Existence of policy space in Developing Countries</i>	5
3.2 How effective will the expansionary policy be and what can be done to maximise the effectiveness of the expansionary policy?	6
3.2.1 <i>The set of Initial Conditions and Policy Credibility</i>	6
3.2.2 <i>Size of Fiscal multipliers and Social Protection</i>	7
3.3 Does the Government have the ability to implement a timely, well targeted and temporary fiscal stimulus?	8
4. MONETARY POLICY CONSIDERATIONS AND EXCHANGE RATE MANAGEMENT	8
4.1 How effective will monetary policy be?	8
4.2 Does the Government have the policy room for manoeuvre to ease monetary policy? What factors influence policy space to respond?	9
4.2.1 <i>Advanced Country Monetary Policy Freedom</i>	9
4.2.2 <i>Developing Country Monetary Policy Freedom</i>	9
4.2.3 <i>What is the Governments’ exit strategy?</i>	10
4.2.4 <i>How should macrofinancial considerations be factored into monetary policy?</i>	10
5. FURTHER INTERNATIONAL POLICY CHALLENGES	10
5.1 Financial Sector Stability	11
5.2 Redressing Global Imbalances	11
5.3 Global Coordination	11

1. INTRODUCTION

In the past year, the financial crisis in advanced countries has become a global economic and development crisis which has spread to all countries through a range of financial and real sector impacts. Within the Commonwealth countries experiences of the crisis have differed and there is no single policy prescription common to all. But every country has been affected by the crisis and there are lessons to be learned even from this differing experience.

2. This paper provides background to discussion amongst Ministers on these issues which can be framed by four overarching questions

- **What have been the main policy lessons learned from the crisis?**
- **What are the greatest immediate policy challenges facing countries as a consequence of the crisis?**
- **What policy further policy measures could be promoted in the international community to alleviate those challenges?**
- **What role can fellow Commonwealth members play in supporting the achievement of sustained growth?**

3. This paper supports the discussion of these questions by presenting an overview of first the macroeconomic policy response to the crisis, before considering the policy options facing Ministers in shaping national policy responses.¹

4. The global context for these national responses amongst Commonwealth members has been the imperative felt around the world to avoid the mistakes which turned the financial shock of the late 1920s into the Great Depression of the 1930s. This has seen unprecedented levels of global cooperation and coordination in macroeconomic policy to maintain demand. It has also seen the use of novel policy instruments to achieve these aims. Recent economic data suggests that the global contraction is slowing thanks to this resolute policy action. But this has left policy makers in uncharted territory.

5. Although all Commonwealth countries have a shared objective of minimising the adverse impact of the crisis on economic growth and living standards, the policy options available and the challenges faced by countries differ profoundly. For the largest Commonwealth countries which have contributed importantly to the global stimulus, managing rising debt levels, especially in the context of continuing medium term fiscal challenges, will become an increasing challenge. For developing countries, policy options are typically more restricted – especially following the adverse impact of the food and fuel crises in 2008. For the poorest countries, the need for increased international support in the form of concessional external financing to manage the impact of the crisis – not created in the developing world – on the achievement of the Millennium Development Goals is clear.

6. And despite recent signs of improvements, recession continues in many countries and the recovery is expected to be sluggish and uneven among countries and regions. This is the still sombre backdrop pointing to the need for continued supportive – and internationally coordinated - macroeconomic policy.

¹ This paper focuses on short term macroeconomic policy response and issues, it does not cover financial sector policy response and issues.

7. Throughout the paper there are a number of questions raised where members of the Commonwealth may be able to learn from each other which are designed to assist in the sharing of lessons learned and identification of areas in which members of the Commonwealth can provide mutual support. A final section briefly highlights the key international policy challenges that the international community must address.

2. MACROECONOMIC POLICY RESPONSE – AN OVERVIEW

8. This section provides an overview of the fiscal and monetary policy measures taken within Commonwealth countries in response to the crisis to set the context for consideration of the wider policy choices.

