GROUP OF TWENTY

Global Prospects And Policy Challenges

G-20 Finance Ministers and Central Bank Governors' Meetings
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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

The global recovery has weakened further amid increasing financial turbulence and falling asset prices. Activity softened towards the end of 2015 and the valuation of risky assets has dropped sharply, especially in advanced economies, increasing the likelihood of a further weakening of the outlook. Growth in advanced economies is modest already under the baseline, as low demand in some countries and a broad-based weakening of potential growth continue to hold back the recovery. Adding to these headwinds are concerns about the global impact of China's transition to more balanced growth, along with signs of distress in other large emerging markets, including from falling commodity prices. Heightened risk aversion has triggered global equity market declines and brought a further tightening of external financial conditions for emerging economies. Strong policy responses both at national and multilateral levels are needed to contain risks and propel the global economy to a more prosperous path.

These developments point to higher risks of a derailed recovery, at a moment when the global economy is highly vulnerable to adverse shocks. Financial market turbulence and asset price declines have tightened financial conditions in advanced economies and, if persistent, could further weaken growth. Emerging market stress could rise more, also reflecting domestic vulnerabilities. At the same time, there is a risk that the decline in oil prices will further destabilize the outlook of oil exporters while the impact on importers generates less demand support than expected, lowering global growth and exacerbating the current low-inflation environment. Finally, shocks of a non-economic origin—related to geopolitical conflicts, terrorism, refugees, and global epidemics—loom over some countries and regions, and, if left unchecked, could have significant spillover impacts on global economic activity.

The fragile conjuncture increases the urgency of a broad-based policy response that strengthens growth and manages vulnerabilities.

- *Strengthening growth*. In advanced economies, securing higher and sustainable growth requires a mix of mutually-reinforcing demand and supply policies. On the demand side, accommodative monetary policy remains essential where inflation is still well below central banks' targets. However, a comprehensive approach is needed to reduce over-reliance on monetary policy. In particular, near-term fiscal policy should be more supportive where appropriate and provided there is fiscal space, especially through investment that boosts both the demand and the supply potential of the economy. In a number of countries, efforts to accelerate the repair of private sector balance sheets would help improve the transmission of monetary policy and support domestic demand. On the supply side, across advanced and emerging economies, credible and well-designed structural reforms remain critical to lift potential output, and can provide some near-term demand support directly and through increased confidence and expectations of higher future income.
- *Securing resilience*. In emerging economies, policymakers should reduce macroeconomic and financial vulnerabilities and rebuild resilience. In commodity exporters, fiscal buffers can help smooth the adjustment to lower commodity prices, but it will be important to plan for fiscal adjustment and new, more diverse growth models. Exchange rate flexibility, where feasible, should also be used to cushion the impact of adverse external shocks, with a temporary role for foreign exchange interventions to prevent disorderly market conditions. Rebuilding resilience also requires strengthening supervision and macro-prudential frameworks, as well as addressing corporate and banking sector vulnerabilities.

At the same time, bold multilateral actions are needed to boost growth and contain risks.

- *Coordinating the international policy response*. To support global activity and contain risks, the G20 must act now to implement forcefully the existing G-20 growth strategies and plan for coordinated demand support using available fiscal space to boost public investment and complement structural reforms.
- *Enhancing the global financial safety net and oversight*. To address the potentially protracted risks faced by commodity exporters and emerging markets with strong fundamentals but high vulnerability, there may be a need to consider reforms to the global financial safety net, including new financing mechanisms.
- *Ring-fencing spillovers from non-economic shocks*. Countries at the center of the current refugee crises and epidemics are shouldering a burden for others and could be backed up by a coordinated global initiative —with those at risk from spillovers contributing financial support, and multilateral agencies, including the Fund, reassessing how they can best help channel those resources to areas of most need.

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RECENT DEVELOPMENTS, OUTLOOK, AND RISKS

The recovery has weakened further amid increasing financial market turbulence and falling asset prices. These developments, if they persist, could add to the existing headwinds for the global outlook, including the already modest recovery in advanced economies, China's rebalancing, the weaker-than-expected growth impact from lower oil prices, and generally diminished growth prospects in emerging and low-income economies. This points to higher risks of a derailed recovery, at a moment when the global economy is highly vulnerable to adverse shocks.

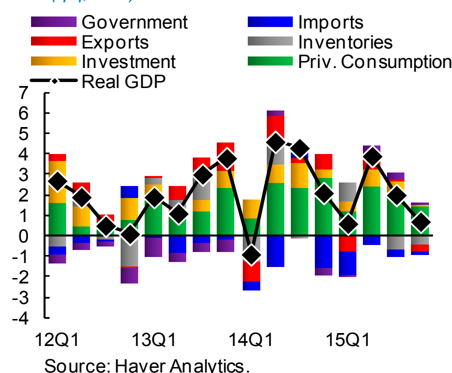
1. **Global activity has slowed unexpectedly at the end of 2015, and it has weakened further in early 2016 amid falling asset prices**. Activity in 2015Q4 seems to have softened in the United States, the euro area, and Japan. In emerging economies, China's GDP slowed in line with forecasts, while trade data suggest weak economic activity in the rest of emerging Asia. Lower oil prices and domestic strife in several economies have weakened prospects for the Middle East, and Brazil's recession has turned out deeper and more protracted than previously expected. In January, the IMF's forecasts for global growth have been revised downward by 0.2 percentage points for both 2016 and 2017, to 3.4 and 3.6 percent respectively, and a downgrade is likely as the outlook is revised for the April World Economic Outlook (WEO).

