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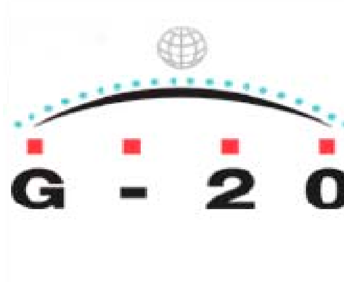

MEETING OF G-20 FINANCE MINISTERS AND CENTRAL BANK GOVERNORS

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Global Economic Prospects and Policy Challenges
Prepared by Staff of the International Monetary Fund

I N T E R N A T I O N A L   M O N E T A R Y   F U N D

G-20: The Path from Crisis to Recovery

October 2011

Key Points

- The global economy has entered a dangerous phase. Policy makers must act boldly to finish the job they began in 2009, lest the gains from the recovery since then be lost. Collective action can put the global economy on a path to strong, sustainable, and balanced growth.

- Adverse feedback loops between the real economy and the financial sector have intensified, as private and public sector balance sheets have weakened, uncertainty has been exacerbated by policy indecision, and demand rebalancing has stalled. Even assuming that policies prevent downside risks materializing, projections are for an anemic recovery in major advanced economies and a cyclical slowdown in emerging economies. Global growth is expected to fall to about 4 percent in 2011–12.

- Downside risks are severe. The immediate risk is that the global economy tips into a downward spiral of increased uncertainty and risk aversion, dysfunctional financial markets, unsustainable debt dynamics, falling demand, and rising unemployment. Even in a less severe scenario, key advanced economies could suffer from a protracted period of low growth.

- Policy action along three key fronts will help break the adverse feedback loop between weaker growth and confidence, fiscal tensions, and financial fragilities. This includes well calibrated fiscal adjustment to reassure markets; liquidity provision in the euro area to avoid deeper dislocation and relieve funding strains; and building banks' capital buffers in Europe.

- In *advanced G-20 economies*, fiscal sustainability must be restored through credible medium-term consolidation plans. Countries with high debt and facing market pressure must press ahead with "growth-friendly" consolidation now. In others, fiscal policy should navigate between the perils of undermining credibility and undercutting recovery, and facilitate a pick-up in private demand. To alleviate prevailing market pressures in the euro area, the ECB should continue its extended liquidity operations and sustain the Securities Market Program (SMP) alongside the support provided by the European Financial Stability Facility (EFSF) for as long as necessary to stabilize issuance costs for banks and sovereigns. At the same time, banks should be urged to build capital buffers in a coordinated fashion, using national public and euro area resources, including the EFSF, if necessary.

- In *emerging G-20 economies*, near-term policy should focus on responding to spillovers from moderating growth in advanced economies and heightened global risk aversion in financial markets, subject to available policy space. In key surplus economies, fostering sustained, inclusive medium-term growth requires removing distortions, implementing structural and financial reforms, and moving to a more market-based exchange rate.

THE GLOBAL CONJUNCTURE

1. **Global activity has weakened and confidence has fallen sharply.** Weakening economic activity and heightened financial stress are reinforcing each other, reflecting, fundamentally, the inadequate repair of balance sheets across major advanced economies. The dual rebalancing acts needed to secure strong, sustainable, and balanced growth—a handover from public to private demand in major advanced economies, and stronger domestic demand growth in external surplus economies—have stalled.

2. **Mutually-reinforcing macro-financial stresses have risen again, and sharply.** Concerns over the sustainability of public debt in the euro area have intensified and broadened to some of the area's core economies, heightening fears over the health of the area's banks. Bank equity prices have fallen sharply, credit default spreads have widened, and funding access for some banks has been reduced. The direct spillover to EU banks from the perceived increase in sovereign credit risks from high-spread countries since the outset of the crisis is estimated at around €200 billion.[1] Spillovers outside of the euro area are intensifying, with financial institutions reliant on wholesale funding also coming under pressure. Thanks to exceptional liquidity support from key central banks, interbank funding stresses are still less elevated than at the time of the collapse of Lehman Brothers in 2008, and equity prices are still above post-Lehman lows. However, sovereign debt stresses are now more elevated in Europe, and this has led to higher perceived risks of some European banks.

