Consolidated Multilateral Surveillance Report

APRIL 2012

INTERNATIONAL MONETARY FUND

KEY POINTS

After suffering a major setback, global prospects are gradually strengthening again. Improved activity in the United States and better policies in the euro area in response to the deepening economic crisis there have reduced the immediate threat of a sharp global slowdown. Weak recovery is likely to resume in the major advanced economies, and activity should remain relatively solid in emerging market and developing economies.

But the recovery remains fragile, and risks are firmly to the downside. The most immediate concern is still a renewed escalation of the euro area crisis. In addition, geopolitical uncertainty could sharply increase oil prices and undermine world growth. Risks over the medium term relate to persistently weak activity and high public deficits and debt in advanced economies as well as overly optimistic expectations and strong credit growth in various emerging market economies.

Without a stronger policy response, this period of relative stability could prove fleeting and be followed by prolonged stagnation.

- In *advanced economies*, prospects for subdued inflationary pressure and risks for debt–deflation call for continued accommodative monetary policy, particularly in light of high unemployment rates. This should be coupled with measured near-term fiscal restraint as well as strong medium-term consolidation plans and entitlement reform, and restructuring and reform of the financial sectors. Additionally, structural reforms to labor and product markets can help support long-term growth. In the *euro area*, stabilization measures need to be followed up with strong medium-term structural and institutional reforms.

- In *emerging market and developing economies*, requirements vary but many authorities need to guard against too much stimulus in response to downside risk, while continuing to rebuild policy room and promoting inclusive growth. Stronger prudential frameworks and policies are necessary to deal with volatile capital flows. Furthermore, emerging surplus economies would benefit from policies that promote a continued shift from external to domestic demand.

Policymakers must use the breathing space offered by markets to finally get ahead of this crisis. Multilateral action needs to complement national action to build confidence and stability—raising the IMF's lending capacity would help stem risks and, alongside strong policies, facilitate a durable exit from the crisis.

Policy Advice Summary

Advanced economies

Measured near-term fiscal consolidation, including fiscal policies that do the least harm to demand in the short term:

(i) Raising high-multiplier spending and cutting low-multiplier spending or raising low-multiplier taxes in a budget-neutral manner.

(ii) Allowing automatic stabilizers to operate freely, if market conditions permit.

(iii) Consider slower adjustment, if credibility with markets is strong and sufficient policy space to do so is available.

Medium-term fiscal consolidation, entitlement reform, better fiscal rules and institutions.

Accommodative monetary and liquidity policies; unconventional support as needed to limit risks for debt-deflation traps.

Structural reforms to boost long-term productivity and employment.

Support for the unemployed.

Euro area economies

Building a stronger currency union with institutional and governance reforms and structural reforms that facilitate internal demand rebalancing.

Strengthening banking systems by raising capital while avoiding a credit crunch.

Emerging market and developing economies

Rebuilding macroeconomic policy room.

Strengthening prudential policies and frameworks to deal with greater capital flow volatility.

Promoting more inclusive growth.

Economies with large external surpluses

Fostering domestic consumption, including with more exchange rate flexibility.

All economies

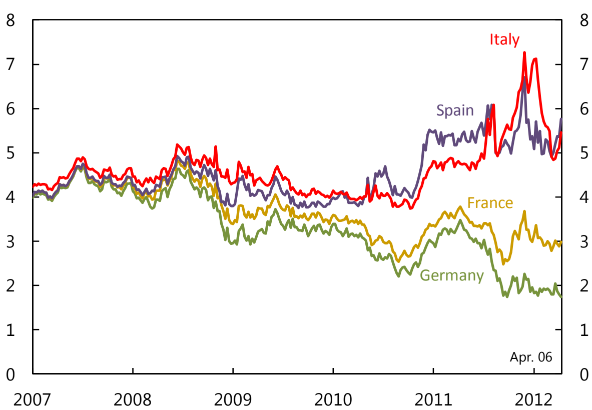
More coordination of financial policies; reform of financial stability frameworks.

Strengthening the global firewall.