2. **The baseline outlook suggests a continuation of the modest recovery in advanced economies, and weaker growth prospects in emerging economies**.

- In *advanced economies*, the recovery will continue to be modest, reflecting a combination of weak demand and slow potential growth in the aftermath of the crisis. In the *United States*, domestic demand is expected to remain robust, supported by still easy financial conditions and strengthening housing and labor markets. However, the economy is facing headwinds owing to dollar appreciation and cuts in structures and equipment investment in the mining sector—notably in energy—prompting increasing market expectations for a slower monetary policy normalization by the Fed. The *euro area* continues to recover gradually, in part supported by lower oil prices, despite slowing net exports. However, low investment, high unemployment, and weak balance sheets weigh on growth. Growth in *Japan* remains weak but should firm somewhat in 2016, on the back of fiscal stimulus, lower oil prices, accommodative financial conditions, and rising incomes.

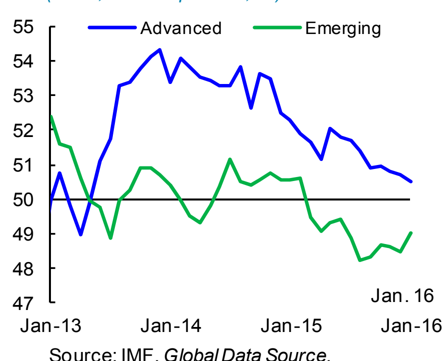
- In *emerging economies*, growth prospects remain weak in historical perspective, reflecting a variety of factors,

United States: Contributions to GDP
(q/q; saar)



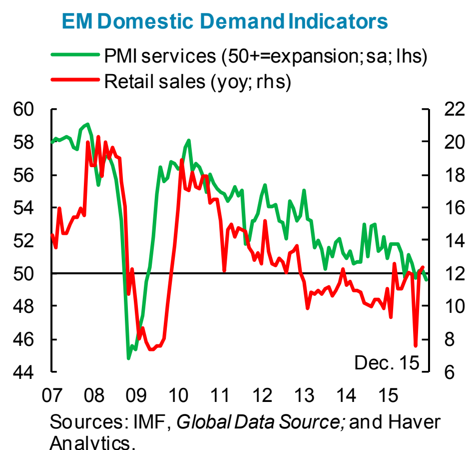
Source: Haver Analytics.

Global Manufacturing PMI
(index; >50 = expansion; sa)



Source: IMF, *Global Data Source.*

including the slowdown and rebalancing in China, lower commodity prices, and distress in some large emerging market economies. Growth is projected to increase in 2016 and 2017, primarily due to the projected gradual improvement in countries currently in severe distress. Growth in *China* is expected to slow as imbalances in real estate, credit, and investment continue to unwind and the economy rebalances towards consumption and services. *India* is projected to continue growing at a robust pace, reflecting lower commodity prices, higher real incomes, and recent policy reforms. However, recent data for *Brazil* suggest that weak business and consumer confidence amid difficult political conditions continue to weigh on domestic demand. In *Russia*, the pace of contraction triggered by lower oil prices and sanctions is expected to slow.



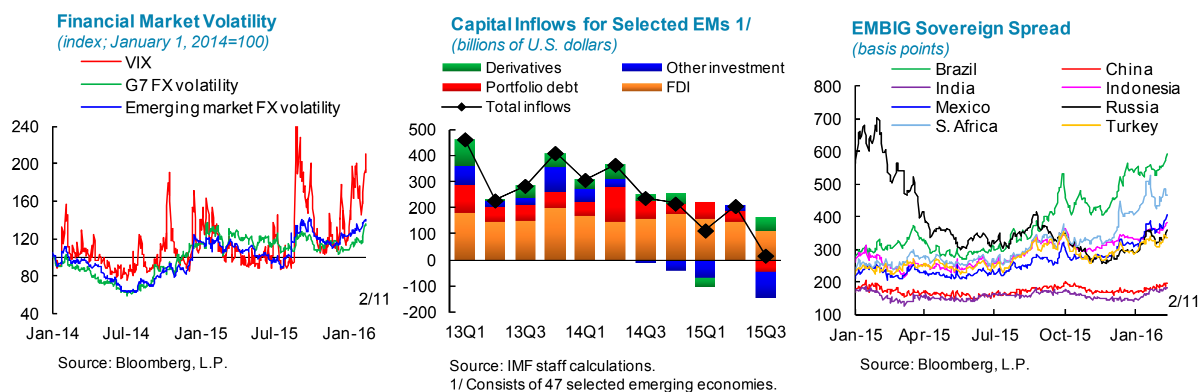
Sources: IMF, *Global Data Source;* and Haver Analytics.

3. **China's transition has been among the key factors behind the weakening of global manufacturing, trade, and investment**. The deceleration in Chinese manufacturing activity, especially in some overcapacity sectors, has brought a significant slowdown in imports and impacted commodity prices and confidence. Other important factors at play include the further deterioration in vulnerable countries, the continued need for corporate deleveraging in advanced economies, in particular the euro area, and lower global investment and trade, likely reflecting in part downward revisions in private agents' expectations about long-term growth prospects.

