



GROUP OF TWENTY

GLOBAL PROSPECTS AND POLICY CHALLENGES

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

EXECUTIVE SUMMARY

Global growth remains moderate, reflecting a further slowdown in emerging economies and a weak recovery in advanced economies. In an environment of rising financial market volatility, declining commodity prices, weaker capital inflows, and depreciating emerging market currencies, downside risks to the outlook have risen, particularly for emerging markets and developing economies.

Global growth in the first half of 2015 was lower than in the second half of 2014, reflecting a further slowdown in emerging economies and a weaker recovery in advanced economies. In advanced economies, weaker exports, partly reflecting temporary factors, and a slowdown in domestic demand were key factors. Productivity growth has been persistently weak. In emerging economies, the slowdown reflects a continuation of the adjustment after the investment and credit boom post-crisis, together with the fallout from declining commodity prices, geopolitical tensions, and conflict in a number of countries. In advanced economies, economic activity is projected to pick up modestly in the 2nd half of the year and into 2016. In emerging economies growth this year is projected to slow again relative to 2014; some rebound is projected next year, as conditions in distressed economies, while remaining difficult, are projected to improve.

Financial conditions for emerging economies have tightened. In an environment of rising financial market volatility, dollar bond spreads and long-term local currency bond yields have increased relative to the spring, stock prices have weakened, and capital inflows have declined. Emerging market currencies have generally depreciated, reflecting weakening commodity prices, concerns about the growth transition in China, an increase in risk aversion, and expectations of a lift-off in policy rates in the United States. In contrast, financial conditions in advanced economies continue to be easy. On the back of weak demand, safe real interest rates remain low, despite some widening of spreads, even as the policy rate lift-off approaches in the United States.

Risks are tilted to the downside, and a simultaneous realization of some of these risks would imply a much weaker outlook. Near-term downside risks for emerging economies have increased, given the combination of China's growth transition, lower commodity prices, potential adverse corporate balance sheet and funding challenges related to a dollar appreciation, and capital flow reversals and disruptive asset price shifts.

Strong mutual policy action is needed to raise growth and mitigate risks:

- *Advanced economies* should maintain supportive policies. In most advanced economies substantial output gaps and below-target inflation suggest that the *monetary* stance must stay accommodative. Fiscal policy should remain growth friendly and be anchored in credible medium-term plans. Managing high public debt in a low-growth and low-inflation environment remains a key challenge.
- In many *emerging economies*, policy space to support growth remains limited. The commodity price declines over the past year have alleviated inflation pressures and mitigated external vulnerabilities in net commodity importers, but increased external and fiscal vulnerabilities in commodity exporters. Oil exporters that have accumulated savings and have fiscal space can let fiscal deficits increase and allow a more gradual adjustment of public spending. For floaters with less policy space, exchange rate flexibility will be a critical buffer to the shock. This may require improving macroeconomic policy frameworks in some countries and keeping balance sheet exposures manageable.
- Decisive *structural reforms* are needed to raise potential output and productivity across the G-20 members. *Labor market reforms* in advanced economies undergoing population aging should aim at raising labor participation, and actions to increase labor demand and remove impediments to employment are also needed in euro area economies and some emerging markets. Reforms to improve the functioning of *product markets* are also needed in Japan and the euro area, and reforms to improve productivity and raise potential output are key in many emerging economies. Joint policy efforts by deficit and surplus economies are needed to reduce *excess imbalances* while sustaining growth.

DEVELOPMENTS, OUTLOOK, AND RISKS

Global growth remains moderate, reflecting a further slowdown in emerging economies and a weak recovery in advanced economies. Productivity growth in both advanced and emerging economies continues to be low, suggesting that medium- and long-term common factors are also at play. Financial conditions in advanced economies continue to be easy, but they have tightened for emerging economies. In advanced economies economic activity is projected to pick up modestly this and next year. In emerging economies, growth has slowed this year; some rebound is projected next year, as the economic outlook in distressed economies, while remaining difficult, is projected to improve. With declining commodity prices, depreciating emerging economy currencies, and rising financial market volatility, downside risks have increased, and include disruptive asset price shifts and financial turmoil, a further strengthening of the U.S. dollar, and lower growth in China.