2.1 Fiscal Policy

9. The ability of countries to use fiscal policy in the short term as a means for managing the impact of the crisis varies depending on the differences in the set of initial country conditions at the onset of the crisis and the way in which the crisis has impacted on particular countries – that is the transmission mechanism of the crisis. This defines the policy options available.

10. Fiscal deficits in advanced countries are expected to increase by approximately 3 per cent of GDP on average in 2009². The increase in the fiscal deficit is due to a number of factors including: reduced tax revenue; support to financial systems; operation of automatic stabilizers; and discretionary fiscal stimulus measures. In Commonwealth G20 countries fiscal deficits are projected to increase in 2009 from pre-crisis levels (2007) by 5.8 per cent of GDP in Australia, 5.8 per cent of GDP in Canada, 4.6 per cent of GDP in India, 4.0 per cent of GDP in South Africa and 9 per cent of GDP in the United Kingdom. General government debt is also projected to increase from pre-crisis levels (2007) by 2010 by 38.1 per cent of GDP in the United Kingdom, by 12.4 per cent of GDP in Canada, by 10.6 per cent of GDP in Australia, by 4.5 per cent of GDP in India and by 2 per cent of GDP in South Africa³.

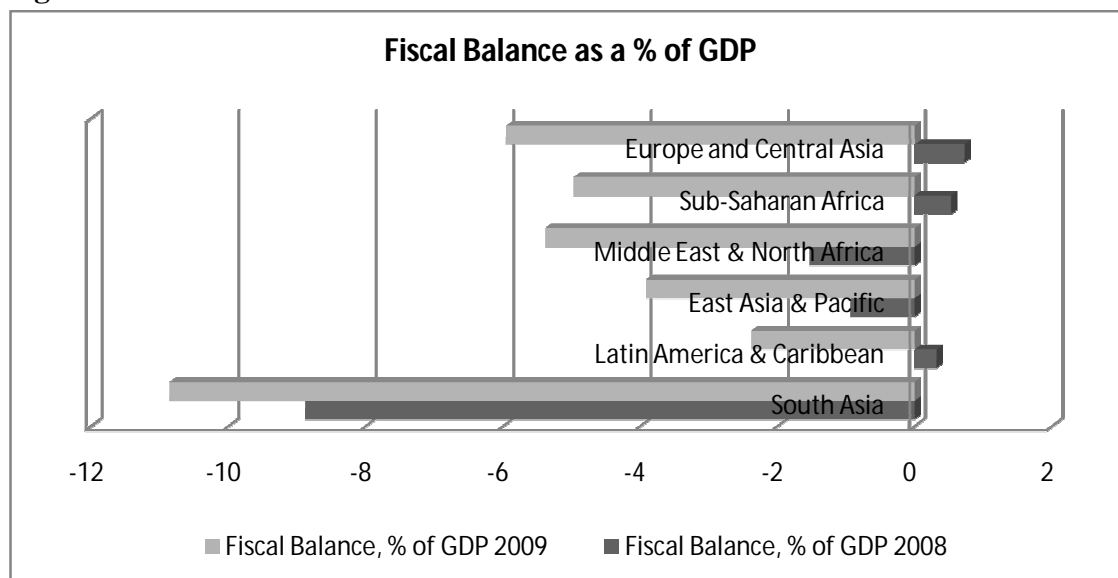
11. These countries together play a significant role in the global economy and with other members of the G20 have supported global demand through this fiscal expansion which has helped mitigate – partially – the depth of the recession in all Commonwealth countries. Discretionary fiscal stimulus measures in G-20 countries are estimated to average 2 per cent of GDP in 2009 and 1.6 per cent in 2010. The largest Commonwealth G-20 discretionary stimulus packages in 2009 is India (3.5 per cent of GDP) followed by South Africa (3 per cent), followed by Australia (2.9 per cent), Canada (1.9 per cent) and the United Kingdom (1.6 per cent)⁴. In general, emerging market discretionary measures are more focused on infrastructure investment and less on income tax cuts and emerging market discretionary measures have been larger than advanced countries partly because of smaller increases in government spending as a result of automatic fiscal stabilizers.