4. **Oil prices have further declined markedly, reflecting subdued global demand and expectations of sustained increases in production by OPEC members.** Lower oil prices strain the fiscal positions of fuel exporters and weigh on their growth prospects, while supporting household demand and lowering business energy costs in importers. Part of the decline in oil prices has been driven by higher oil supply. This should support global demand given a higher propensity to spend in oil importers relative to oil exporters. However, several factors have dampened the positive impact of lower oil prices. First and foremost, financial strains in many oil exporters reduce their ability to smooth the shock, entailing a sizable reduction in their domestic demand. The oil price decline also has had a notable impact on investment in oil and gas extraction, also subtracting from global aggregate demand. Finally, the pickup in consumption in oil importers has so far been somewhat weaker than expected, possibly reflecting continued deleveraging in some of these economies and a limited pass-through of price declines to consumers in several emerging market and developing economies.

5. **With renewed declines in commodity prices and weakness in global manufacturing, headline inflation is set to soften again in most countries**. Core inflation rates remain generally stable and well below inflation objectives in advanced economies. Inflation developments are more mixed in emerging market economies, arising from conflicting effects of currency depreciations and lower commodity prices, alongside weak domestic demand.

6. **Financial market volatility has risen amid declining asset prices**. This adjustment is difficult to explain by weaker fundamentals alone, and may also be reflecting a correction of rich asset price valuations, some market overreaction, or a more fundamental re-assessment of the outlook and concerns about lack of policy actions. Global risk aversion has increased, in part reflecting persistent modest growth in advanced economies and questions about the speed at which China's economy is slowing and the authorities' policy responses. One result has been substantial declines in global equity markets, the widening of credit spreads, and historically low yields for safe haven government bonds. The rise in global risk aversion has led to a further tightening of external financial conditions for emerging economies in the face of their diminished growth prospects. Moreover, capital flows—particularly portfolio flows—have declined, many sovereign spreads have increased, and many currencies have depreciated further against the U.S. dollar. Financial conditions in advanced economies, while remaining accommodative overall, have seen some tightening associated with increasing yields in corporate debt markets and lower equity prices. At the same time, banks experienced sharp declines in share prices, on the back of weakening profitability, particularly in Japan and Europe, reflecting the debt overhang legacy, commodity and emerging economies' exposures, and negative rates.



7. **Reflecting the weakness of the recovery and turbulence in financial markets, the global economy is highly vulnerable to adverse shocks**. The main risks include:

- Persistent financial market turbulence and the associated asset price declines could perpetuate tighter financial conditions in advanced economies, increasing the cost of capital as well as risk premiums and interest rates. Wealth effects from asset prices declines could also weigh on consumption. Such a scenario could have a negative impact on advanced economies and, ultimately, global growth, adding to existing risks, including from further weakening of investment in the U.S. energy sector and still high non-performing loans in Europe;

- Triggered by developments in financial markets in advanced economies, a more significant and lasting rise in global risk aversion accompanied by a stronger pullback of capital flows to emerging markets may generate even tighter financial conditions in these economies. The result would be further depreciations of emerging market currencies and the possibility of significant adverse corporate balance sheet effects and funding challenges. Vulnerabilities—including those associated with further declines in commodity prices—and further negative news about

emerging economies' growth prospects could worsen the initial impact of the surge in risk aversion;

- A sharper-than-currently-expected slowdown in China, with stronger spillovers through trade, commodity prices, confidence, financial market volatility, and currency valuations (see Annex 1). This outcome could lead to a more generalized slowdown in both emerging and advanced economies, especially if it further affected investment, potential growth, and expectations of future income;

- With vanishing fiscal buffers, further declines in oil prices could mean that oil exporters would have to cut spending significantly. The absence of buffers might have further detrimental effects on global activity relative to the baseline, especially if the decline in oil prices fails to deliver the expected boost to demand in oil-importing countries. In the current low inflation environment, this comes with a risk of a further reduction in inflation expectations;

- Finally, a worsening of geopolitical tensions and other shocks from a non-economic origin—such as terrorism, refugees, and global epidemics—loom over some countries and regions, and could have large spillover impacts on global activity, disrupting global trade, financial, and tourism flows.

POLICIES TO BOOST GROWTH AND CONTAIN RISKS

The fragile conjuncture requires a comprehensive policy response both at the national and the G-20 level. In many advanced economies, where the recovery remains disappointingly weak, both demand and supply measures are needed to deliver stronger growth gains. Emerging economies, faced with tightening external financial conditions and diminished growth prospects, should focus on managing vulnerabilities and rebuilding resilience while implementing policies to lift potential growth. At the G-20 level, the full and prompt implementation of G-20 growth strategies will support global activity. However, should global downside risks materialize, more action will be needed, and the G-20 should proactively identify policies that could be rolled out quickly if necessary.

ADVANCED ECONOMIES: TACKLING SIMULTANEOUSLY DEMAND AND SUPPLY WEAKNESSES

8. **Sustainably higher growth will come from a mix of mutually reinforcing demand support and structural reforms that raise actual along with potential output**. For example, a protracted period of weak demand can lead to lower potential output, through both hysteresis effects and persistently low investment. In turn, lower potential growth depresses expected future income, which reduces demand today. On the policy side, some structural reforms can lift supply while also providing a degree of short-run demand support, but others require supportive macroeconomic policies to speed their positive impacts while minimizing possible short-run deflationary side-effects (see below and Annex 2).