1. **Uncertainty about emerging economies prospects has increased.** The outlook in these economies is being affected by more difficult external financial conditions. Financial market volatility has risen sharply since early-August, with declining commodity prices and downward pressure on many emerging economy currencies. And, China's transition to a lower growth, while broadly in line with forecasts, appears to have larger-than-previously-envisaged cross-border repercussions, reflected in weakening commodity prices and stock prices.

2. **Global growth in the first half of 2015 declined relative to the second half of 2014, reflecting a further slowdown in emerging markets and a weaker recovery in advanced economies.** Growth in global manufacturing, as measured by industrial production, slowed markedly over the first half of 2015, as inventories built up in late 2014 and early 2015 and investment growth slowed. World trade in volume terms contracted in the second quarter, highlighting the failure of investment to pick up as expected, but also the trade spillovers of China's growth transition. In advanced economies, weaker exports, partly due to temporary factors, and a slowdown in domestic demand were key factors. In emerging economies, the slowdown reflects a continuation of the adjustment after the investment and credit boom post-crisis, together with the fallout from declining commodity prices, weakening exchange rates, geopolitical tensions and conflict in a number of countries.

3. **In advanced economies, the pace of recovery has slowed amid protracted weakness in productivity growth.** Specifically:

- In the *United States*, growth in the first half of the year was 1.8 percent, compared to 3.8 percent in the 2nd half of 2014. The growth slowdown reflected harsh winter weather, port closures, and a strong downsizing of capital expenditure in the oil sector in Q1, and relatively sluggish business investment in Q2. Recent revisions in the U.S. national accounts suggest that productivity growth during 2012-14 was lower than previously thought.
- In *Japan*, a strong rebound in Q1 was followed by a contraction of 1.6 percent (q-o-q, saar) in Q2 due to a sharp fall in exports and private consumption, driven by the slowdown in emerging markets and weak compensation growth, respectively.

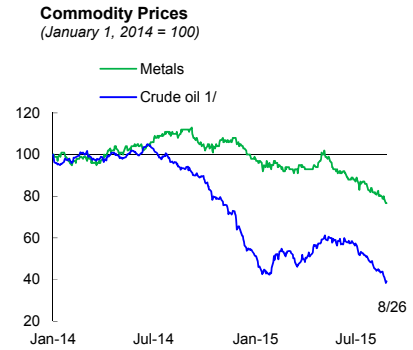
- In the *euro area*, preliminary Q2 growth was somewhat weaker than expected, with a negative surprise in Germany, and stronger-than-expected growth in Italy, Ireland, and Spain. Preliminary data suggest that the weaker euro is having a positive impact on exports for France and Germany, with net exports contributing positively to growth. In the *United Kingdom*, the economy expanded at an annualized rate of 2¼ percent in the first half of 2015, driven mainly by strong domestic demand.

4. **Growth in emerging economies has been slowing with marked differences across countries and regions.** The slowdown reflects the dampening impact of lower commodity prices on commodity exporters and tighter external financial conditions—particularly in Latin America and oil exporters, the rebalancing in China, and structural bottlenecks, as well as economic distress related to geopolitical factors—particularly in the Commonwealth of Independent States and some countries in the Middle East and North Africa.

- In *China*, growth in the first half of 2015 was broadly in line with previous forecasts. Fueled by a needed correction in residential real estate construction, investment slowed compared to last year, but consumption growth remained steady. As import contracted, net exports contributed positively to growth despite weaker-than-expected exports. Equity prices dropped sharply in July after a one-year bull run, but the authorities intervened to stabilize prices at lower levels.
- In *Russia*, the recession continued in the second quarter, with GDP falling by 4.6 percent year-on-year. The decline in GDP over the first half of 2015 was somewhat larger than forecast, reflecting the effects of lower oil prices and sanctions.
- In *Latin America*, the downturn in *Brazil* was deeper than expected, as business and consumer confidence continued to retreat amid deteriorating political conditions. With declining commodity prices, momentum continued to weaken in other countries in the region. Growth was also lower than expected in *Mexico*, reflecting slower U.S. growth but also lackluster domestic demand.
- In *India*, domestic demand is accelerating, underpinned by the large positive terms of trade shock (mostly due to collapsing commodity-import prices).