THE GLOBAL CONJUNCTURE

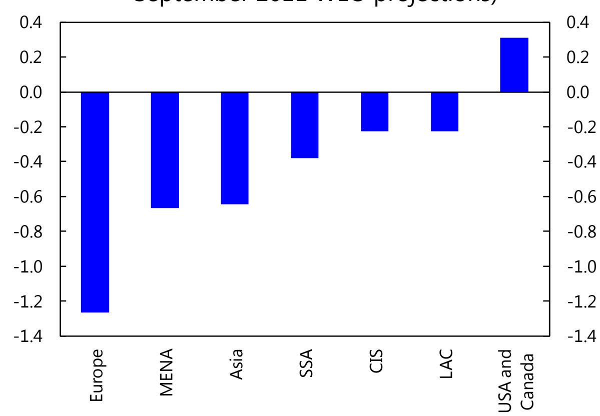
1. **After suffering a major setback, global prospects are gradually strengthening again but markets remain jittery**. Intense pressure in sovereign debt markets and the freezing of bank funding markets in November 2011 (Figure 1) threatened to plunge Europe, and possibly the advanced economies as a whole, into deep recession. The financial and fiscal turmoil was reflected in low growth or contraction in the euro area in the second half of 2011. This turmoil spilled over to emerging market and developing economies, notably emerging Europe. Improving activity in the United States, however, partly offset these negative developments (Figure 2). A number of developments have since stabilized markets, including decisive action by the European Central Bank (ECB) to provide large amounts of long-term liquidity to banks, fiscal adjustment and structural reforms by key euro area members, improvements in European Union governance structures, completion of the Greek debt exchange, and the recently agreed combination of the European Stability Mechanism (ESM) and the European Financial Stability Facility (EFSF).

Figure 1. Ten-Year Government Bonds
(Percent)



Source: Bloomberg.

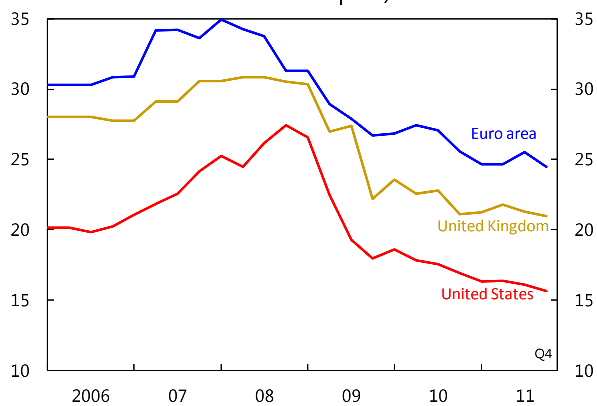
Figure 2. Revisions to 2012 WEO Growth Projections
(percentage point difference from September 2011 WEO projections)



2. **However, growth in the advanced economies remains weak and fragile**. While recent policy steps have restored some stability to financial markets, there are still risks of significant setbacks. Pressures on the European banking sector remain intense, as banks cope with continued sovereign stress, weak economic growth, high rollover requirements, and the need to increase capital to regain investor confidence. Together, these pressures have induced a broad-based effort by banks to shrink balance sheets (Figure 3), thereby squeezing bank asset holdings and contributing to pressure on the euro area credit supply. This financial effect is compounded by synchronized and front-loaded fiscal consolidation by many euro area governments (Figure 4). Also, investors remain concerned about medium-term growth prospects, including in the United States and Japan, where robust plans to deal

with high public debt are not yet in place. At the same time, rising oil prices are cutting into household disposable incomes, prospects for which are subdued and uncertain because of high unemployment. Worryingly, a large and growing fraction of this unemployment is long-term.

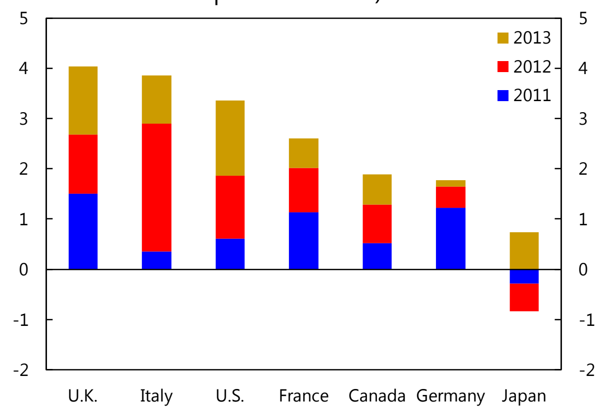
Figure 3. Bank Leverage[1]
(Adjusted tangible assets to tier 1 common capital)



Sources: SNL Financial; and IMF staff estimates.

[1] Tangible assets are adjusted for accounting differences on a best endeavors basis.