9. **Monetary policy should remain accommodative where inflation rates are still well below target**. In the *United States*, following the increase of the federal funds rate in mid-December, further actions should be well-communicated and based on clear evidence of wage or price pressures and an assessment that inflation is set to rise steadily toward the Federal Reserve's two percent medium-term objective. In the *euro area*, the ECB's asset purchase program has supported the recovery by improving confidence and financial conditions. But with inflation remaining low, the ECB should continue to signal strongly its willingness to use all the instruments available until its price stability mandate is met. Moreover, QE should be supported by a more balanced policy mix comprising fiscal support, balance sheet repair, and structural reforms. In *Japan,* the introduction of negative deposit rates by the BoJ underscores its commitment to maintain inflation momentum. To benefit most from the additional easing, it should be supported with fiscal, structural, and ambitious incomes policies. Building on recent achievements, the authorities should aim for sustained wage inflation, supported by higher public sector and minimum wages, alongside labor market reforms that reduce duality.

10. **To avoid over-reliance on monetary policy, near-term fiscal policy should support the recovery where appropriate and provided there is fiscal space, focusing on investment**. Where public debt is high, commitments to credible medium-term consolidation plans can create policy space. Where necessary, fiscal consolidation should remain growth-friendly and support policies that foster innovation and productivity, while protecting the most vulnerable. In the *United States*, while the recent bipartisan fiscal agreements was an important positive step, further fiscal efforts are needed to stabilize the debt-to-GDP ratio in the medium term as interest rates gradually increase and the demographic transition intensifies. An early agreement on credible medium-term deficit reduction would provide the space to fund investments in infrastructure, to raise productivity and innovation, and enhance workers' skills. In the *euro area*, countries with fiscal space should do more to support growth—for example, through infrastructure investment in Germany. Swift implementation—and an expansion—of the EU scheme to provide public and private investment would raise growth in the short and medium term and have positive spillovers in the region. Temporary costs related to refugee expenditures should generally be accommodated, and the compatibility with current fiscal targets assessed on a case-by-case basis. In *Japan*, a commitment to fiscal consolidation centered on a pre-announced path of gradual consumption tax hikes and a strengthening of fiscal institutions would create near-term policy space to maintain growth momentum.

11. **Efforts to raise potential output through structural reforms are critical**. Credible structural reform programs, well-tailored to country needs and designed to raise long-term growth, can help build confidence and stimulate investment and consumption by raising expected future incomes. Some structural reforms, such as lowering barriers to entry in product markets, especially in services, or Active Labor Market Policies, also raise demand directly. Reduction of market rigidities not only raises potential output, it also improves the effectiveness of demand-side policies.

- In the *United States*, boosting labor supply, productivity, and growth will require simultaneous policy initiatives on a number of fronts, including an expansion of the earned income tax credit,

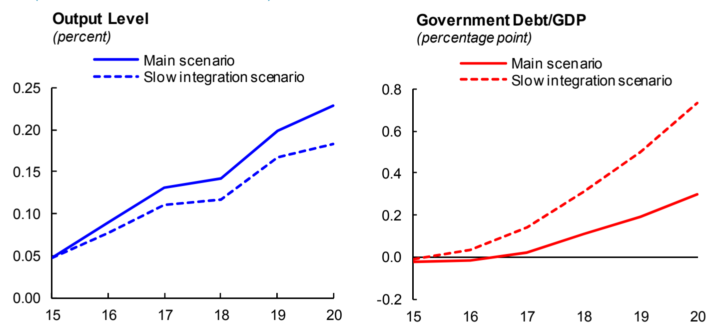
an increase in the federal minimum wage, increased family benefits, a comprehensive, skills-based immigration reform, as well as enhanced infrastructure spending, innovation incentives, and vocational training.

- In the *euro area*, national-level reforms in labor, product, and services markets, as well as in insolvency regimes, would help to improve productivity, competitiveness, and private-sector investment prospects. At the regional level, a strong push toward single markets in capital, transport, energy, and digital technologies would promote productivity-enhancing economic integration. A more effective governance framework—including outcome-based structural reform benchmarks, effective use of EU legislation and full use of SGP flexibility for structural reforms—is also needed.

- In *Japan*, incomes policies and structural reforms that raise productivity are vital to tackle medium-term risks coming from continuing lackluster growth and the overburdening of monetary policy. Structural reforms should focus on boosting labor supply, including by women and foreigners, reforming labor markets to remove duality, and deregulating further product and services markets.

12. **In Europe, policy actions to support the integration of migrants into the labor force are urgently needed**. In the short term, the macroeconomic impact of the refugee surge is likely to be a modest increase in GDP growth, reflecting the fiscal expansion flowing from support of the asylum seekers. The impact of the refugees on medium to long-term growth and the public finances depends on how effectively they can be integrated into national labor markets. Policies that can help facilitate integration include minimizing restrictions on taking up work during the asylum application phase, strengthening active labor market policies specifically targeted to refugees, providing wage subsidies to private employers who hire immigrants, and temporary exceptions to minimum or entry-level wages where these constrain employment. Initiatives to ease avenues to self-employment and facilitate skill recognition could also help refugees to succeed. Finally, reducing restrictions on refugees' geographical mobility, including those linked to housing, would allow them to move to where the probability of good job matches is high.

Impact of Refugee Inflows
(deviation from baseline scenario)



Source: IMF staff estimates.
1/ The simulation was conducted using the IMF EUROMOD model and assumes two simultaneous shocks, one to the size of the population reflecting the expected magnitude of refugee inflows in 2015-2017 and the other one to government expenditure to reflect the anticipated fiscal cost of supporting asylum seekers. For details on assumptions, see IMF January 2016 Staff Discussion Note/16/02.