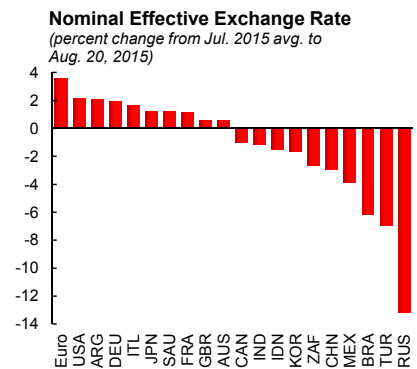
5. **Financial conditions in advanced economies continue to be easy, but they have tightened for emerging economies as financial market sentiment is deteriorating.** In an environment of weak demand, safe real interest rates remain low even as the policy rate lift-off approaches in the United States. There have been temporary surges in volatility associated with protracted program negotiations between Greece and its official creditors, the sharp stock market decline in China despite significant intervention by the authorities, as well as the recent the depreciation of the renminbi. Overall, financial conditions for emerging markets have tightened, with dollar bond spreads and long-term local currency bond yields increasing by 40–50 basis points on average since May, stock prices weakening, and exchange rates depreciating.

6. **Commodity prices have weakened sharply.** After remaining broadly stable during the second quarter of 2015, oil prices have resumed their decline in recent weeks, reflecting resilient supply, a weakening in global demand, and the prospects of higher future output following the Iran deal. Metal prices have fallen on concerns about global demand, especially the slowdown in commodity-intensive investment and manufacturing activity in China, but also increases in supply (as production has come on-stream reflecting the past investment boom).



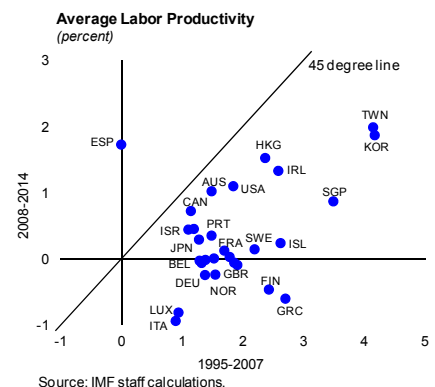
Source: Bloomberg, L.P.
1/ Simple average of three spot prices: U.K. Brent, West Texas Intermediate, and Dubai Fateh.

7. **Exchange rates in emerging economies have come under considerable pressure over the past weeks.** Several factors have likely contributed, including *inter alia* the sharp drop in equity prices and the depreciation of the remimbi, with the associated concerns about the extent of the growth slowdown in China, and weaker commodity prices. Emerging economy currencies have depreciated across the board, with particularly strong depreciation pressures in commodity exporters (Russia) and countries under stress (Brazil).



Source: IMF, Global Data Source.

8. **Economic activity in advanced economies is projected to pick up modestly this and next year.** The further decline in oil prices should provide some additional boost, although the response of demand to the earlier decline has so far been slightly weaker than expected. Unemployment is declining but underlying productivity growth remains weak, heightening concerns about the medium-term outlook:



Source: IMF staff calculations.

- In the *United States*, growth is expected to pick up further in the second half of the year, supported by lower energy prices, the reduced fiscal drag, strengthened balance sheets, and an improving housing market. These forces are expected to more than offset the drag on net exports from the strengthening of the dollar. Longer-term growth prospects are weaker, reflecting an aging population and low total factor productivity growth.
- The moderate *euro area* recovery is projected to continue in 2015–16, sustained by lower oil prices, monetary easing, and the euro depreciation. Growth is expected to pick up in Germany, France, Italy, and especially in Spain. However, the outlook for Greece is more difficult following the protracted period of uncertainty earlier in the year. In the *United Kingdom*, continued steady growth is expected, supported by continued recovery of wage growth and lower oil prices. Potential growth remains weak—a result of crisis legacies, but also demographics and weak total factor productivity.

