

GROUP OF TWENTY

GLOBAL PROSPECTS AND POLICY CHALLENGES

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Prepared by Staff of the

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*Does not necessarily reflect the views of the IMF Executive Board.

EXECUTIVE SUMMARY

Financial markets have rallied and near-term stability risks have eased in response to better policies, but this is translating to activity very slowly. Decisive actions in the euro area and the United States have contained the most immediate threats to the global recovery. Financial markets have rallied and equity price volatility has fallen to pre-crisis levels. However, lead indicators suggest that real activity will strengthen only gradually, as easier financial conditions take time to transmit to the broader economy.

Despite an improving economy and better policies, significant downside risks remain. These relate to the potential for stalled policy implementation in the euro area, unsustainable public finances in the United States and Japan, and further growth disappointments in emerging economies. However, there are also upside risks from better financial conditions and confidence.

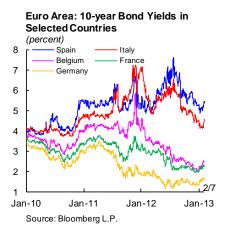
Policymakers cannot afford to let up their efforts. While near-term threats have been avoided, important medium-term challenges remain. The imperatives remain broadly unchanged. Specifically:

- The euro area should proceed towards a genuine economic and monetary union. Rolling back financial fragmentation is also essential to improve the transmission of monetary policy. This will require making tangible progress toward a banking union with greater fiscal integration.
- In advanced economies, fiscal consolidation needs to continue at a gradual and sustained pace, supported by accommodative monetary policy. Fiscal adjustment and targets in most advanced economies are broadly appropriate. Consolidation must be supported by the adoption and implementation of concrete medium-term consolidation plans in the United States and Japan, where the recently-announced stimulus makes this even more urgent. U.S. authorities should act early and decisively to durably raise the debt ceiling and avert automatic spending cuts. More generally, advanced economies need to curtail rising age-and health-related spending.
- Policy responses for emerging economies vary. With short-term risks to activity abating,
 the general challenge is to rebuild fiscal space. Some emerging economies can afford to
 maintain current monetary policy settings, while others may have to gradually tighten. In
 countries with strong capital inflows or still-elevated credit growth, supervisory and
 macroprudential measures should be deployed to curb sectoral excesses.

I. RECENT DEVELOPMENTS & OUTLOOK

Financial market conditions have improved considerably as policy action bolstered confidence and helped mitigate near-term risks. Improved financial conditions, however, are only slowly translating to the broader economy. Prospects are for a gradual reacceleration of activity.

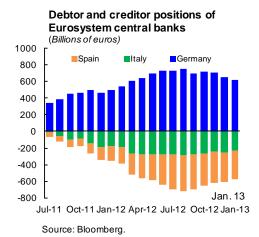
1. **Financial market conditions are much improved**. Markets have rallied on a broad front in response to strengthening policies and prospects. Since July 2012, equity prices in advanced and emerging markets have gained some 15 percent and equity price volatility has fallen to pre-crisis levels, while high-yield bond issuance in the United States has significantly surpassed pre-crisis levels. Periphery sovereign spreads, though still elevated, have dropped appreciably (by some 200 bps for Italy and Spain) and, for the first time in a year, some periphery economies have successfully placed large volumes of medium- to long-term syndicated bonds. Capital flows to emerging economies picked up again and risk spreads on their sovereign and corporate bonds declined further. Syndicated loan issuance reached high levels and an increasing share of borrowing is foreign currency denominated. Nevertheless, the limited increase in safe-haven yields continues to point to caution among bond investors.





2. Improved financial conditions have yet to translate to the broader economy.

This has been a bumpy recovery. Low policy rates are only gaining traction in some major advanced economies. In the euro area, there has been some slowdown of investment in Germany amid adverse spillovers from the rest of the area; elsewhere efforts to repair public and private balance sheets are hindered by elevated bank lending rates, weak near-term prospects for activity, and continuing financial fragmentation. Election-related uncertainty and



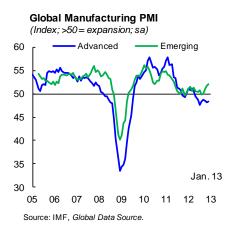
adjustment fatigue in the periphery or reform complacency in general, could renew pressures on banks and sovereign funding. Prospects are better in the United States, because of a healthier housing market and greater adjustment in household and bank balance sheets. However, critical decisions still need to be made on the short-and long-term path of fiscal policy. Japan still lacks a credible plan to ensure fiscal sustainability, and remains hobbled by deflation. Activity is stronger in emerging and developing economies, but even there developments have disappointed in Brazil and India. Overall, global growth projections have been marked down modestly in the *January WEO Update*.