Figure 1. Cumulative Spillovers from High-Spread Euro Area Sovereigns to the European Union Banking System
(billions of euros)

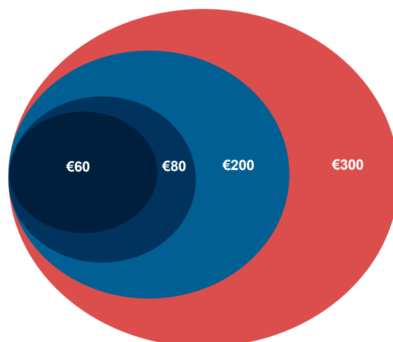
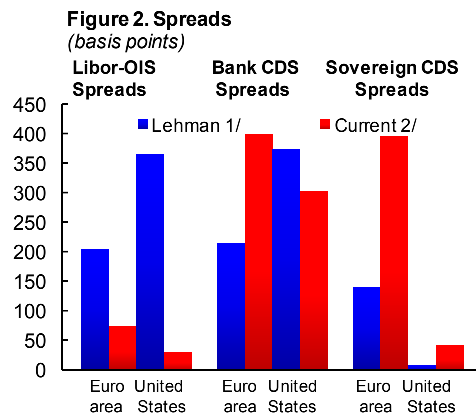


Figure 2. Spreads
(basis points)

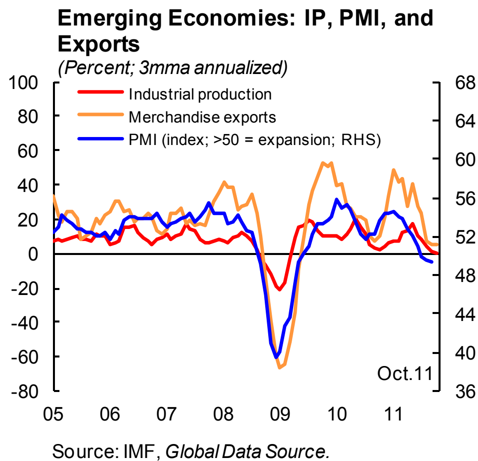


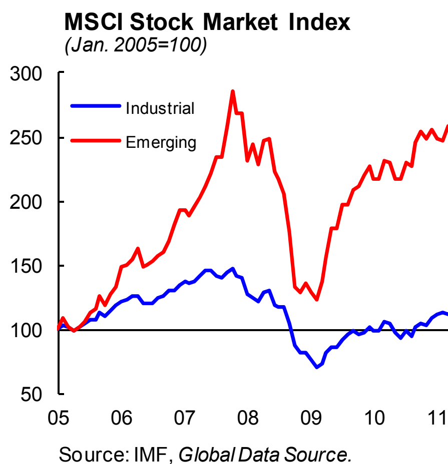
1/ Worst during period September 15, 2008 to April 30, 2009.
2/ October 3, 2011 or latest available.

3. **There are now clear signs of a real slowdown in emerging economies.** Spillovers from moderating growth in

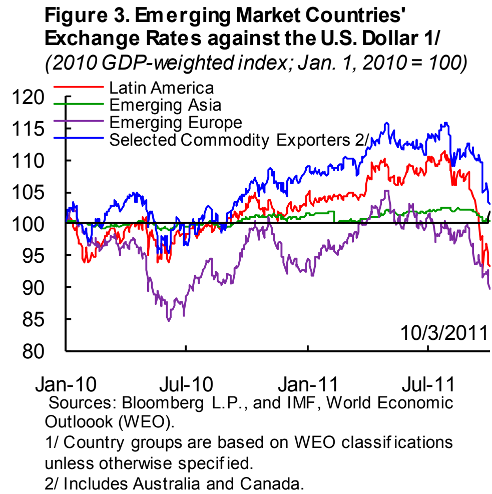
[1] This is not a measure of capital needs of banks. The methodology and caveats applying to this exercise are explained in the September 2011 Global Financial Stability Report (Box 1.3).

advanced economies and heightened global risk aversion have contributed to a slow down and dimming of prospects in emerging economies. This is reflected in a moderation of PMIs, industrial production, and merchandise exports, as well as in financial market indicators.