- In *Japan*, GDP growth is projected to rise gradually, following the 0.1 percent decline in 2014, supported by higher real compensation, higher equity prices due to the Bank of Japan's additional quantitative and qualitative easing, and lower oil and commodity prices. Among the other Asian advanced economies, growth will be generally weaker than in 2014, reflecting domestic shocks and slower exports.

9. **The outlook for emerging economies has weakened in 2015 relative to last year.** This reflects *inter alia* weaker growth in commodity exporters—especially in Latin America—and a slowdown in China. External conditions are becoming more difficult as the “pull” from advanced economies remains modest and capital inflows have slowed. A rebound in activity in distressed economies is expected to result in a pickup in growth in 2016, offsetting the projected continuation of the slowdown in China. Specifically:

- In *China*, growth is expected to decline as excesses in real estate, credit, and investment continue to unwind, with a further moderation in investment growth, especially residential real estate. Policy action will aim at reducing vulnerabilities from recent rapid credit and investment growth, and not at fully offsetting the underlying moderation in activity. Ongoing implementation of structural reforms and lower oil and commodity prices are expected to expand consumer-oriented activities, partly buffering the slowdown.
- In *India*, one of the world's largest commodity importers, growth will benefit from recent policy reforms, a consequent pickup in investment, and lower commodity prices. In *Brazil*, weak business and consumer confidence amid difficult political conditions and the needed tightening in the macroeconomic policy stance are expected to weaken domestic demand, with investment declining particularly rapidly. In *Russia*, economic distress reflects the interaction of falling oil prices and international sanctions with underlying structural weaknesses. A contraction is expected to take place in both economies in 2015—with significant regional spillovers—with activity remaining weak into 2016.
- Lower oil prices will continue to take a toll on the outlook for oil exporters; where the negative shock on terms of trade and real incomes will have an impact on medium term growth. Some exporters—notably *Saudi Arabia*—are using their fiscal buffers, but policy space is more limited in other countries (e.g., *South Africa*).

10. **The distribution of risks remains to the downside, and a simultaneous materialization of some of these risks would imply a much weaker outlook.** Near-term downside risks to growth for emerging economies have increased, given the combination of risks from China's growth transition, lower commodity prices, adverse corporate balance sheet effects and funding challenges related to dollar appreciation, and capital flow reversals.

- *Risks primarily affecting emerging economies include:* (i) lower growth in China, either a moderate slowdown as policies focus on reducing vulnerabilities rather than supporting growth or a harder landing over the medium term, which would produce sizeable spillovers, slowing global trade and putting additional downward pressure on commodity prices; (ii) lower commodity prices, which would negatively affect commodity exporters; (iii) a further sizeable strengthening of the U.S. dollar which could cause balance sheet and funding strains

for dollar debtors, offsetting trade benefits from real depreciation in some economies; and (iv) increased corporate leverage and the associated high bank credit growth, particularly foreign currency debts.

- *Disruptive asset price shifts and financial market turmoil remain a downside risk, which could involve capital flow reversals in emerging economies.* Several factors underpin this risk, notably the still historically low term and risk premiums in bond markets, the changing context underlying this asset price configuration (in particular, the gradual normalization of accommodative monetary policies in the United States, as well as crisis legacies and deflation risks), and the increased vulnerabilities and financial stability risks in emerging market economies amid lower growth and declines in commodity prices. Financial market reaction to the protracted uncertainties surrounding the negotiations for a new program with Greece was limited, and risks have significantly diminished since the agreement on a new ESM program for Greece. However, should program implementation falter due to political uncertainty or reform fatigue in Greece, financial stress in the euro area could reemerge.
- *Potential output could be lower than expected in both advanced and emerging economies.* Capital stock growth could be lower for longer, reflecting crisis legacies in advanced economies and structural constraints and less favorable external conditions for investment in emerging economies.
- *The risk of secular stagnation for advanced economies and geopolitical risks for emerging markets* from ongoing events in Ukraine, the Middle East, and parts of Africa still remain relevant.