² Global Development Finance 2009, World Bank

³ The State of Public Finances: A cross-country fiscal monitor, IMF Staff Position Paper, July 2009.

⁴ The State of Public Finances: A cross-country fiscal monitor, IMF Staff Position Paper, July 2009. These figure reflect the budgetary cost of crisis-related discretionary measures compared to 2007, based on measures announced through mid-July 2009. They do not include acquisition of assets or automatic stabilizers.

Figure 1 – Fiscal Balance as % of GDP



Source: Global Development Finance 2009

12. However, the fiscal position of developing countries is expected to deteriorate more than in advanced countries. Fiscal deficits in developing countries are expected to increase by 4.4 per cent of GDP on average in 2009⁵ as illustrated in Figure 1. The fiscal deterioration will be particularly acute for Sub-Saharan Africa where the fiscal deficit is projected to increase by 5.5 per cent; followed by 3 per cent deterioration in East Asia and the Pacific; 2.7 per cent deterioration in Latin America and the Caribbean; and 2 per cent deterioration in South Asia⁶.

13. Among Commonwealth developing regions, South Asia entered the crisis with the least fiscal space (estimated average fiscal deficit 10.8 per cent GDP in 2009), followed by Sub-Saharan Africa (-4.9 per cent GDP 2009), East Asia and the Pacific (-3.9 per cent GDP 2009) and Latin America and the Caribbean (-2.4 per cent GDP 2009). Nevertheless some developing countries have pursued discretionary action, for example Bangladesh with a stimulus 0.7 per cent GDP in 2009⁷. But for the most part the deterioration in fiscal positions has been the result of exogenous adverse impacts on taxation receipts rather than discretionary spending.

2.2 Monetary Policy

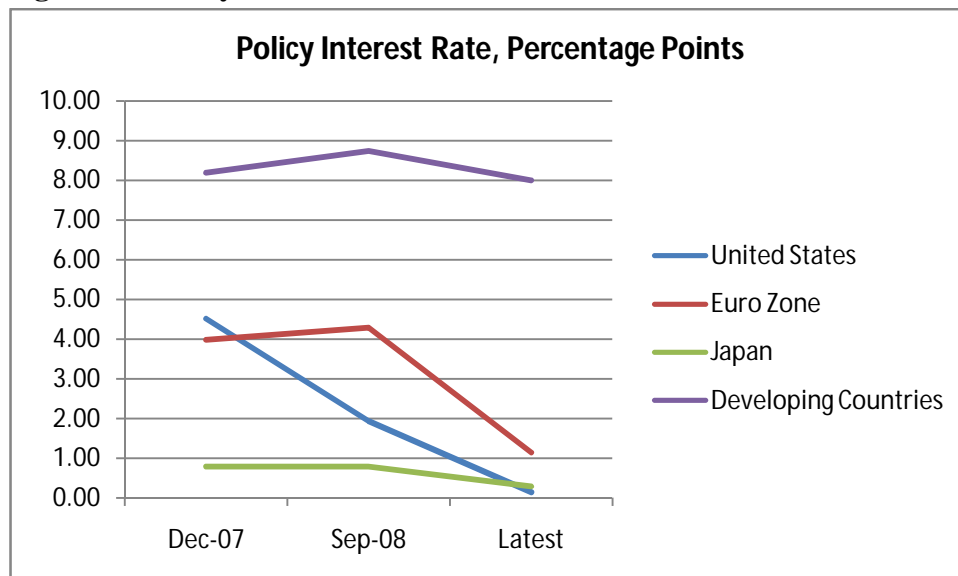
14. Monetary policy has been geared to stabilising and supporting the financial system in fulfilling its primary function of intermediating between savers and investors and supporting demand domestically and globally.

