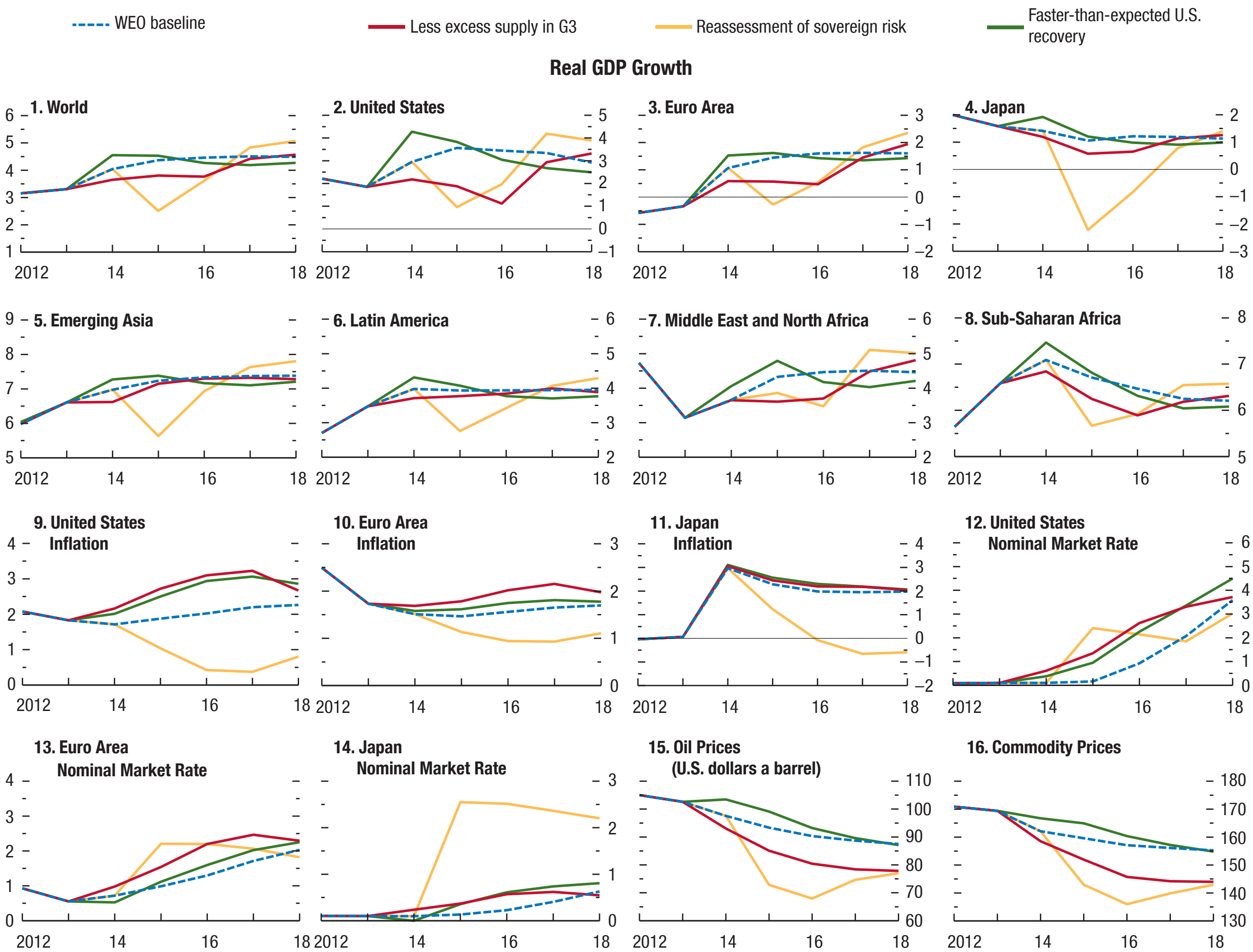
Figure 1.14. Interest Rate Risk Scenarios

(Percent unless noted otherwise)

The Global Integrated Monetary and Fiscal Model (GIMF) is used here to consider scenarios under which interest rates in the major advanced economies rise from their current low levels much sooner than envisaged in the WEO baseline. Three potential causes are considered: a faster-than-expected recovery in the U.S. economy; less excess capacity than expected in G3 economies; and rising concerns about fiscal sustainability. In the faster-than-expected U.S. recovery (green line), rising private demand quickly closes the output gap, putting upward pressure on inflation and thus prompting the Federal Reserve to raise the policy interest rate in 2014. Higher returns in the United States and increased optimism about advanced economy growth prospects lead to some capital flowing from emerging market economies back to advanced economies. However, the positive impact from higher advanced economy growth more than offsets the impact of capital outflows, and all regions of the world experience faster growth in 2014 and 2015. In the scenario with less excess supply than expected in the baseline (red line), the misperception starts in 2014 and is largest in the United States, roughly half the U.S. magnitude in the euro area, and a quarter of the U.S. magnitude in Japan.

With less excess supply than expected, inflation pressure starts to build in 2014 despite growth being weaker than in the baseline. Consequently, monetary policy starts to tighten in 2014, and interest rates in advanced economies are above baseline for most of the WEO horizon. Lower-than-expected supply capacity in advanced economies results in below-baseline GDP growth from 2014 onward, with negative implications for growth in all emerging market economies. In the scenario under which markets become concerned about medium-term fiscal sustainability (yellow line), sovereign risk premiums rise sharply in the United States and Japan, but more modestly elsewhere in 2015. Heightened fiscal sustainability concerns also lead to further increases in risk premiums for firms and households worldwide. With policy interest rates still very low in advanced economies in the baseline, there is only limited scope for monetary policy to offset the impact on market interest rates, and GDP growth falls sharply along with inflation in 2015. In emerging market economies, although the use of available monetary policy space helps mitigate the impact, growth also falls notably below baseline for several years.



Source: IMF staff estimates.
Note: G3 = euro area, Japan, United States.