POLICIES TO RAISE ACTUAL AND POTENTIAL GROWTH

Policy priorities have taken on more urgency compared to the February G-20 Surveillance Note. Notably, raising actual and potential growth remains a key objective. In advanced economies, accommodative monetary policy remains essential. Fiscal policy should be growth friendly, including through increased infrastructure investment. In many emerging economies, macroeconomic policy space to support growth is more limited, with inflation still above target in some economies, and fiscal positions weaker than desirable in others. Structural reforms are needed to raise potential output in both advanced and emerging economies. Joint efforts by deficit and surplus economies to rebalance global demand would reduce excess external imbalances while sustaining growth.

POLICIES FOR FULL EMPLOYMENT AND STABLE INFLATION IN ADVANCED ECONOMIES

11. **Accommodative monetary policies remain essential in many advanced economies, given still sizable output gaps.** In most advanced economies, output gaps are still substantial, inflation is expected to remain below target, and monetary policy remains constrained by the zero lower bound. The expected boost in economic activity from lower oil prices has not materialized, and lower energy costs are keeping inflation low. Hence, monetary policy must stay accommodative to prevent real interest rates from rising prematurely.

- In the *United States*, the main near-term policy issue is the appropriate timing and pace of monetary policy normalization. The Federal Open Market Committee's (FOMC) decision should remain data-dependent and with little evidence of meaningful wage and price pressures so far, the normalization is expected to be gradual. An effective monetary policy communication strategy will remain essential, also in light of differences between market and FOMC expectations about the path of short-term interest rates.
- In the *euro area*, the ECB's expanded asset purchase program has improved confidence and financial conditions, and raised inflation expectations initially. More recently however, inflation expectations have reversed, and the euro has strengthened, which could put downward pressure on prices. Hence, the program should be extended if there is not sufficient improvement in inflation consistent with meeting medium-term price stability objectives. These monetary policy efforts should be supported by measures to strengthen bank balance sheets, which would help to improve monetary policy transmission and credit market conditions. Stricter regulation of nonperforming loans and measures to improve insolvency and foreclosure procedures are a priority in this regard.
- In *Japan*, accelerating structural reforms is critical to boost confidence and contribute to higher domestic demand and favorable wage-price dynamics. In this context, the Bank of Japan should stand ready for further easing. It should also consider providing stronger guidance to markets by moving to more forecast-oriented monetary policy communication to increase the transparency of its assessment of inflation prospects and strengthen the signal of its commitment to the inflation target.

12. **Fiscal policy should be growth friendly.** Managing high public debt in a low-growth and low-inflation environment remains a key challenge in many economies. Fiscal consolidation should remain growth friendly and be anchored in credible medium term plans. In the *United States*, the priority remains to agree on a medium-term fiscal consolidation plan, including higher tax revenue. In the *euro area*, countries should adhere to their commitments under the Stability and Growth Pact (SGP), but those with fiscal space, notably Germany, could do more to encourage growth, especially by undertaking much-needed public infrastructure investment and supporting structural reforms. Growth-friendly fiscal rebalancing could include lower marginal taxes on labor and capital financed by cuts to unproductive spending or base-broadening measures. In *Japan*, a credible medium-term strategy for fiscal adjustment with specific measures is urgently needed, given high public debt ratios.

13. **Structural reforms are essential to boost potential output and productivity.** After six years of demand weakness, the likelihood of damage to potential output is increasingly a concern. Hence, continued support to demand should be accompanied by structural reforms, with particular emphasis on measures that would support demand in the short term. Labor market reforms could strengthen both labor force participation and trend employment by removing tax disincentives (*Japan, United States*) and improving family benefits such as childcare assistance (*United States*)/improving child care (*Japan*). In the *euro area*, better targeted training programs and active labor market policies could address concerns about skill erosion. Structural reforms to

improve the functioning of product markets are needed in *Japan* (the third arrow of Abenomics) and *euro area* countries.