⁵ Global Development Finance 2009, World Bank

⁶ Global Development Finance 2009, World Bank

⁷ Global Development Finance 2009, Regional Outlook Appendix, World Bank

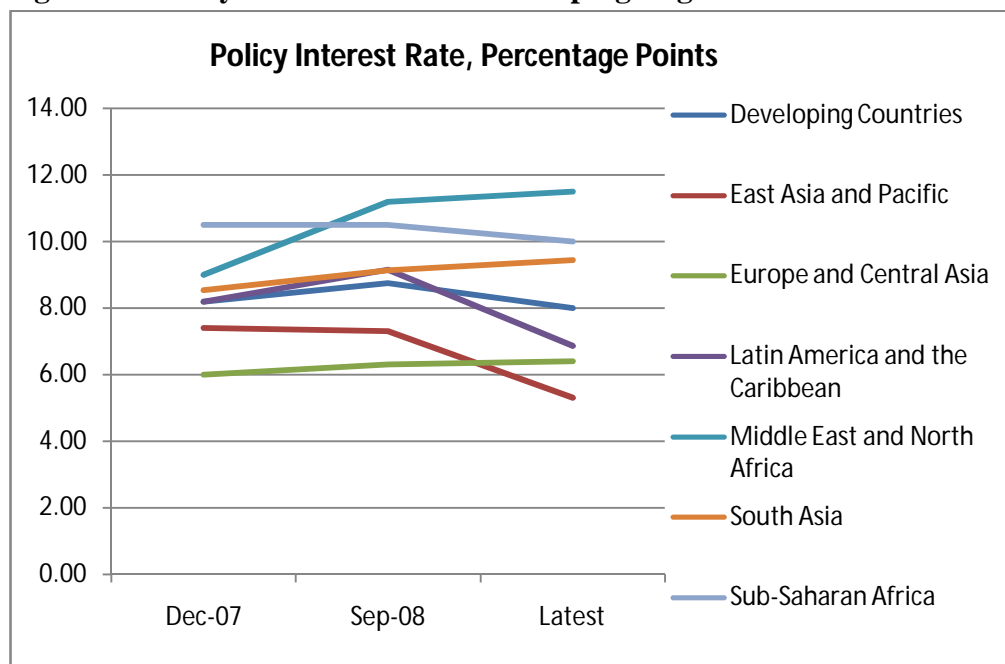
Figure 2 – Policy Interest Rates



Source: Global Development Finance 2009

15. The primary global action in this area lies outside the Commonwealth. Broadly speaking monetary policy has been eased throughout the global economy with policy interest rates falling, especially in the United States and Euro Zone as illustrated in Figure 2. Among advanced countries, rates have fallen by an average of 180 basis points since mid-September 2008. Policy rates have also been cut in $\frac{3}{4}$ of developing countries by an average of 75 basis points⁸ where the highest falls in policy rates have been in Latin America and Caribbean (228 basis points) and East Asia and Pacific (200 basis points), as illustrated in Figure 3.

Figure 3 – Policy Interest Rates in Developing Regions



Source: Global Development Finance 2009

⁸ For which data is available, Global Development Finance. P19 GDF

3 FISCAL POLICY CONSIDERATIONS

16. This section looks beneath headline figures on fiscal policy to consider the design choices facing different countries and the way in which the fiscal response to the crisis has been crafted. The desirability and feasibility of undertaking counter-cyclical fiscal policy varies throughout the Commonwealth. Three key questions guide the consideration of the fiscal policy response for all countries, although the weighing of them may vary:

3.1 Does the Government have the fiscal space to pursue expansionary fiscal policy?

17. The exact response of Government will depend on the degree to which countries have fiscal flexibility as a result of previous policy choices⁹ and the ability to access additional finance at reasonable cost. The existence of this flexibility varies significantly throughout the Commonwealth.

3.1.1 Existence of flexibility in Advanced Countries

18. As described in Section 2.1 the crisis is having a significant impact on fiscal positions. Fiscal deficits and public debt ratios have expanded sharply in many advanced Commonwealth countries. Whilst these countries can afford to run moderate fiscal deficits for extended periods, without adversely affecting the cost of financing, short term choices have medium term consequences. Even in these countries questions about medium term debt sustainability and fiscal solvency – which can raise long term interest rates, harm recovery and worsen debt dynamics further - exist. The use of looser fiscal policy to meet the crisis also plays directly into the longer term fiscal pressures in many developed economies associated with long-term demographic change.