Figure 4: Fiscal Consolidation
(Change in structural balance; percent of GDP)

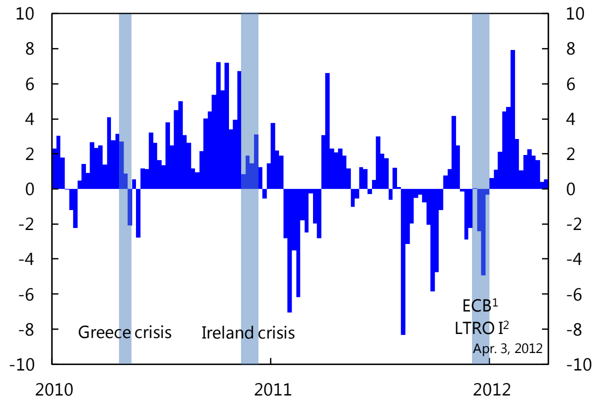


Source: IMF staff estimates.

3. **Emerging market and developing economies lost momentum, but growth remains strong**. The softening of growth in emerging market and developing economies is related to weaker export demand from the euro area crisis, but mainly reflects domestic factors. Growth has been slowed in some countries by policy tightening and in others by natural disasters. In the Middle East and North Africa, growth has been disrupted by the ongoing effects of the Arab Spring. Furthermore, swings in sentiment due to events in Europe have increased the volatility of exchange rates and capital flows to emerging market economies (Figure 5). However, unlike the major advanced economies, many emerging and developing economies do not have much, if any, spare capacity. Also, various economies continue to see elevated domestic credit growth, notwithstanding some tightening of lending conditions.

4. **In these circumstances, the IMF staff projects weak and fragile growth and, in many advanced economies, high unemployment**. In the advanced economies, the problems in Europe and their spillovers to other countries, the need for fiscal adjustment everywhere, and the general damage inflicted by what has become known as the Great Recession will continue to weaken activity, which will expand by only 1½ percent in 2012 and 2 percent in 2013. Unemployment rates are expected to remain around 7¾ percent in 2013. In emerging market and developing economies, policy tightening and idiosyncratic shocks are projected to lower growth to 5¾ percent in 2012 and 6 percent in 2013.

Figure 5. Capital Flows to Emerging Market and Developing Economies
(Billions of U.S. dollars; weekly)



Source: EPFR Global.

[1]ECB= European Central Bank

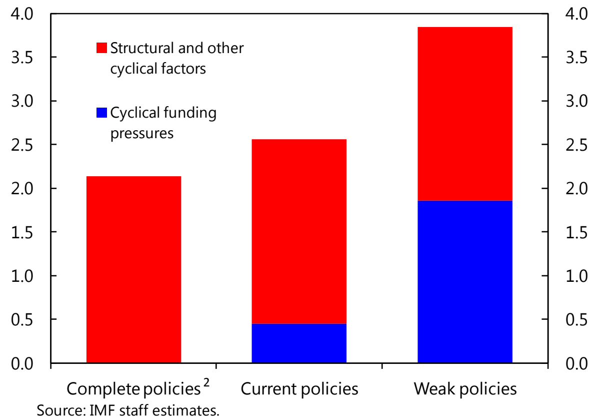
[2]LTRO= Long-term refinancing operation

KEY RISKS

5. **Recent policy actions have helped reduce risks, but the global economy remains unusually vulnerable**. The two most immediate risks are a renewed escalation of the euro area crisis and a sharp oil price increase caused by heightened geopolitical uncertainty.