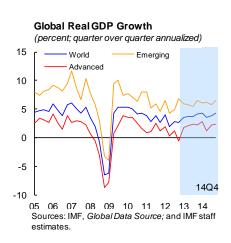
3. Looking ahead, global activity will be supported by easier financing conditions and better confidence.

- Accommodative monetary conditions will continue to support the recovery. Financial conditions in the euro area improved following the ECB's announcement of Outright Monetary Transactions (OMT). The Fed has enhanced its forward guidance to emphasize that the fed funds rate will remain exceptionally low at least as long as the unemployment rate remains above 6½ percent, near term inflation (between 1 and 2 years ahead) is projected to be no more than 2½ percent, and longer-term inflation expectations remain in check. The Fed has also replaced Operation Twist with new purchases of longer-term Treasury securities. The Bank of Japan recently shifted to an open-ended asset purchase program and strengthened its resolve to exit deflation by adopting a 2 percent inflation target. In emerging economies, many central banks postponed monetary tightening.
- In advanced economies, easy monetary conditions will translate slowly into more dynamic lending, provided financial stability risks continue to abate. In the United States, credit growth is picking up and bank lending conditions are easing slowly, supported by recovering house prices, greater loan demand from households, and stronger bank balance sheets and profitability. In the euro area, however, bank lending remains weak and is unlikely to recover rapidly. Despite improved funding conditions following the OMT, many nonfinancial corporations struggle with weak demand and impaired balance sheets, while many banks remain under strain from lingering concerns about capital or asset quality and their underlying business models. In this setting, while progress on national adjustment should lead to greater traction of monetary policy in the periphery, low policy rates will gain only limited traction in the near term, and financial fragmentation is unlikely to reverse quickly.
- In emerging economies, financial conditions will ease in the short run but monetary and macroprudential policies may have to tighten. The credit cycle is in an advanced stage. While policy rate hikes and macroprudential measures have successfully reduced very high credit growth since 2006, reaccelerating activity and capital inflows

are likely to boost loan demand and loosen credit standards. Accordingly, monetary policy may well have to become more neutral, while macroprudential measures target excesses in certain sectors.

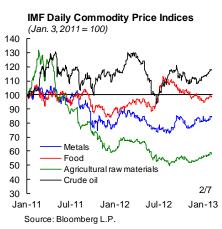
- 4. **Fiscal policy may weigh on activity somewhat less than previously expected, owing mainly to a change of stance in Japan**. In 2013, the amount of fiscal withdrawal in advanced economies will be some ³/₄ percent of GDP, which is similar to 2012. Japan's fiscal stance was expected to be contractionary in 2013 with the unwinding of reconstruction-related spending. However, faced with a deteriorating economic outlook and to support the higher inflation target, the new government has introduced a stimulus equivalent to about 1½ percent of GDP, spread over fiscal years 2012-14. Euro area fiscal policy will tighten less in 2013 than in 2012, and U.S. fiscal policy will tighten somewhat more—this assumes that the sequester (½ percentage point of GDP) is postponed beyond 2013 and a durable solution to raising the debt ceiling is achieved. In emerging economies, fiscal policy is expected to remain close to neutral. While the fiscal positions of these economies are generally healthy, they have not yet reached the pre-crisis surpluses that allowed them ample space to respond to the fall in global demand. Also, some economies continue to face significant fiscal challenges.
- 5. **Against this background, global growth is projected to increase only gradually over the near term**. On an annual average basis, global real GDP growth is projected to reach 3½ percent in 2013 (up from 3¼ percent in 2012) and increase further to 4 percent in 2014. In *advanced economies*, the acceleration is expected to be more evident in the second half of 2013 as easier financial conditions and less uncertainty about policies and prospects foster a rebound in investment. In *emerging economies*, improvements in activity are expected to become more broad based: growth has already returned to a healthy pace in China, solid consumption and policy improvements are expected to lift activity in India, and still-strong consumption and a recovery in investment, including infrastructure, should support faster growth in Brazil. Accordingly, activity in these economies is projected to accelerate from around 5 percent in the first half of 2012 to 5½ percent and then 6 percent in 2013–14. Recent improvements to structural policies will also help bolster growth over the medium term.





