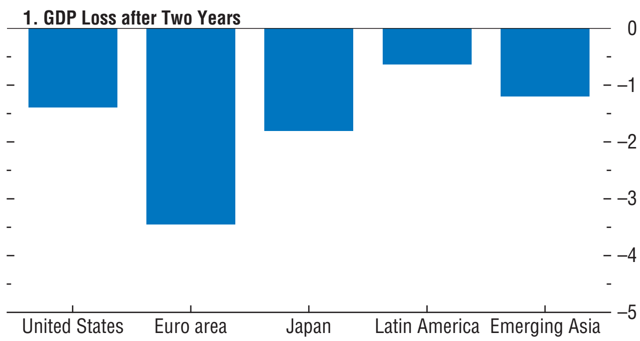
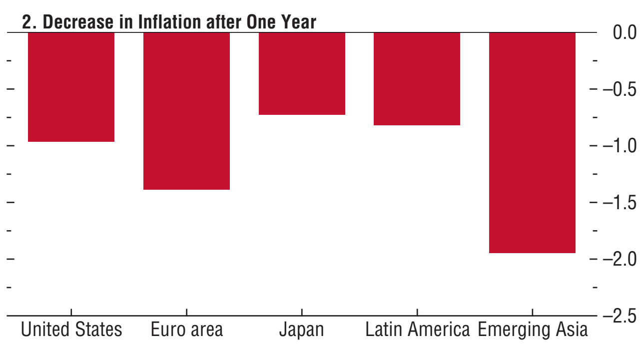
Figure 1.14. WEO Downside Scenario for Increased Bank and Sovereign Stress in the Euro Area

(Percent or percentage point deviation from WEO baseline)

This scenario uses a six-region version of the Global Economy Model (GEM) to estimate the global impact of heightened adverse feedback between banking and sovereign stress in the euro area. The scenario assumes that banks tighten lending standards and constrain credit growth to rebuild capital buffers, consistent with the April 2012 *Global Financial Stability Report* (GFSR) “weak policies” scenario. The resulting weaker growth outlook amplifies concern over fiscal sustainability, and sovereign spreads rise temporarily by roughly 100 basis points. Given increased market concern, several euro area sovereigns are forced into more front-loaded fiscal consolidation, averaging to an additional 1 percentage point of GDP in 2012 and 2013, which further depresses near-term demand and growth. Also, credit in other regions of the world is assumed to contract as it does in the GFSR weak policies scenario. Monetary policy in many advanced economies is constrained by the zero lower bound on nominal interest rates, amplifying the negative impact on activity of these adverse conditions. The global macroeconomic implications are presented below.





Source: GEM simulations.