World Economic and Financial Surveys

Consolidated Multilateral Surveillance Report

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INTERNATIONAL MONETARY FUND

CONSOLIDATED MULTILATERAL SURVEILLANCE REPORT

September 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 strengthened, 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. Policy inaction would lead to substantially worse outcomes.

- Downside risks are severe. The global economy could trip 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.

- In advanced economies, the key is to encourage growth in private demand while public demand is reduced. Europe is making progress on fiscal adjustment, but must do more to break the adverse feedback loop between the banking sector and the real economy. To that end, capital buffers should be increased in banks that need it, using public resources if necessary. The United States has made good progress on financial sector repair. But it urgently needs a credible fiscal plan that brings down public debt in the medium run without harming the fragile recovery in the short run. Japan has begun to recover from the earthquake and tsunami and now needs to strengthen its medium-term fiscal consolidation plans.

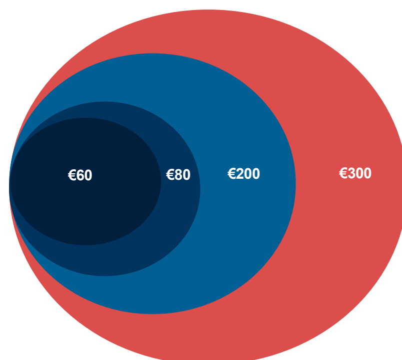
- In emerging and developing economies, policies need to make up for weaker external demand and foster more inclusive growth. In emerging surplus economies, this necessitates structural and financial reforms as well as exchange rate adjustment. All emerging and developing economies need to continue to strengthen their macroeconomic and financial frameworks.

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.

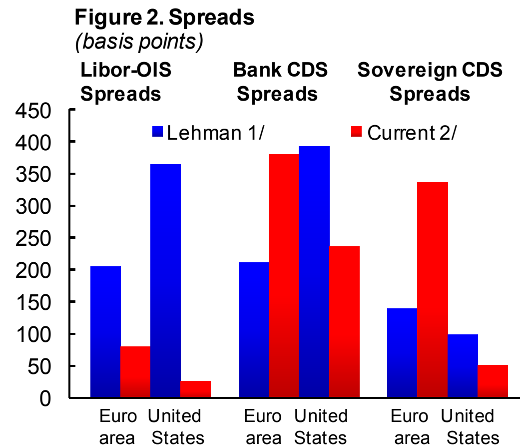
2. **Mutually-reinforcing macro-financial stresses have risen again, and sharply.** In particular, concerns over the sustainability of public debt in the euro area have intensified and extended to some of the area's core economies. Sovereign concerns have reignited fears over the health of the area's banks. Bank equity values have fallen sharply. Credit default spreads have widened and funding access for a number of 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] 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, with respect to sovereign debt, the 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)



Spillovers from . . .
- Greek sovereign
- Irish & Portuguese sovereign
- Belgian, Spanish & Italian sovereign
- High-spread euro area banking sector

Figure 2. Spreads
(basis points)



1/ Worst during period September 15, 2008 to April 30, 2009.
2/ September 9, 2011 or latest available.

3. **Against this backdrop, staff projects a weak, uneven, and bumpy recovery, subject to major downside**

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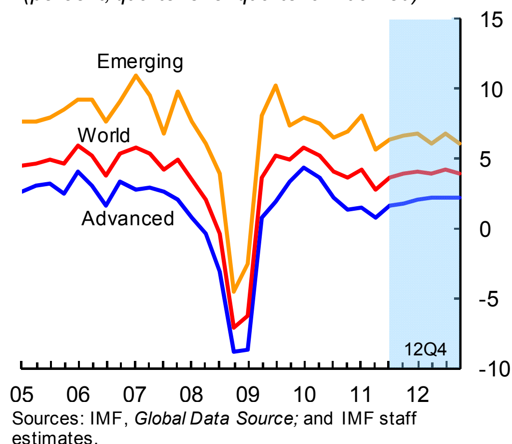
[1] This is not a measure of capital needs of banks. The methodology and caveats applying to this exercise are explained in the September 2011 Global Financial Stability Report (Box 1.3).

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.

Figure 3. Global Real GDP Growth
(percent; quarter over quarter annualized)



Sources: IMF, *Global Data Source;* and IMF staff estimates.

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. Thanks to stronger macroeconomic policy frameworks, low-income economies are still expected to post relatively high growth of around 5 percent during 2011-12. Global growth falls to about 4 percent in 2011-12, from over 5 percent in 2010. *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.*

4. **Given a weak recovery, many economies will continue to struggle with very high unemployment.** In the United States, exceptionally high job losses during the crisis overlay 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 they have contributed to political instability.

KEY RISKS

5. **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 economies, principally the euro area and the United States. But policy makers need to take heed of other risks; in particular, commodity price volatility has stayed elevated, despite the significant role played by Saudi Arabia and some other OPEC members in stabilizing oil production levels.

- **Risks from sovereign debt and bank funding pressures in the euro area:** High sovereign funding costs and low growth rates threaten fiscal

sustainability. Banks holding such sovereign debt would in turn come under pressure. Conditions in European wholesale funding markets could worsen, due to heavy reliance on these markets. This would spread financial stress to the rest of Europe and, potentially, the rest of the world. The real economy could be badly hurt as banks are forced to cut back on lending and shrink their balance sheets. This is a major risk if strong national adjustment programs are not carried out. Even if programs are implemented, risks are still severe because of doubts about the credit worthiness of some financial institutions. If growing fiscal and financial concerns are unchecked, policymakers might have to resort to extreme measures to defend against intensifying strains on the euro area.