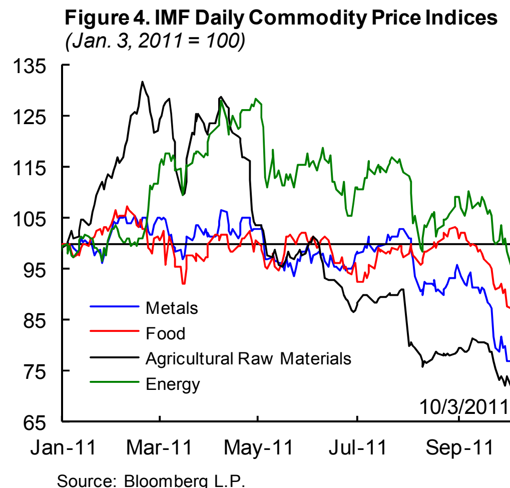


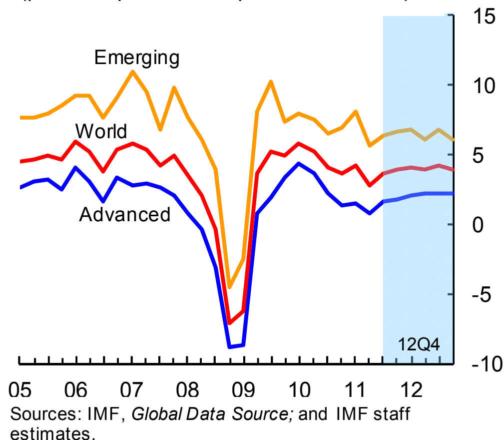


4. **Exchange rates of emerging economies and some commodity exporters have experienced sizable depreciations against the U.S. dollar and Japanese yen**. Depreciations have been larger for emerging economies with deeper, more liquid financial markets, flexible exchange rates, and geographical proximity to the euro area. These moves, while reversing some of the preceding appreciation, are accelerating and largely reflect rising global growth concerns, higher risk aversion and the unwinding of carry trades in some markets, and falling commodity prices.



5. **Commodity prices have fallen and are being affected by the same global factors as exchange rates in emerging economies.** In particular, the outlook for demand has deteriorated and risk aversion has increased. Commodities more sensitive to the economic cycle, such as metals, have fallen most sharply but recent declines have been broad and include both crude oil and food. This also





partly reflects supply factors, including increased oil output from OPEC members, notably Saudi Arabia, to offset supply losses from Libya and upward revisions to still-low grain inventories in the United States. Physical activity in commodity markets is still robust, largely due to emerging markets and China, but slowing activity indicators suggest some moderation ahead.

6. **Against this backdrop, staff projects a weak, uneven, and bumpy recovery, subject to major downside risks.** The September 2011 World Economic Outlook projections show that the United States, euro area, and Japan are projected to grow by only around 1½ percent in 2011–12, reflecting weak financial and household balance sheets that are holding back private demand. In emerging and developing economies, a mixture of weaker external demand, capacity constraints, and policy tightening is expected to lower growth from about 7½ percent in 2010 to 6 percent in 2012. *Crucially, these projections assume that current policy commitments will be met and thus macro-financial conditions will not deteriorate further. If downside risks were to materialize, growth would be substantially lower.*

7. **A weak recovery means that unemployment will remain high in many economies.** In the United States, exceptionally high job losses during the crisis followed lackluster employment generation during the previous decade, leaving households more worried than any time since the 1980s about future income prospects. Persistently high unemployment may result in a permanent loss of work skills. Unemployment rates are also high in Europe, especially in the crisis-hit economies, as well as in emerging economies such as the Middle East and North Africa region, where structural unemployment has contributed to political instability.

KEY RISKS

8. **Downside risks have increased and are severe.** The overarching risk is of a global "paradox of thrift" as households, firms, and governments around the world reduce demand, with many advanced economies unable to lower policy rates further. Immediate risks are centered in the major *advanced G-20 economies*, principally the euro area and the United States. Uncertainties about the program in Greece are fuelling market fears of a disorderly default that would have large spillover effects.