With this in mind:

- **What further room there is for continued fiscal support to balance these competing forces? How have Ministers managed this choice in practice?**
- **What techniques have been used to reassure markets that fiscal solvency is not a risk?**

19. A third force which policy makers will need to balance is the risk of tightening fiscal policy too early. Coordinated fiscal loosening has been key to nursing the global economy to the point of nascent recovery. Too rapid withdrawal of this support can lead to loss of economic momentum. The experience of Japan in 1997 serves as a reminder about the danger of a premature withdrawal of stimulus. A **credible exit strategy** is needed to unwind the stimulus measures once they have been effective in reviving growth. This is related to the issue of the credibility of fiscal frameworks discussed below.

3.1.2 Existence of policy space in Developing Countries

20. Commonwealth developing countries have more limited fiscal space and are less able to use domestic fiscal policy as a cushion against the crisis. Many developing countries were

⁹ For example; Budget deficits were not reduced sufficiently during the boom years when revenues were high, which limits the fiscal space needed to fight the crisis, Lessons of the global crisis for macroeconomic policy, IMF 2009..

left fiscally vulnerable as a result of the food and fuel price hikes in 2008¹⁰ and the impact of the crisis will result in a further deterioration in their fiscal position. Weakening growth as a result of a decline in export prices and volumes, remittances, tourism and capital flows translate into significant government revenue loss. This combined with limited access to external sources of finance at reasonable cost will constrain most countries' ability to respond with countercyclical fiscal policies.

21. At the same time Governments will be under pressure to maintain or increase spending to cushion the impact of the crisis on the poor as poverty is set to rise. Yet many countries will be obliged to tighten fiscal policy (*as is the case in Pakistan under its new IMF program*) cutting expenditure precisely when it is needed most as policy makers grapple with widening current account deficits and deteriorating fiscal positions coupled with reduced access to affordable finance. The need for and speed of the necessary adjustment will depend on the level of public debt and the availability of financing on sustainable terms. Additional donor support would reduce the need for adjustment.

22. Furthermore, developing countries generally face stricter policy constraints due to lack of policy credibility which reduces the scope for financing a deficit without substantially increasing borrowing costs. This is discussed further in section 3.2.1 below.

- **How have Ministers in small and poor countries been able to maintain fiscal flexibility in the face of the economic crisis?**
- **What measures could the international community take to support countries efforts to maximise their fiscal space?**

3.2 How effective will the expansionary policy be and what can be done to maximise the effectiveness of the expansionary policy?

23. To maintain economic growth and offset the effects of the crisis, the design and composition of fiscal stimulus – as well as its size - matters. In order to maximise the effectiveness of the stimulus, the key issues are:

3.2.1 The set of Initial Conditions and Policy Credibility

24. The credibility of medium term fiscal policy affects its short term effectiveness in supporting demand. Governments with low debt burdens and flexible monetary frameworks have the highest credibility and, as a result, the greatest fiscal multipliers. Where there are concerns about future fiscal sustainability¹¹ fiscal multipliers can be small or even negative as real interest rates due to fears of future crowding out from sustained government debt growth

25. Consequently, effective discretionary fiscal stimulus needs to be anchored in a **credible medium-term fiscal policy framework**. Credibility is more difficult to build - and more easily lost - in developing countries. The result is that the impact of higher budget deficits on financing conditions and interest rates – as markets insure against future inflation

¹⁰ Where many countries absorbed the impact fiscally in order to minimise social and political impacts. For example; in Sub-Saharan oil importing countries the fiscal cost of delaying the pass-through to domestic prices averaged 1 per cent of GDP in 2008 (Global Development Finance, 2009, Regional Appendix).