6. Inflationary pressures are projected to remain subdued. Global inflation is

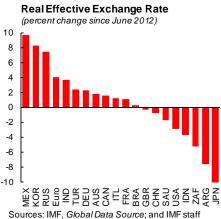
forecast to moderate over the near term from 33/4 percent in 2012 to about 3½ percent in 2014. Inflation is projected to ease in the major advanced economies, consistent with still-large output gaps. In many emerging economies, inflationary pressures are expected to retreat modestly over the near term, given the recent activity slowdown and lower food and energy prices. However, output is generally running above pre-crisis trends. Thus, inflationary pressures are projected to remain fairly high in some economies (e.g., Argentina, India), and could surprise on the upside.



7. Exchange rates have responded to fundamentals and changing risk perceptions.

The recent sizable depreciation of the yen has sparked concerns about competitive devaluations. Taking a broader perspective, however, such concerns seem overstated; the yen which weakened in response to promises for easier monetary policy to support a weak

economy, a higher trade deficit, lower global risk aversion, and following a period where the exchange rate was assessed to be moderately overvalued. Since the middle of 2012, the euro has strengthened in real effective terms, as ECB actions alleviated market concerns about redomination risks. More generally, perceptions of global risk have improved, safe-haven flows have begun to reverse, and the currencies of some economies have appreciated (e.g. Mexico, Korea, and Russia). By contrast, the U.S. dollar has depreciated modestly toward mediumterm fundamentals.



Sources: IMF, Global Data Source; and IMF staff calculations

II. KEY RISKS

Some upside risks have emerged as policy actions have avoided tail risks. However, important downside risks and medium-term challenges remain. Concerns relate to the potential for stalled policy implementation in the euro area, unsustainable public finances in the United States and Japan, and further growth disappointments in emerging economies.

- 8. **Risks have become more symmetric in the short term**. The ECB's OMT has lowered important tail risks relating to the viability of euro. The U.S. fiscal cliff has largely been avoided, while latest developments suggest that the risk of a hard landing has receded in China. Accordingly, the improved financial conditions and confidence could trigger stronger-than-projected global investment and growth.
- 9. However, important downside risks remain.
- A stalling of policy implementation represents a key risk in the euro area. On the back of remaining near- and medium-term challenges, stalled policy commitment and implementation would weigh against financial market sentiment and growth and could rekindle investor flight. Over the medium term, a concern is a protracted period of stagnation or low growth, as high spreads and debt overhang of the private sector in the periphery depress investment and potential growth.
- Unsustainable fiscal positions in the United States and Japan over the medium term represent another major risk. Fiscal sustainability concerns are even more pertinent for Japan and have risen with the recent announcement of additional fiscal stimulus. In the United States, the absence of a deal on durably raising the debt ceiling increases the threat of financial market turmoil. Upward pressure on interest rates from deteriorating fiscal conditions could be substantial, and risk perceptions can change suddenly, undermining financial stability.
- Lower expectations for medium-term growth for some emerging economies could come with further cutbacks in investment and capital outflows, reducing short-term growth. After many years of strong investment and growth, fueled by rapid credit expansion and capital inflows, medium-term prospects for major emerging economies are subject to vulnerabilities from still-high asset prices and stretched financial sectors. At the same time, potential output in these may be lower than assumed.

III. POLICY IMPERATIVES

Policymakers should not become complacent in response to improving financial conditions. The imperatives remain broadly unchanged.