- **Sovereign debt and bank funding pressures in the euro area:** High sovereign funding costs and low growth rates risk undermining fiscal sustainability and raising already intense pressure on banks holding such sovereign debt. Conditions in European wholesale funding markets could worsen further, due to heavy reliance on these markets. The financial stress already spreading to the rest of the world would escalate. While deleveraging by banks is already taking place, in an extreme case, major unexpected defaults or failures in the financial system could trigger large adverse spillovers in the real economy, notably by banks further cutting back their lending and shrinking sharply their balance sheets.

- **Household and public debt sustainability in the United States:** Household and fiscal stresses could produce severe downside scenarios. Recent declines in financial asset prices have further reduced household net wealth already hit by the housing market collapse, damaged confidence, and contributed to lower spending growth. Debt deflation could weigh on activity for many years. Sharp near-term fiscal cutbacks without long-term expenditure or revenue reforms would further weaken the outlook for growth. Continued low growth, without necessary fiscal medium-term consolidation, could cause an increase in risk premiums and interest rates on U.S. bonds, with adverse effects for public debt sustainability.

9. Emerging G-20 economies could be hit severely by a further downturn and an intensification of financial stress in advanced economies.

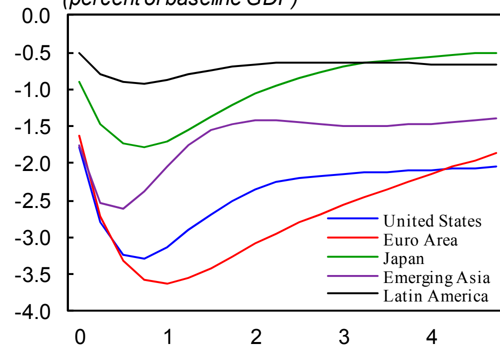
- **There are now clear signs of a real slowdown in several emerging economies.** A further deterioration in global financial conditions, including due to funding stress among euro area or wholesale-funding dependent banks or concerns about fiscal sustainability in major advanced economies, raises the risks of abrupt and potentially large capital outflows. Notwithstanding their resilience so far, emerging G-20 economies exhibit vulnerability to shifts in global risk aversion—recent exchange rate depreciations have been associated with a pick-up in capital outflows from local markets and increased demand for hedging of currency risk. The experience of 2008 underscores that capital reversals can intensify rapidly and economies that have large direct linkages with the euro area banking system would be most at risk.

- **Trade-dependent emerging economies would be especially vulnerable to a sustained downturn in advanced economy growth, but also market stresses that impede the provision of trade financing.** Weaker global growth would reduce commodity prices and adversely affect the export revenues of

commodity exporters. Analysis of downside scenarios for GDP growth in advanced economies suggests that such effects could be substantial.

- **Weaker global demand and intensified global financial stress could expose underlying vulnerabilities from excessive credit growth** (e.g., borrowing by local government vehicles, incautious infrastructure projects, expanding off-balance sheet activities by banks, and property bubbles). Declining real activity and volatile capital flows could therefore undercut high real estate prices in various emerging economies, raising nonperforming loans, and thereby setting off another deleveraging cycle.

Figure 6. GDP Losses in Downside Scenario 1/
(percent of baseline GDP)



1/ The scenario assumes major turbulence in the euro area banking sector and weakened medium-term growth prospects in the United States. See the September 2011 World Economic Outlook for more details of a similar exercise.

10. **Global risks are closely linked and rise and fall together.** Furthermore, as elaborated in the IMF Spillover Reports, when risks materialize, they are rapidly transmitted across the world by financial and commodities markets. This would compound the negative effects from trade channels.