EMERGING ECONOMIES: REDUCING VULNERABILITIES AND INCREASING POTENTIAL OUTPUT

13. **In emerging economies, managing vulnerabilities and rebuilding resilience are high priorities in a context of tightening external financial conditions**. An effective response requires strengthening supervision and macro-prudential frameworks, as well as addressing corporate and

banking sector vulnerabilities. Those *commodity exporters* that still have fiscal buffers should use them to smooth the adjustment to lower commodity prices. Many countries, however, will need to plan for fiscal adjustment, including through reduced but more efficient public expenditures and stronger fiscal frameworks, mobilizing new sources of revenues, as well as new growth models. Exchange rate flexibility can usefully cushion the impact of adverse external shocks, provided that the effects of currency depreciations on balance sheets and domestic inflation rates are contained. While net *commodity importers* benefit from reduced inflation pressures and external vulnerabilities, the scope for monetary policy easing could be limited in a context tighter external financing conditions. More specifically:

- In *China*, the challenge is to achieve a transition to a more balanced growth model while reducing vulnerabilities from excess leverage and strengthening the role of market forces, including in the foreign exchange market. The authorities should ensure clear communication of their exchange rate policies and be willing to accept the moderately lower growth consistent with rebalancing. In other words, the quality of growth matters, not just the quantity. If growth risks slipping significantly below a prudent range, the first line of defense should be on-budget fiscal stimulus that supports the rebalancing process. Although the transition process is likely to entail foreign significant spillovers through trade and commodities, possibly amplified by financial channels, a well-managed rebalancing of China's growth model would benefit global growth down the road and reduce tail risks. The international community should support China's efforts to reform and rebalance its economy.

- In *India*, while external vulnerabilities have moderated and inflation has fallen faster than expected, persistently high inflation expectations and large fiscal deficits remain key macroeconomic challenges. The monetary policy stance needs to remain tight to ensure a durable reduction in inflation and inflation expectations. Fiscal consolidation should continue, underpinned by comprehensive tax reform and further reductions in subsidies. Vulnerabilities in corporate financial positions and public bank asset quality could threaten financial stability if left unaddressed.

- In *Brazil*, an appropriate macroeconomic policy mix and restored policy frameworks are imperative for a turnaround in confidence and investment once major political uncertainties are resolved. The government should pursue fiscal consolidation by addressing rigidities and unsustainable mandates on the spending side, including in the social security system, and through tax measures and discretionary spending cuts to bolster fiscal results in the short run. The reduction in inflation toward the 4.5 percent target by 2017 will require a tight monetary policy stance.

- In *Russia*, given the magnitude of the negative shock to revenues from lower oil prices, some spending adjustment is necessary in 2016, and fiscal consolidation should continue over the subsequent medium term. Reestablishing the three-year fiscal framework around a revised oil price rule would help reduce policy uncertainty and support the adjustment. The recent pause in monetary policy easing has been appropriate given the risks to inflation from ruble depreciation,

external risks, and the need to build credibility under the newly introduced inflation targeting regime.

14. **Policymakers need to press on with structural reforms to lift growth and ensure continued convergence**. Reforms should focus on alleviating infrastructure bottlenecks, facilitating a dynamic and innovation-friendly business environment, and bolstering human capital. In *China*, good progress has been made on financial liberalization and laying the foundations for stronger local government finances, but the reform strategy for state-owned enterprises needs to be more ambitious and its implementation accelerated. While this reform aims at modernizing corporate governance, it continues to emphasize the strategic role of the state while providing no clear road map to a substantially greater role for the private sector and to imposing hard budget constraints. In *India*, authorities should build on recent progress to further relax long-standing supply bottlenecks, especially in the energy, mining, and power sectors, as well as in the food storage and distribution sectors. Implementing labor market reforms also remains a priority. In *Brazil*, structural reforms to raise productivity and competitiveness, and implementation of the infrastructure concessions program, are key. In *Russia*, structural reform should focus on enhancing governance and property-right protection, lowering administrative barriers and regulation, increasing competition in domestic markets, and reinvigorating the privatization agenda as soon as market conditions permit.

MULTILATERAL ACTIONS TO BOOST GROWTH AND RESILIENCE

15. **Strong action is needed to achieve full implementation of the G-20 growth strategies across countries now, which would provide a significant boost to the global economy at a critical moment**. The most recent assessment prepared by the IMF and the OECD for the Antalya Summit suggested that just under half of key commitment measures have been fully implemented, with several large countries showing below-average implementation. The implemented measures are estimated to raise potential G-20 GDP by around 0.8 percent by 2018—just slightly above one third of the 2.1 percent target. While most other measures are assessed as "in progress," they are subject to a number of implementation risks.

16. **In implementing and strengthening structural reforms, prioritization and sequencing should be tailored to the macroeconomic context and country circumstances based on some core principles.** As emphasized above, the growth impact of structural reforms depends on the complex interplay of their supply and demand effects, including their impact on confidence and transitory costs (see Annex 2). Against this background, recent work at the IMF suggests that the principles guiding successful structural reforms should be informed by an economy's stage of development and the distance to the frontier on structural performance, as well as its position in the business cycle and the available macroeconomic policy space.