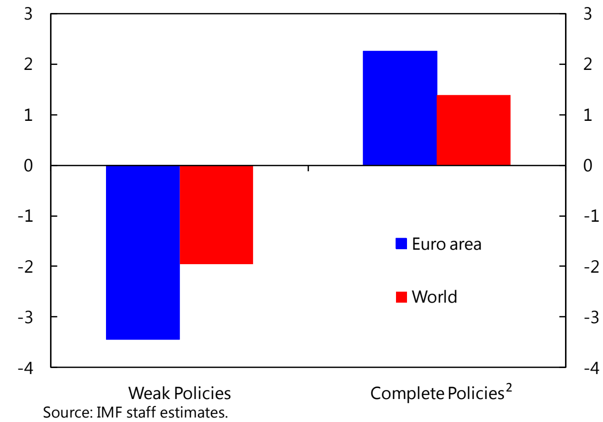
6. **Risk 1: Sovereign stress and bank deleveraging in the euro area**. If current policies fail to revive growth or are poorly implemented, there could be a re-intensification of the adverse feedback loops between sovereign risk and bank balance sheets. Doubts about fiscal policy commitments could lead to rising sovereign spreads. These doubts could also force several euro area countries into more immediate fiscal consolidation, which would further depress demand and growth and possibly initiate a vicious cycle between further tightening and lower growth. The resultant losses on sovereign debt holdings and loans to the private sector would weaken bank balance sheets and elevate funding costs. This would prompt large-scale deleveraging and substantial further tightening of the credit supply. A "weak policies scenario" (Figures 6 and 7) illustrates this risk, showing the potential for deleveraging among EU banks and their spillovers to other regions of the world through financial contagion, increased risk aversion, and diminished international trade. Euro area output could be lower by about 3½ percent and global output by about 2 percent, relative to WEO projections.

Figure 6: Estimated Reduction in EU Bank Assets from September 2011 to December 2013[1]
(Trillions of U.S. dollars)



[1] Reduction in total assets for a sample of 58 large EU banks. Under the current policies, this reduction is equivalent to 7 percent of total bank assets
[2] See paragraph 15

Figure 7: Estimated Effect of EU Bank Deleveraging, More Fiscal Adjustment, and Higher Global Risk Premia on World and Euro Area Growth[1]
(Percent deviation from baseline)



[1] Deviations from the baseline in the complete and weak policies scenarios—2012/13.
[2] See paragraph 15

7. **Risk 2: Oil supply disruptions**. Escalating tension in the Middle East could result in sharply higher oil prices. A halt of the Islamic Republic of Iran's exports to Organization for Economic Cooperation and Development (OECD) economies (if not offset) would likely trigger an initial oil price increase of about 20 to 30 percent, with other producers or emergency stock releases likely providing some offset over time—a part of this is likely priced in already. Further uncertainty about oil supply disruptions could trigger a much larger price spike. By way of example, model simulations suggest that a hike in the oil price by about 50 percent would lower global output by about 1¼ percent or more relative to WEO projections. The decline depends on the extent to which higher oil prices damage confidence and spill over to financial markets, and thereby undermine the slow recovery in advanced economies and squeeze budgets in emerging market and developing economies that have extensive energy subsidies.

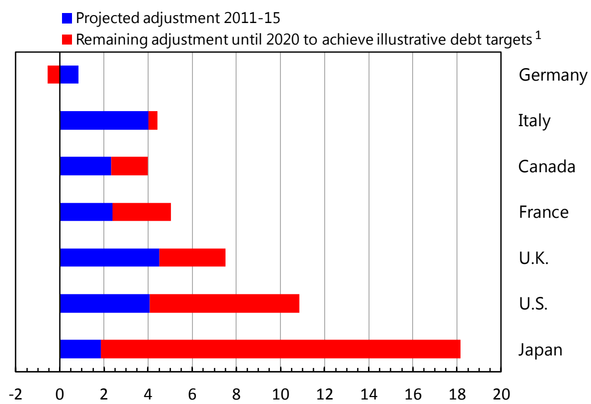
8. **Another important downside risk: weak medium-term growth.** Weak growth in advanced economies could undercut support for fiscal adjustment and for trade and financial integration. This could again increase volatility in global bond and currency markets, which could be compounded by concerns about high public deficits and debt in the United States and Japan. Growth could also disappoint in key emerging market economies, as credit and investment booms peter out.

POLICY ADVICE

9. **Policymakers in advanced economies must prioritize growth by rebuilding financial stability and implementing fundamental reforms**. Without a resumption of stronger growth, unemployment will not decline from its high level in many advanced and various emerging economies. While the euro area crisis dominates the short term, other advanced economies also face daunting problems. High debt burdens constrain the freedom of fiscal policy, and monetary policy is already close to the zero interest rate lower bound. The United States and Japan have high and rising debt burdens but lack agreed measures to put public debt on a sustainable medium-term path (Figure 8). This is raising questions about how they can maintain growth in the face of the needed adjustment. In the absence of structural, productivity-enhancing reforms, it is difficult to see anything but a long slow grind of tepid growth and small employment gains for many years to come in many economies.

Figure 8: Fiscal Adjustment Needs

(Change in cyclically-adjusted primary balance; percent of GDP)



Source: IMF staff estimates.