POLICIES

11. **Policy responses are urgently needed to decisively reduce rising uncertainty and fear.** The world economy has entered a dangerous phase in which negative developments could quickly run beyond the control of policy makers. Policy actions along three fronts will help break the adverse feedback loop between weaker growth and confidence, fiscal tensions, and financial fragilities:

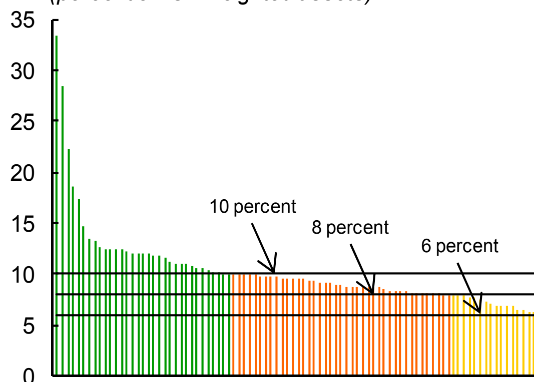
- **Credible medium-term fiscal plans, which would create space for providing further support for fledgling recovery,** and well calibrated and appropriately paced fiscal adjustment in the near term to anchor investor confidence. This need to be supported by rapid implementation of structural reforms to raise growth and enhance debt sustainability;

- **Continued liquidity provision and measures to stabilize issuance costs for banks and sovereigns in Europe in the short-run.** This is an imperative for avoiding deeper dislocation and relieving funding strains that remain at heightened levels, notably because of the uncertainty about Greece; and

- **Support for banks to rebuild capital buffers in a coordinated fashion, using public funds if necessary.**

12. **Financial repair: strengthen capital buffers; restructure and resolve weak banks.** Along with addressing sovereign tensions, removing uncertainty about the resilience of banks is the top priority for the euro area. Recovery in advanced economies will need readily-available credit to allow easy monetary conditions to pass through. Building bank capital buffers will help to achieve this by breaking the adverse feedback loop between rising sovereign spreads, deteriorating bank funding, and flagging activity. Policymakers should urge banks in need of capital to raise it from private sources, and either restructure or resolve weak banks. But public capital injections may also be necessary. National backstops should be used where fiscal space exists. Ultimately, in some European cases, this may well entail the use of pooled euro area resources, including EFSF funds. This might necessitate additional measures to make the facility more effective. Importantly, countries that do implement strong recapitalization programs should not be left to fall into a downward spiral for lack of adequate external support.

Figure 7. European Bank Core Tier 1 Ratios
(percent of risk-weighted assets)

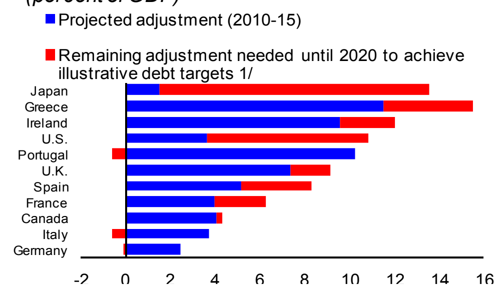


Sources: European Banking Authority; and IMF staff estimates.
Note: Includes core Tier 1 capital at end-2010, actual equity raising in from January to April 2011, and commitments made by April 2011 for equity raisings and government support.

13. **Fiscal repair: achieve sustainable balances, while supporting growth.** *Advanced G-20 economies* must articulate credible medium-term fiscal consolidation plans with specific measures embedded in a realistic macroeconomic framework. This would create more policy space for near-term support to growth and employment if needed. In the event of a further significant slowdown in growth, a number of these economies have scope to slow their current pace of consolidation, if offset by a commitment of additional tightening later.

- **In the *United States*, the proposed American Jobs Act would provide needed near-term support.** However, parallel and credible medium-term fiscal adjustment plan that raises revenues and contains the growth of entitlement spending remains essential.

Figure 8. Change in Cyclically Adjusted Primary Balances
(percent of GDP)



Source: IMF, FAD staff calculations.
1/ To reduce the gross debt ratio to 60 percent by 2030 (net debt target of 80 percent for Japan) or stabilize the debt ratio at end-2012 levels if the ratio is below 60 percent. After 2020, the primary balance must be maintained at its prevailing level until 2030 to ensure that public debt reaches its target ratio by 2030.

- ***Japan's* near-term fiscal stance is appropriate given the need to rebuild after the earthquake,** but a comprehensive and ambitious plan to put public debt on a sustainable footing over the medium term remains essential.
- **In most other *advanced G-20 economies*** (e.g., *Australia*, *Canada*, *Germany*, *Korea*, and the *United Kingdom*), current plans are appropriate, but near-term tightening should also slow if growth threatens to be substantially lower than projected, with compensating stronger medium-term adjustment.
- **Economies facing adverse private funding conditions**—such as those with IMF- and EU-supported programs—have little choice but to press ahead with current consolidation plans.