POLICIES TO ADDRESS CHALLENGES IN EMERGING ECONOMIES

14. **Policymakers in many emerging economies face a growth slowdown accompanied by a more challenging environment.** On the external front, financial conditions have tightened, commodity prices have declined sharply, and exchange rates have been under pressure. On the domestic front, macroeconomic policy space remains limited as several economies have experienced inflation above target or/and weaker fiscal positions than before the crisis. External and financial vulnerabilities have risen, and could be exacerbated if capital flow reversals materialize, as private sector leverage has increased significantly, and current account positions have deteriorated. Finally, lack of credibility, notably where inflation is above target, complicates the monetary policy response as exchange rate depreciation could feed into inflation expectations and lead to a worsening inflation outlook.

15. **Emerging market economies need to strike an appropriate balance between fostering growth and managing vulnerabilities.** In many net *commodity importers*, lower commodity prices have alleviated inflation pressure and reduced external vulnerabilities. The tradeoff between supporting demand and reducing vulnerabilities has become less pronounced as a result. Policy space, though, has declined as a number of central banks have already reduced interest rates over the past year. In some commodity importers, the terms of trade and real income gains from lower oil prices have been used to increase public sector savings and strengthen fiscal positions. In *commodity exporters*, fiscal positions have deteriorated and external and fiscal vulnerabilities have increased. The urgency to adjust policies to lower commodity prices depends on the buffers accumulated in the past. Where policy space is limited, allowing substantial exchange rate depreciation will be critical. Policies across economies include:

- In *China*, the policy priority is achieving a smooth transition to more sustainable patterns of growth, while containing vulnerabilities. The recent sharp equity market corrections should not discourage the authorities from continuing with reforms to give market mechanisms a more decisive role in the economy, eliminate distortions, and strengthen institutions. The new mechanism for determining the central parity of the renminbi appears a welcome step towards achieving an effectively floating exchange rate system in the next couple of years.
- In *India*, while near-term growth prospects remain favorable and external vulnerabilities have decreased, some macroeconomic imbalances remain. While the faster-than-expected fall in inflation has created space for considering modest cuts in the nominal policy rate, medium-term inflationary pressures and upside risks to inflation remain. With balance sheet strains in the corporate and banking sectors, financial sector regulation should be enhanced, provisioning increased, and debt recovery strengthened.
- *Structural reforms* to raise sustainable growth differ across countries. They include removing infrastructure bottlenecks in the power sector (*India, Indonesia, South Africa*); easing limits on trade and investment and improving business conditions (*Brazil, Indonesia, Russia*); and implementing reforms to education, labor, and product markets to raise competitiveness and

productivity (*Brazil, China, India, South Africa*) and government services delivery (*South Africa*). In India, the post-election recovery of confidence and lower oil prices offer an opportunity to pursue much-needed structural reforms.

16. **Joint policy actions by both deficit and surplus economies are needed to reduce excess imbalances while sustaining growth.** After narrowing modestly in 2013, the global current account imbalances held steady at 3½ percent of world GDP in 2014. Over the last several

years the composition of current account imbalances has changed—the large deficits of the United States and the surpluses of China and oil exporting countries have more than halved, while the current account surplus in the euro area has increased. Overall, there has been little progress in reducing excess imbalances. Thus, joint policy action by both surplus and deficit economies is needed to reduce excess imbalances

while supporting growth. Actions in debtor economies include medium-term fiscal consolidation and structural reforms to improve competitiveness and facilitate adjustment. In creditor economies, policies should support stronger domestic demand, including through infrastructure investment (*Germany*) or focus on rebalancing toward consumption, while preventing too sharp a slowdown, including by moving toward more market-based exchange rates, and reducing capital account restrictions (*China*).