¹¹ Recent research by the IMF finds that whilst discretionary fiscal policy can have moderately countercyclical effects in advanced countries, the stimulus could have adverse long-term effects in emerging countries, World Economic Outlook, October 2008, Chapter 5, IMF.

and taxation - are potentially much stronger in developing countries than in advanced countries, reducing the impact of a fiscal expansion.

26. In addition, a credible fiscal framework can assist policy makers to guard against the “easing bias”, where stimulus during the downturn is greater than the tightening during the upturn leading to a ratcheting up of public debt levels. Spending increases can be difficult to reverse especially those which are targeted at the most vulnerable.

- **What lessons have Ministers learned through the crisis about the use and effectiveness of fiscal frameworks through the crisis?**
- **How will Ministers build policy credibility in the coming period?**

3.2.2 Size of Fiscal multipliers and Social Protection

27. In determining the composition of the discretionary fiscal stimulus policy makers need to consider whether revenue or expenditure based policy changes will be more effective at stimulating growth.

28. Discretionary government spending increases (either for consumption or investment) and targeted tax cuts and transfers are more likely to be effective than general tax cuts – which can lead to increased saving, not spending - or general subsidies.

29. In many developing Commonwealth countries a focus on expenditure is likely to be most effective, as the scope for reducing tax rates is likely to be limited given low revenue ratios and doing so may be inequitable¹². However, some forms of spending should be avoided and these include universal subsidies or general public wage increases.

30. A lesson from the Asian crisis is that a broad-based crisis can disrupt development momentum well into the future. Recent analysis suggests that 45 per cent of the Commonwealth’s members are highly and moderately exposed to adverse poverty effects of the crisis. 15 developing Commonwealth countries are highly exposed to the poverty effects of the crisis¹³ and an additional 9 developing Commonwealth countries are moderately exposed¹⁴. In all countries policy makers should give priority to protecting MDG spending and expanding social safety nets to cushion the impact of the crisis on the poor and ensure that recent progress in poverty reduction is not reversed¹⁵. Fiscal support should be targeted to those who are vulnerable and those who have a higher propensity to consume. However, as noted before, social spending increases need to be well designed to ensure that bring about sustainable development outcomes.

31. Another lesson from the Asian crisis is that it is very important to protect public infrastructure investment to ensure that post-crisis long-term growth is not undermined. Emphasis should be placed on bringing forward approved investment projects given the long

¹² In many developing countries the direct tax burden falls mostly on relatively well-off groups.

¹³ The following Commonwealth countries are exposed to both declining growth rates and high poverty levels: Bangladesh, Botswana, Gambia The, Ghana, India, Lesotho, Mozambique, Namibia, Nigeria, Pakistan, Sierra Leone, South Africa, Swaziland, Tanzania, and Zambia. WB Crisis through a poverty lens. The analysis excludes many small states including the Caribbean. The Global Economic Crisis: Assessing Vulnerability with a Poverty Lens, World Bank, 2009

¹⁴ The following Commonwealth countries face either decelerating growth or high poverty levels: Jamaica, Kenya, Malaysia, Sri Lanka, Trinidad and Tobago, Cameroon, Malawi, Papua New Guinea, Uganda.

¹⁵ The implications for poverty reduction and the Millennium Development Goals of a failure to maintain social spending could be far reaching. For example; following the East Asian crisis in the late 1990’s, it took almost a decade for the poverty headcount to regain its pre-crisis level in affected countries.

process involved in the preparation, design, construction and review of major new infrastructure projects. Existing infrastructure should be preserved by protecting operations and maintenance, which are typically labour intensive.

- **What lessons have Ministers learned about the targeting of social expenditure?**
- **How can the necessary measures for social protection be made affordable in the longer term?**

3.3 Does the Government have the ability to implement a timely, well targeted and temporary fiscal stimulus?

32. The design of the fiscal stimulus also needs to recognise the potential for implementation lags (for example, the design, approval, and implementation of new road projects). The challenge for policy makers is to ensure that the stimulus is delivered quickly so that it does not end up having unintentional pro-cyclical effects.