- 10. In the euro area, EMU-wide policies should support individual countries' efforts to repair public and private balance sheets and implement structural reforms to restore competitiveness. Reversing financial fragmentation (e.g., reducing financial home bias, improving cross-border bank flows; reducing credit spreads in the periphery) is essential to improve the transmission of monetary policy as well as foster sustainable growth. This will require making tangible progress toward a genuine economic monetary union—starting with a banking union with greater fiscal integration. Key elements are:
- Further repair of bank balance sheets. Domestically systemic banks should be recapitalized and non-viable ones resolved. Direct equity injections through the ESM would be instrumental for severing adverse bank-sovereign feedback loops when bank recapitalization threatens public debt sustainability. This should move alongside faster progress on the single supervisory mechanism.
- Timely implementation of a more complete banking union with an integrated regulatory and supervisory structure. A full banking union should eventually have a single supervisory-regulatory framework, a pan euro-area resolution mechanism with a common fiscal backstop, and a pan euro-area deposit guarantee scheme. Building blocks have already been outlined and are being put in place. Implementation raises challenges that should not be underestimated.
- 11. **Fiscal consolidation needs to continue at a gradual and sustained pace**. Fiscal adjustment in most advanced economies is broadly appropriate. Fiscal targets should be pursued in structural rather than nominal terms, ensuring that negative growth surprises do not trigger additional consolidation efforts (in the euro area, the current fiscal framework provides sufficient flexibility and should be used appropriately). Countries facing higher debt or greater market pressure are generally adjusting more than their advanced economy peers. In the event of large negative shocks or growth disappointments, the current fiscal policy stance may need to be reassessed in countries that can afford it. Policymakers need to focus on following issues:
- U.S. authorities should act early and decisively to find a durable solution to raising the debt ceiling and avert automatic spending cuts. If a resolution is not found, confidence in U.S. policymakers could rapidly erode, with potentially large spillovers to the rest of the world.

- Fiscal adjustment must be supported by the adoption and implementation of concrete medium-term consolidation plans. The recently-announced stimulus by Japan makes this even more urgent. Despite progress made so far, U.S. policymakers should agree on a comprehensive plan that includes both higher revenues and contains entitlement spending. More generally, in advanced economies, growth in public health care spending is on an unsustainable trajectory (with projections indicating increases in net present value terms of close to 100 percent of GDP). Thus, it is important for advanced economies to move early to curtail rising age- and health-related spending to ensure debt sustainability.
- 12. **Monetary policy in the major advanced economies should remain accommodative**. Fears of high inflation appear overstated—central banks have the tools needed to mop up liquidity and tighten their policy stance should inflation expectations unexpectedly rise. Nevertheless, there is a concern about diminishing effectiveness of unconventional actions, their side effects (e.g., volatile capital flows), and potential difficulties related to unwinding them. While advanced economy central banks can likely address short-term issues related to policy normalization given their large balance sheets, they should continue to monitor any unintended consequences of their policies on sovereign-bank linkages, corporate leverage, financial innovation, international capital flows, and asset price bubbles.
- In Japan, more resolve is required to durably exit deflation. The Bank of Japan recently announced a 2 percent inflation target and a switch to open-ended asset purchases. These are steps in the right direction but stronger commitment and more effective communication are also needed. This should be accompanied by stronger action, such as substantially expanding its asset purchase program.
- In the United States, further repair of household balance sheets is needed, as middle-income households, who were hurt severely by the housing bust, have made limited progress in repairing their balance sheets. In the euro area, improving the effectiveness of monetary policy will require the broad range of policies discussed above to reverse financial fragmentation. In the meantime, there is some room for a lower policy rate.
- 13. **Policy requirements differ among emerging economies**. With short-term risks to activity abating, the general challenge is to rebuild policy space, as medium-term growth dynamics now appear less favorable than before the crisis. Specifically:
- Fiscal buffers should be rebuilt over time. While emerging economies generally have much lower public debt than advanced economies, the healthy debt dynamics in many of these economies is largely due to negative interest-growth differentials,

which allow debt ratios to remain stable despite the presence of primary fiscal deficits. Thus, fiscal positions must be strengthened while balancing external downside risks against risks from rising domestic imbalances. Medium-term fiscal targets should be more ambitious in some countries (e.g., Russia: to reduce the non-oil deficit; Turkey: to support external adjustment), policy should remain embedded in existing frameworks in Brazil, while India needs substantial fiscal reform to better anchor medium-term consolidation. By contrast, economies that have sufficient fiscal space (e.g., China) can use discretionary fiscal stimulus with a view to facilitating the needed rebalancing of the economy towards consumption should downside risks materialize.