17. **The global economy needs bold multilateral actions to boost growth and contain risk**. The G20 must plan now for coordinated demand support using available fiscal space to boost public investment and complement structural reforms, and act to implement forcefully the existing G-20

growth strategies. There is scope to go beyond the agreed strategies and introduce significant new measures designed along the principles of successful reforms to further boost output.

18. **Promoting further trade integration is another area through which multilateral action can promote efficiency and productivity gains**. There is scope for further trade integration and participation in global value chains. The G-20 can promote trade integration through multilateral and, where appropriate, regional trade initiatives, and should buttress this with a strong commitment to stop and roll back protectionist measures. The recent conclusion of the Trans-Pacific Partnership is very welcome. But the challenge now is to establish a clear path forward for the multilateral trade system, post-Doha, to advance integration at a more global level. An open architecture that allows different speeds and depths of liberalization can advance trade integration, especially if complemented by coordination among preferential and multilateral efforts so as to avoid fragmenting the global trading system.

19. **Collective efforts should focus urgently on further enhancing the global financial safety net and strengthening financial oversight**. Given the high likelihood of spillovers in the interconnected international financial system, the global safety net should be enhanced to better manage the risks associated with capital flows. In particular, there may be a need to consider new financing mechanisms to address the risks faced by commodity exporters and emerging markets with strong fundamentals but high vulnerability to spillovers. Based on a stocktaking of member-country experiences with capital-flow liberalization and management, the Fund will also conduct a review this year of appropriate policies to effectively address financial-account risks, including macro-prudential and capital flow management measures. Attention will focus on source as well as recipient countries. Moreover, there remains a pressing need at the global level to complete and implement the regulatory reform agenda. Advanced economies and emerging market economies should also continue strengthening the regulation and supervision of rapidly expanding financial activities outside the banking system.

20. **Finally, the G-20 needs to consider a new mechanism to contain geopolitical spillovers that threaten the global recovery.** Shocks of a non-economic origin—such as refugee flows triggered by geopolitical conflicts and global epidemics—affect some countries and regions, and, if left unchecked, could have significant spillover effects on the global economy. However, the world is lacking a mechanism to handle these issues. Many countries at the center of such shocks are shouldering a burden for others, with often limited capacity and fiscal space. Recognizing the global public good nature of their actions, they could be backed up by a coordinated worldwide initiative to provide financial support, with those at risk from such spillovers contributing necessary resources and multilateral agencies, including the Fund, reassessing how they can best help channel those resources to areas of most need.

Table 1. Real GDP Growth

(percent change)

	Year over Year					
		Estimates	Projections (from Jan. 2016)		Deviations (from Oct. 2015)	
	2014	2015	2016	2017	2016	2017
World 1/	**3.4**	**3.1**	**3.4**	**3.6**	**-0.2**	**-0.2**
Advanced economies	1.8	1.9	2.1	2.1	-0.1	-0.1
Euro area	0.9	1.5	1.7	1.7	0.1	0.0
Emerging market and developing countries 2/	4.6	4.0	4.3	4.7	-0.2	-0.2
Advanced G-20	1.8	1.9	2.1	2.1	-0.1	-0.1
Emerging G-20	5.2	4.6	4.5	5.0	-0.2	-0.1
G-20 3/	3.6	3.3	3.4	3.7	-0.2	-0.1
Argentina 4/	0.5	1.5	-1.0	2.6	-0.3	2.6
Australia	2.6	2.4	2.6	3.1	-0.3	0.0
Brazil	0.1	-3.8	-3.5	0.0	-2.5	-2.3
Canada	2.5	1.2	1.7	2.1	0.0	-0.3
China	7.3	6.9	6.3	6.0	0.0	0.0
France	0.2	1.1	1.3	1.5	-0.2	-0.1
Germany	1.6	1.5	1.7	1.7	0.1	0.2
India	7.3	7.3	7.5	7.5	0.0	0.0
Indonesia	5.0	4.7	4.9	5.3	-0.2	-0.2
Italy	-0.4	0.8	1.3	1.2	0.0	0.0
Japan	0.0	0.6	1.0	0.3	0.0	-0.1
Korea	3.3	2.7	2.9	3.2	-0.3	-0.4
Mexico	2.3	2.5	2.6	2.9	-0.2	-0.2
Russia	0.6	-3.7	-1.0	1.0	-0.4	0.0
Saudi Arabia	3.6	3.4	1.2	1.9	-1.0	-1.0
South Africa	1.5	1.3	0.7	1.8	-0.6	-0.3
Spain 5/	1.4	3.2	2.7	2.3	0.2	0.1
Turkey	2.9	3.8	3.2	3.6	0.3	-0.1
United Kingdom	2.9	2.2	2.2	2.2	0.0	0.0
United States	2.4	2.5	2.6	2.6	-0.2	-0.2
European Union	1.4	1.9	2.0	2.0	0.1	0.0

Source: IMF, *World Economic Outlook* January 2016 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/ The data for Argentina are officially reported data as revised in May 2014. On February 1, 2013, the IMF issued a declaration of censure, and in December 2013 called on Argentina to implement specified actions to address the quality of its official GDP data according to a specified timetable. On June 3, 2015, the Executive Board recognized the ongoing discussions with the Argentine authorities and their material progress in remedying the inaccurate provision of data since 2013, but found that some specified actions called for by the end of February 2015 had not yet been completely implemented. The new government has announced its intention to improve the quality of GDP statistics, and temporarily suspended the publication of GDP statistics to review the national accounts methodology. The Managing Director will report to the Executive Board on this issue again by July 15, 2016, in line with the procedures set forth in the IMF legal framework.
5/ Permanent invitee.