[1] Total required adjustment to reduce gross debt ratio to 60 percent by 2030 (net debt target of 80 percent for Japan). After 2020, primary balance must be maintained constant at the prevailing level until 2030.

10. **Monetary and liquidity policies in advanced economies should continue to be supportive**. Policymakers must guard against overstating the risks of higher inflation from unconventional monetary policy and thereby limiting central banks' room for maneuver. While unconventional policies cannot substitute for fundamental reform, they can limit the risk of another major economy falling into a debt-deflation trap, which could seriously hurt global prospects for better policies and higher global growth. When weighing the implications of rising oil prices or tax hikes, monetary policymakers should look beyond their effects on headline inflation and focus on the potential for a transmission to wages, which is unlikely given high unemployment.

11. **High deficits, rising debt ratios, and the volatility of financial markets all argue for fiscal consolidation—but at a measured pace given still-weak activity**. In an environment of high financial market volatility, policymakers could feel themselves compelled to adopt excessive short-term consolidation in the face of slowing growth, fearing an adverse market reaction to any failure to achieve deficit targets. The implications of the fiscal tightening in the teeth of an economic downturn could be particularly severe and even perverse, leading to a worsening rather than an improvement in the debt ratio, at least in the short run. The best course of action is to adopt fiscal policies that do the least harm to demand in the short term. One means of supporting output growth while keeping fiscal consolidation on track is through temporary tax hikes matched by budget-neutral increases in government spending targeted toward productive investment and support for distressed households. Similarly, those countries with the fiscal room should let automatic stabilizers operate freely. Those with room for policy maneuvering and sufficient credibility with markets can reconsider the pace of consolidation. However, these short-term considerations should not be taken as an excuse to postpone the adoption of strong medium-term consolidation plans until a dangerous adverse market reaction forces the issue.

12. **Structural reforms can support long-term productivity growth and thereby ensure future economic growth and fiscal sustainability**. Challenges vary across advanced economies.

- Strengthening fiscal institutions and reforming entitlement programs can help to place long-term public finances on a more sustainable footing. Entitlement reforms—for example, linking retirement age to life expectancy and improving incentives in the health care sector—would be particularly beneficial because they demonstrate policymakers' ability to act and lend credibility to changes in fiscal institutions and rules without depressing demand in the near term.

- Reforms to labor and product markets, including income support and training for the unemployed, can help raise productivity and increase labor force participation. Policies that encourage bank lending to small and medium-sized enterprises, which account for a large share of employment, would also help. Furthermore, action is needed to bring down long-term unemployment, which harms the long-term viability of pension systems and, more generally, undermines social cohesion.

- Policies directed at real estate markets, which pose major challenges in the United States and some other economies, can accelerate the improvement of household balance sheets and thus support otherwise anemic consumption. Countries that have adopted such policies, such as Iceland, have seen major benefits. In the United States, the administration has tried various programs. However, given their limited success, a more forceful approach is needed and in the works.

13. **In the euro area, the strong measures to reestablish short-term stability could quickly lose effectiveness unless they are followed up with measures that create a stronger currency union over the medium term**. In particular:

- The recently agreed combination of the ESM and the EFSF, along with other recent European efforts, will strengthen the European firewall. During periods of acute stress, the ECB must continue to stand ready to intervene to maintain orderly conditions in bond markets and thereby facilitate the pass-through of monetary policy to the real economy. The counterpart to this should be a strong mechanism that delivers responsible fiscal policies. In this regard, the recently-agreed "fiscal compact" marks important progress in improving fiscal credibility with little detriment to fiscal flexibility—which is important given the period of weak growth ahead. However, enforcement will be key, and this might mean EU institutions have to be actively involved in national budgetary plans, as envisaged by current proposals (the "two pack"). The "fiscal compact" will also need to be complemented by greater fiscal risk sharing to ensure that economic dislocation in one country does not develop into a costly fiscal and financial crisis for the entire region.

- The banking system needs to be further strengthened. Nonviable banks—whose continued existence allows problems to fester—need to be resolved. Viable banks need continued access to strong funding support through either the ECB or a centralized program. Close, coordinated oversight by the European Systemic Risk Board and European Banking Authority, along with national regulators, is needed to ensure that deleveraging is accomplished by raising capital and does not result in a credit crunch.