33. Fiscal stimulus measures should be temporary and be able to be quickly reversed when the recovery commences and has become sustainable to ensure that stimulus measures do not have permanent effects on the fiscal deficit.

- **What capacity constraints have Ministers met in managing a fiscal stimulus**

4. MONETARY POLICY CONSIDERATIONS AND EXCHANGE RATE MANAGEMENT

34. For an effective macroeconomic policy response to the crisis fiscal and monetary policy need to be co-ordinated: fiscal policy will be more effective when monetary policy is accommodative, so interest rates do not rise to offset any fiscal expansion. Countries have responded to the crisis by easing monetary conditions and policy rates have been reduced sharply throughout most of the world so monetary policy is generally conducive for fiscal stimulus.

35. As is the case for fiscal policy, the scope for monetary easing will depend on country circumstance. Four issues shape the determination of monetary policy in response to the crisis:

4.1 How effective will monetary policy be?

36. A main feature of this crisis has been financial sector disruption and the emergence of widespread credit constraints. As a result, conventional monetary policy has become less effective in some advanced countries as policy interest rates have fallen towards zero combined with greater caution in lending by banks and rising risk premiums. For these reasons policy-makers are resorting to unconventional monetary policy such as quantitative easing and credit easing measures to improve the availability and cost of credit.

37. Whilst policy rates are not near the zero floor level in developing countries, policy makers in some developing countries may also need to turn to unconventional monetary policy to improve the availability and cost of credit where there is disruption to financial markets.

4.2 Does the Government have the policy room for manoeuvre to ease monetary policy? What factors influence policy space to respond?

4.2.1 *Advanced Country Monetary Policy Freedom*

38. To the extent that the risk of deflation outweighs the risk of high inflation, policy space exists. In advanced countries, monetary policy should remain supportive until the recovery begins and deflationary risks recede. Policy makers should make use of any remaining room to cut policy rates further whilst exploring nonconventional policy to ease credit constraints. As is the case for fiscal policy, a key challenge in advanced countries will be designing a **credible exit strategy** to unwind the expansion in the money supply to contain future inflationary pressures. Policy makers will have to carefully manage the trade-off between the risk of a premature tightening of policy that would stunt any recovery and the risk of inflation and creation of new asset price bubbles.

- **What indicators are policy makers using to judge the opportunities for tightening?**

4.2.2 *Developing Country Monetary Policy Freedom*

39. Inflation in developing countries has fallen from a peak of more than 16 per cent in mid-2008 to less than 2 per cent by end the of 2009, before picking up to a relatively subdued 5 per cent¹⁶ in 2011. Nevertheless, the monetary policy options facing developing countries are constrained by the continuing volatility and uncertainty of capital flows. In contrast to advanced countries¹⁷, developing countries face a shock whose impact – from worsening terms of trade, decreased export demand, remittances and capital flows - is felt mostly through the balance of payments. Developing countries face a dual squeeze on both the capital and current accounts with the result that current account deficits can no longer be easily funded by strong capital inflows¹⁸.

40. Global deflationary pressures and widening interest differentials¹⁹ provide scope for some monetary easing in developing countries, although this may be limited by the exchange rate regime or previous credibility to manage inflation. Pegged exchange rates limit the ability to ease monetary policy. In addition, in many economies the weakening of balance of payments positions will put greater pressure on fixed exchange rate regimes where they exist. Monetary policy in developing countries can be eased more easily where the exchange rate can be allowed to adjust. This allows external adjustment to ease the pressure on the domestic economy. There remains the need to balance considerations: on the one hand depreciation can boost exports, to the extent that depressed global demand and other depreciations allow. But on the other it can also increase inflation and the local currency cost of servicing debt denominated or indexed to foreign currencies which could adversely impact the balance sheets and budget positions of households, private sector and government.

41. Where capital flows have collapsed and where countries are facing large or growing external deficits, external adjustment will be required. This pressure can be relieved temporarily through sustainable external financing or by running down international reserves. This double squeeze on the balance of payments will be particularly acute in Commonwealth

¹⁶ Global Development Finance, 2009, World Bank

¹⁷In advanced countries the shock was predominately to domestic demand as a result of the financial system disruption.