14. **Household balance sheet repair:** In the United States, halting the spiral of foreclosures, falling house prices and deteriorating household spending is essential. To help work off problems in the housing sector, expanding the existing mortgage refinancing and modification programs would be helpful, although the authorities' existing efforts in this area face a plethora of political and technical constraints. More radically, consideration could also be given to allowing the courts to modify the terms of residential mortgages.

15. **Monetary policy: maintain accommodation.** Given falling confidence and activity as well as well-anchored inflation expectations, monetary policy in *advanced G-20 economies* should remain very accommodative. There is scope for lower ECB policy rates. The Federal Reserve, Bank of England, and Bank of Japan should stand ready to continue their deployment of unconventional measures and take further steps if needed. Prudential authorities will need to be watchful of risks flowing from low interest rates.

16. **Emerging G-20 economies need to be nimble** in dealing with potentially adverse spillovers from advanced economies, and continue to strengthen macroeconomic policy frameworks. Monetary policy should be the first response to spillovers from advanced economies as long as inflationary pressures remain in check. Fiscal positions should generally aim at rebuilding policy space. However, if growth begins to slow substantially, emerging economies with fiscal space (China, Indonesia, Mexico, and South Africa) should ease the pace of consolidation, including by allowing automatic stabilizers to fully operate. Most emerging G-20 economies need to bolster their financial stability frameworks to cope with volatile capital flows, including notably from sharp swings in global risk aversion.

Collective Action

17. **Collective action can set the stage for a return to strong, sustainable, and balanced growth.** Policies should fit individual country circumstances, but if all economies work together, the risks of downward spirals can be significantly reduced and a stronger, more even recovery achieved. This is true for the urgent challenges faced today—notably addressing pressures in the financial system—and over the medium term.

18. **External rebalancing, now more important than ever, requires collective action.** Households in advanced deficit economies must continue deleveraging, in part to ensure that ongoing fiscal consolidation is not offset by deterioration in the private saving-investment balance. At the same time, sustained, more inclusive, growth in emerging surplus economies that lowers saving—including through reduced distortions, better pension, healthcare, and education systems, together with less (sterilized) intervention in foreign exchange markets—can help offset weaker demand in major advanced economies and support global growth.

19. **Coordinated policies could achieve impressive gains for the global economy.** Simulations prepared by IMF staff in collaboration with OECD staff for the Mutual Assessment Process suggest that joint actions by G-20 members aimed at the priorities above could result in an overall increase of world GDP by 1½ percent by 2016.

20. **Coordination is essential to reduce the likelihood and impact of another crisis.** Significant progress has been made, but countries urgently need to implement agreed regulatory reforms, while enhancing prudential supervision and domestic resolution toolkits. Multilateral consistency is crucial in three specific areas: systemic capital surcharges for systemically important banks; coordinated crisis management that guide information exchange and cross-border bank resolutions.; and greater transparency, in particular of the shadow banking system, and, as appropriate, expansion of the supervisory perimeter. Further progress will require increased cooperation from all stakeholders.

21. **The G-20 must strive to provide further impetus to ensuring a successful completion of the WTO Doha Round.** A Doha conclusion would boost global welfare and send a strong signal for international cooperation by providing new market access and adding security to trading relationships and limiting protectionist potential. In the meantime, maintaining the credibility of the multilateral trading system is crucial given Doha's paralysis. Policymakers must resist rising trade protectionist pressures arising from high unemployment in advanced economies and the lack of exchange rate appreciation in some emerging

economies. In addition, G-20 economies should also resist "financial protectionism." In particular, in the context of deleveraging to improve the balance sheet positions, banks should be discouraged from relying largely on liquidating their foreign asset holdings, since this can have deleterious spillover effects.

22. **The path to recovery has narrowed, but the path is still open, if action is taken now.** Countries must adopt comprehensive action across all policy levers, and implement them in a globally-coordinated way to secure strong, sustainable, and balanced growth.