- Some emerging economies can afford to maintain current monetary policy settings or ease if downside risks materialize, while others may have to take measures to gradually tighten financial conditions. Some emerging economies should remain watchful of inflationary pressures and should not lower interest rates further. Policymakers in Brazil should begin unwinding monetary stimulus as the recovery proceeds to ensure inflation expectations remain well anchored. Room for monetary easing is also more limited where strong credit expansion continues, or where currencies are undervalued. In countries with still-elevated credit growth, supervisory and macroprudential measures should be deployed to curb sectoral excesses.
- 14. Global imbalances have narrowed considerably but old challenges remain unaddressed. Much of the adjustment in global imbalances came from demand compression in crisis-stricken deficit economies, rather than from necessary fiscal and structural adjustments. Similarly, the decline in euro area imbalances has been driven by lower demand and higher exports in the periphery and unit labor costs have moderated because of rising productivity in response to labor shedding and wage moderation including nominal cuts in some. Further policy action is needed in both deficit and surplus economies to avoid a prolonged period of low global growth. China needs to continue to promote greater consumption-driven growth and Germany needs reforms to boost domestic demand, notably investment. Reserve accumulation by China has appropriately slowed down. Going forward, it will be important to continue to allow the market to play a stronger role in determining the exchange rate. The United States should raise its saving rate further, particularly through more fiscal consolidation. Other deficit economies need further fiscal adjustment and structural reforms to boost competitiveness, particularly in the euro area periphery.

Table 1. Real GDP Growth

(Percent change)

(Fercent change)	Year over Year Averages				Q4 (Q4 over Q4	
		Est.	Projections		Projections		
	2011	2012	2013	2014	2013	2014	
World 1/	3.9	3.2	3.5	4.1	3.8	4.0	
Advanced economies	1.6	1.3	1.4	2.2	2.0	2.1	
Euro area	1.4	-0.4	-0.2	1.0	0.5	1.0	
Emerging market and developing countries 2/	6.3	5.1	5.5	5.9	5.9	6.2	
Advanced G-20	1.6	1.6	1.5	2.2	2.1	2.2	
Emerging G-20	7.3	5.4	6.1	6.5	6.2	6.6	
G-20 3/	4.1	3.3	3.7	4.3	4.0	4.3	
Argentina 4/	8.9	2.0	2.8	3.5	3.1	3.6	
Australia	2.4	3.4	3.0	3.1	4.2	2.5	
Brazil	2.7	1.0	3.5	4.0	4.0	4.1	
Canada	2.6	2.0	1.8	2.3	2.2	2.3	
China	9.3	7.8	8.2	8.5	7.9	8.8	
France	1.7	0.2	0.3	0.9	0.3	1.2	
Germany	3.1	0.9	0.6	1.4	1.3	1.1	
India	7.9	4.5	5.9	6.4	5.8	6.3	
Indonesia	6.5	6.0	6.3	6.5	6.6	6.5	
Italy	0.4	-2.1	-1.0	0.5	0.1	0.4	
Japan	-0.6	2.0	1.2	0.7	2.6	-0.1	
Korea	3.6	2.2	3.2	3.9	4.0	4.0	
Mexico	3.9	3.8	3.5	3.5	4.9	2.5	
Russia	4.3	3.6	3.7	3.8	4.4	3.4	
Saudi Arabia	8.5	6.8	4.2	3.8	3.7	3.6	
South Africa	3.5	2.3	2.8	4.1	4.2	4.1	
Turkey	8.5	2.6	3.4	4.2	3.7	4.5	
United Kingdom	0.9	-0.2	1.0	1.9	1.4	2.0	
United States	1.8	2.3	2.0	3.0	2.4	3.2	
European Union	1.6	-0.2	0.2	1.4	1.0	1.2	

Source: IMF, January 2013 World Economic Outlook Update.

^{1/}The quarterly estimates and projections account for 90 percent of the world purchasing-power-parity weights.
2/The quarterly estimates and projections account for approximately 80 percent of the emerging market and developing countries.
3/G-20 aggregations exclude European Union.
4/Figures on real GDP growth are based on official data. The IMF has called on Argentina to adopt remedial measures to address the quality of the official GDP. The IMF staff is also using alternative measures of GDP growth, including data produced by private analysts, which have shown significantly lower real GDP growth than the official data since 2008.