¹⁸ The financial crisis has sharply curtailed such flows, with total private inflows projected to decline from more than \$1 trillion in 2007 to \$360 billion in 2009, Global Development Finance 2009, World Bank.

¹⁹ With respect to advanced countries

middle income countries in the Caribbean and Pacific as well as frontier African economies such as Ghana, Kenya, Nigeria and United Republic of Tanzania. Several Commonwealth countries, notably, in the Caribbean and Sub-Saharan Africa have already opened up lines of credit with the IMF, while others are meeting shortfalls by reducing international reserves. Others will be forced to deal with much tighter borrowing conditions and large current account deficits by reducing imports and current account deficits. For countries with flexible exchange rates, depreciation will relieve pressure for adjustment.

- **How successful have governments' monetary and exchange rate choices been in balancing external and domestic adjustment in developing countries?**

4.2.3 What is the Governments' exit strategy?

42. In all countries to minimize risks to the balance sheet and credibility of central banks, and to avoid disrupting markets once conditions normalize, a credible exit strategy also needs to be articulated early on.

- **In light of nascent economic recovery what exit strategies have been considered and what challenges are countries expecting to experience in implementing these exit strategies?**

4.2.4 How should macro-financial considerations be factored into monetary policy?

43. As a result of the crisis the consensus that monetary policy conducted by an independent Central Bank pursuing a narrow inflation target has been challenged. It is argued that a focus on a narrow definition of inflation led to too little consideration of rising asset prices and – more widely – the separate treatment of macroeconomic and financial stability which resulted in too little consideration of the build of system leverage.

44. In this context, there is a widespread desire to define the objectives of policy more widely. Within that how regulatory, monetary and fiscal policy should be used to balance the objectives of macroeconomic and financial stability remains unclear. In particular: a debate is centring around the questions of:²⁰

- Whether policy should be used to dampen booms?
- If yes, does this fall under the responsibility of monetary policy?
- If yes, what is any should be the role of fiscal policy?
- **What are the emerging lessons about how future monetary policy objectives should be defined?**

5. FURTHER INTERNATIONAL POLICY CHALLENGES

45. The chief lesson of the crisis at the global level is that the management of a globally integrated economy requires increased levels of macroeconomic dialogue and coordination. This cooperation is required across the full policy range to ensure the stability of financial sectors and the rebalancing of global demand necessary for a sustainable global recovery.

²⁰ Lessons of the global crisis for macroeconomic policy, IMF 2009

46. Three areas are key:

5.1 Financial Sector Stability: Restoring financial sector stability requires coordination internationally to avoid regulatory arbitrage and competitive distortions, and to ensure reasonable burden-sharing of crisis costs. These issues are discussed further in paper FMM(09)8 – *Perspectives on the Governance of Global Financial Regulation*.

5.2 Redressing Global Imbalances: Global imbalances contributed to the unsustainable policy mix which created the conditions for the financial and economic crisis. Rebalancing global demand is needed to ensure stable and sustainable growth in the medium term. This will necessarily entail a rise in saving in advanced countries which will need to be matched by an increase in demand and decrease in saving in emerging countries. This will require global dialogue and coordination to implement structural, fiscal and monetary policies which are globally consistent and support global economic growth but reduces global imbalances.

5.3 Global Coordination: Recognising the need for global cooperation is not the same as achieving it. Mechanisms are needed to promote this needed coordination. How the International Financial Institutions can support this process will be one of the issues Ministers should consider in their discussion of Bretton Wood Institutions reform. A key issue is how the interests of all countries – especially the poorest and most vulnerable – are taken into account in the process of global policy coordination.

- **What role do Ministers envisage the Commonwealth members playing, in:**
 - **Promoting global financial stability?**
 - **Assisting in the rebalancing in global demand?**
 - **Promoting effective global co-ordination?**