- Developing a road map for a complete euro-area-wide financial stability framework is essential to break the link between weak sovereigns and banks. Greater fiscal risk sharing, conditional upon more centralized fiscal governance, is one element. A second is centralized power over bank supervision and regulation, deposit insurance, and bank resolution, funded by common backstops.

- There is need for better adjustment to real as well as fiscal and financial imbalances. Various economies in the euro area periphery are in the process of implementing major structural reforms, especially to labor markets. The importance of progress in these domains for a well-functioning monetary union cannot be overemphasized.

14. **Emerging market and developing economies need to weigh the risks related to lower demand from advanced economies and social exigencies against the need to rebuild policy room for maneuver**. Many of these economies have had an unusually good run over the past decade, supported by rapid credit growth or high commodity prices. To the extent that credit growth is a manifestation of financial deepening, this has been positive for growth. But in various economies, credit cannot continue to expand at its present pace without raising serious concerns about the quality of bank lending. Another consideration is that commodity prices are unlikely to grow at the elevated pace witnessed over the past decade, notwithstanding short-term spikes related to geopolitical tensions. This means that fiscal and other policies may well have to adapt to lower potential output growth, and therefore countries need to guard against overstimulating activity in the short term. The appropriate responses will vary.

- Many economies should continue to rebuild macroeconomic policy room and strengthen prudential policies and frameworks.

- For those economies that have largely normalized macroeconomic policies, the near-term focus should be on responding to lower external demand from advanced economies.

- Monetary policymakers need to be vigilant that oil price hikes do not translate into broader inflation pressure, and fiscal policy must contain damage to public sector balance sheets by targeting subsidies only to the most vulnerable households.

- The swings in sentiment flowing from developments in advanced economies are contributing to significant economic and financial volatility. Strengthened prudential policies are needed to mitigate these risks.

- Various emerging surplus economies, particularly China, would also benefit from having greater home-grown sources of growth that rely less on very high investment. Policies should promote a continued shift from external to domestic demand, and this likely requires, among other measures, exchange rate adjustment. Furthermore, on domestic demand, policies should facilitate a shift from investment to consumption. This would not only help these economies but also others, advancing global demand rebalancing

MULTILATERAL ACTION

15. **Policymakers must use the breathing space offered by markets to finally get ahead of this crisis**. Major strains in some markets make a case for coordinated intervention to re-build confidence and foster growth. If policy actions, including multilateral action, are

successful, sovereign yields could fall, reducing stress on bank balance sheets and reducing the pressure to deleverage. In short, a virtuous cycle could be established rather than the vicious cycle contemplated in Risk 1 above.

- A "complete policies scenario" (see Figures 6 and 7 above) illustrates the potential benefits. It assumes that policies foster a larger-than-expected easing in euro-area banking and sovereign stress. Outside the euro area, credit conditions also improve, most notably in the United States, where lending to small and medium-size firms is assumed to pick up much more quickly than in the WEO projections. Geopolitical tensions are assumed to ease, with the price of oil assumed to be roughly 10 percent below that in the baseline. Under this scenario, global GDP is roughly 1½ percent higher than in WEO projections, led by an improvement of almost 2¼ percent in the euro area (Figure 7). Emerging market and developing economies would benefit through stronger foreign demand and likely lower volatility in capital flows.

However, for a virtuous cycle to have any chance to take hold, policy actions need to be mutually reinforcing and geared towards generating positive spillovers. A key measure is complementing the stronger euro area firewall with a stronger global firewall.

16. **More coordination of financial policies and frameworks**. At the global level, the main challenge is consistent implementation of the new consensus regulations (such as Basel III) and addressing other financial sector weaknesses brought to light by the financial crisis, including the problems related to institutions considered too big or too complex to fail, the large financial institutions outside the regulatory net, and cross-border collaboration between bank supervisors. Otherwise, it is likely that financial institutions will engage in regulatory arbitrage, as they have done in the past, and undermine the prudential controls embodied in the new consensus regulations.

17. **Everyone is connected and all have a part to play to secure sufficient global aggregate demand**. Austerity alone cannot treat the economic malaise in the major advanced economies. With demand generally weak, countries that have easy access to market funding should not fiscally adjust as much as countries without access to market funding. More generally, countries with high saving rates should seek to address distortions that weigh on consumption, while those that have had too much credit-driven growth must do the opposite. And all need to work toward creating a stronger international monetary and financial system. This would provide room for positive spillovers and feedback loops that can ultimately solidify global demand, promoting employment and more inclusive growth.