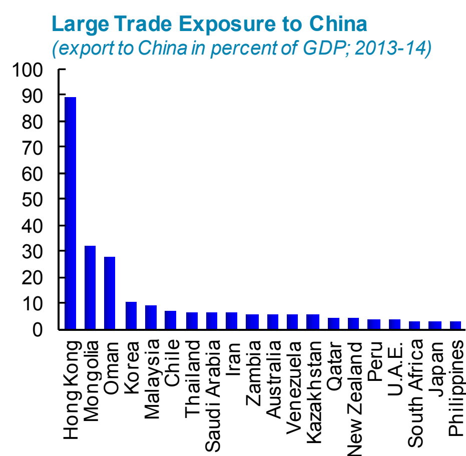
Annex I. Spillovers from Slower Growth in China[1]

China's transition to a slower yet more sustainable growth path would benefit global growth and reduce tail risks. While the transition is proceeding broadly as expected, it is still fraught with uncertainty and likely to entail significant spillovers through trade and commodities, which could be amplified by financial channels. Economies most exposed to these spillovers are commodity exporters, those within the Asian supply chain, and machinery exporters.

Nature of China's slowdown. The current slowdown in China's growth has been mainly driven by investment and exports. The weakening in investment likely reflects a correction after an extended period of very rapid growth. While the reasons for the slowdown in exports are still unclear, weak external demand and the renminbi's real appreciation up to August 2015 are believed to have contributed to it. With investment relying heavily on imports of commodities and machinery, the ongoing transition will likely result in weaker demand growth for these products.

Spillovers. China's size and large footprint in global markets means that its transition will entail global spillovers, especially through trade channels. These trade effects are both direct (reduced demand for trading partners' products) and indirect (impact on world prices for specific goods, for example, commodities). They are likely to be reflected in the affected countries' exchange rates and asset markets.

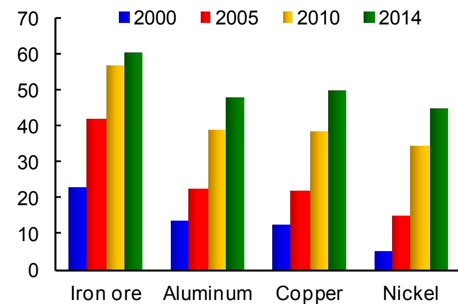
- **Trade.** This is the main channel through which developments in China affect the rest of the world. China is one of the main trading partners (top ten) for over 100 economies that account for about 80 percent of world GDP. Given its key role in global and regional supply chains—importing intermediate and capital goods, and exporting processed goods—China can also transmit shocks that originate in other countries. Furthermore, over the past decade, China's role as a source of final demand has also increased markedly. In particular, China's imports of final capital goods and consumption from Europe and the United States are material. Staff analysis suggests that a 1 percentage point investment-driven fall in China's output growth would reduce G-20 growth by ¼ percentage points.



[1] Based on a note prepared by an IMF staff team comprising Ran Bi, Christina Kolerus, Weicheng Lian, Papa N'Diaye, Tessy Vasquez Baos, Esteban Vesperoni, Christian Saborowski, Emil Stavrev, Katsiaryna Svirydzenka, Sweta Saxena, and Hong Yang.

- **Commodities.** China is a major importer across a range of commodities, especially metals, for which it accounted for around 40 percent of total global demand in 2014. The slowdown has had a significant impact on the demand for and prices of commodities. Metals prices have fallen steadily since early 2011 (by almost 60 percent on average). This has generated a large excess capacity in mining sectors and forced exporters to adjust to an environment of lower revenues. The January 2016 World Bank commodity report highlighted that a 1 percentage point drop in China's growth could result in a 6 percent average decline in commodity prices after two years.

China's Share of Global Consumption
(percent)



Sources: Bloomberg, L.P.; IMF, Primary Commodity Price System; World Bureau of Metal Statistics; and IMF staff estimates.

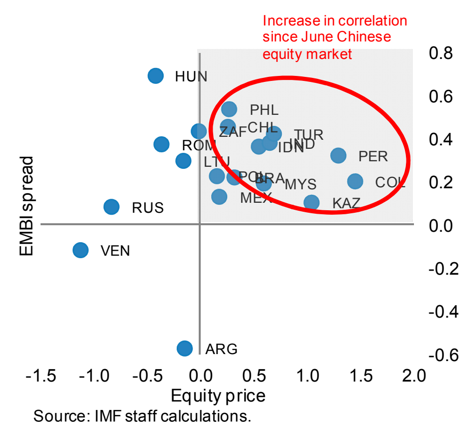
- **Manufacturing.** Excess capacity in some segments of the Chinese manufacturing sector can contribute to lowering the prices of specific manufactured products (e.g., steel) and hence affect China's competitors.

- **FDI.** China's direct investment abroad stood at around $1 trillion in June 2015 and accounted for a significant share of recipient countries' output. However, lower demand for commodities or a bumpier-than-expected transition could reduce such investments.

- **Financial.** While China's capital controls limit direct financial spillovers on the rest of the world, concerns about the speed at which China's economy is slowing and uncertainty about the authorities' policy responses are having an impact on global markets, affecting equity prices, exchange rates, and bond yields, and increasing volatility.

- **Equity prices.** With commodity-related shares representing an important fraction of world market capitalization, concerns about China's economy and its rebalancing could increase global risk aversion and impact a broad range of asset classes. Meanwhile, the correlation between Chinese asset prices and most major EMs' has increased, especially for commodity exporters and those with large trade exposures to China. While this increased correlation may reflect higher global risk aversion and volatility, it is also possible that asset markets in these countries are being affected more severely by disappointing news about the Chinese economy.

Change in Correlation with Chinese Asset Prices
(Nov 1, 2014-Jun 9, 2015 vs. Jun 10, 2015-Sep 23, 2015)



Source: IMF staff calculations.

- **Exchange rates.** Economies with export mixes similar to China's would benefit (lose) through trade from an appreciation (depreciation) of the renminbi. So, in general, would countries that export to China, although those that sell it intermediate products for re-export could see these effects muted or even reversed. The path of the renminbi during China's transition will likely

have significant spillover effects on competing economies and China's suppliers. Developments in exchange markets can also affect corporates and households with large FX exposures.

- **Cross-border banking.** BIS data on cross-border bank holdings show that foreign banks' claims on Chinese entities—including guarantees, derivatives contracts, and credit commitments—stood at around $1 trillion in 2015 Q3, declining by about 15 percent compared to end-2014. This exposure, though, remains small relative to source countries' banking systems.

Annex II. The Growth Impact of Supply and Demand Policies[2]

Supply side policies will lift output over the longer term. However, while future gains from labor and product market reforms and the channels through which they increase productivity, lower unemployment, or raise labor force participation are fairly well documented, much less is known about their short- to medium-term effects on aggregate output, employment, and inflation.[3]

Credible structural reforms can support short-term growth as well. In general, reforms that strengthen confidence and lift expectations of future income have the potential to raise consumption and investment. Moreover, some measures—such as active labor market policies or lowering taxes on production inputs—can simultaneously deliver fiscal stimulus and, thereby, raise domestic demand. On the product or services market side, lowering anti-competitive barriers to firm entry can create new investment and hiring as new firms expand.

That said, some reforms can also inflict transitory costs due to frictions in labor and product markets. For example, looser employment-protection legislation may induce firms to dismiss some workers immediately, and these newly unemployed may need time to find jobs. As a result, unemployment may increase, aggregate demand may decline, and output may contract for some time (Cacciatore and others, 2015). Likewise, lowering entry barriers in non-tradable sectors may lead incumbent firms to downsize quickly, whereas entry of new firms and the associated job creation may be more gradual. Such short-run losses may be larger in periods of major economic slack, where the willingness and ability of new firms to enter the market are weaker, and the incentives for incumbent firms to lay off workers are stronger (Cacciatore and others, forthcoming). Furthermore, if they imply falling wages and prices, reforms may increase the real interest rate in countries where monetary policy is constrained, thereby weakening aggregate demand and delaying recovery rather than speeding it up (Eggertsson and others 2014). This possibility is particularly relevant in the current low inflation environment.

As a consequence, complementary demand-side policies may be needed to make supply-side reform more effective and politically sustainable. In particular, such policies can frontload the long-term gains of structural reforms and alleviate their short-run costs, particularly in periods of weak growth. There are three inter-related, but conceptually distinct, channels through which accommodative macroeconomic policies can raise the short-term response of output and employment to reforms:

- **Amplifying structural reform effects.** By improving overall business conditions, macroeconomic policy stimulus alters the incentives of firms and workers in ways that make their response to reform more growth-enhancing. Indeed, new IMF staff analysis based on a

[2] Prepared by Romain Duval (IMF, Research Department).

[3] For example, see Bouis and Duval (2011) and the studies cited therein, which have been used to estimate the gains from reforms in the context of the G-20 Mutual Assessment Process.

panel of advanced economies spanning four decades finds that job protection reforms have more beneficial employment effects when accompanied by fiscal expansion, where fiscal space exists (Duval and Furceri, forthcoming). This suggests that, in the presence of demand-side support, firms are more willing to recruit new workers (and retain more existing workers) when employment protection legislation is relaxed. Likewise, under fiscal stimulus, new firms may be even more willing to enter markets when entry barriers are lowered; and workers may be less likely to curtail consumption (because of precautionary saving motives or because they face tighter liquidity constraints) if the level or duration of unemployment benefits is cut.[4]

- **Being aware of multipliers.** "Fiscal" structural reforms in the labor market, such as reductions in labor tax wedges and increases in public spending on active labor market policies, may have larger positive effects during periods of low growth and when not accompanied by offsetting spending cuts or tax increases, provided there is fiscal space. This is because such reforms entail a fiscal multiplier effect, which in general tends to be larger in bad times (for instance, Auerbach and Gorodnichenko 2012; Jorda and Taylor 2013; Abiad, Furceri and Topalova 2015).

- **Anchoring inflation expectations.** Structural reforms that can potentially increase supply may have a short-term impact on prices. In light of this, amid persistent low inflation in many countries, strong and credible monetary policy frameworks that keep medium-term inflation expectations anchored and ease the zero lower bound constraint on policy rates—including quantitative easing or negative deposit rates, where relevant—can pre-empt risks that reforms create deflation, increase the real interest rate, and lower aggregate demand.

[4] Bordon and others (forthcoming) find that supportive macroeconomic policies enhance the effect of product market reforms to increase employment.

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