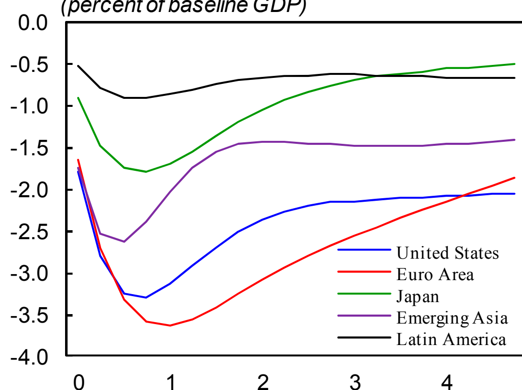
- **Risks to household and public debt sustainability in the United States:** Household and fiscal stresses in the United States could manifest in severe downside scenarios. House prices could fall further, adding pressure to household balance sheets and lowering spending. Debt deflation could weigh on activity for many years. Sharp near-term fiscal cutbacks without long-term reforms on expenditures and revenues would further weaken the outlook for growth. Continued low growth, without necessary fiscal medium-term consolidation, could cause an increase in risk premiums on U.S. bonds, directly leading to a loss of confidence in public debt sustainability. In an extreme case, major unexpected defaults or failures could occur across key financial intermediaries, which would seriously harm global financial stability.

6. Analysis of spillovers suggests that emerging economies would be hit severely by a further downturn in advanced economies.

- Problems in the euro area banking system could lead to problems in subsidiaries of European banks. Further losses on assets in advanced economies could lead investment funds to liquidate positions in emerging economies. Slower growth and increased uncertainty about how long-run fiscal sustainability will be achieved in the United States would increase global financial volatility, reducing asset valuations and growth globally.

- Trade-dependent emerging and developing economies would be particularly vulnerable to a downturn in advanced-economy growth. Falling growth in emerging surplus economies would strain commodity prices and revenues for a number of other emerging and developing economies. Analysis of downside scenarios for GDP growth in the euro area and the United States suggests that these trade effects on other economies could be substantial.

Figure 4. 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.

- Weaker global demand and more difficult international financial conditions 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 capital inflows could therefore undercut high real estate prices in various emerging economies, raising nonperforming loans, and thereby setting off another deleveraging cycle.
- If downside risks materialize, a large number of LICs would need additional concessional financing from the international community to help mitigate these shocks.

7. **Risks are closely linked—if one materializes, others are more likely to.** 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.

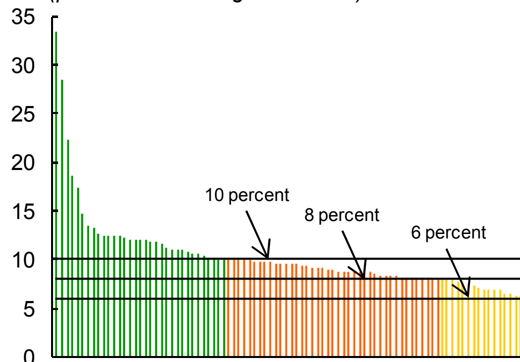
POLICIES

8. **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. Given the nature of the risks facing the global economy, immediate policy priorities must be for policy makers in advanced economies to break the negative macro-financial connections between banks and sovereigns and nurture the recovery of private demand as public demand is reduced. For euro-area economies, this includes addressing decisively major questions about the governance of the union.

9. **Financial repair: strengthen capital buffers; restructure and resolve weak banks.** Removing uncertainty about the resilience of banks is the top priority for the euro area. A stronger recovery in advanced economies will need readily-available credit to allow easy monetary conditions to pass through. Appropriate fiscal action, coupled with building adequate bank capital buffers, will help to achieve this by breaking the adverse feedback loop between rising sovereign spreads, deteriorating bank funding, and flagging activity. National authorities

should encourage banks in need of extra capital to raise it from private sources. Weak banks should be either restructured or resolved. 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 EFSF funds and might necessitate additional measures to make this facility more flexible and effective. Importantly, countries that do implement strong adjustment programs should not be left to fall into a downward spiral for lack of adequate external support.

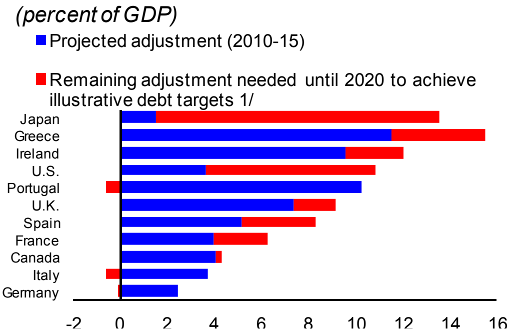
Figure 5. European Bank Core Tier 1 Ratios
(percent of risk-weighted assets)



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.

10. **Fiscal repair: achieve sustainable balances, while supporting growth.** Credible medium-term fiscal consolidation plans are essential for many countries. For some, it is crucial for breaking the adverse feedback loop between rising sovereign spreads and deteriorating bank balance sheets. For others, it would create more room for a slower pace of adjustment in the short-term, which would facilitate the rebalancing from public to private demand. Credible fiscal measures would

Figure 6. 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.

also constrain sovereign risk premia, putting public debt on "good equilibrium" paths. However, consolidation also reduces demand in the short run—authorities should not assume that there will be immediate confidence effects. Fiscal consolidation therefore has to walk a fine line: too little adjustment, and credibility will be lost, with a price to be paid in funding costs; too much, and growth will be sharply depressed. As emphasized in the September 2011 Fiscal Monitor, the primary emphasis should be on adopting credible fiscal adjustment plans to stabilize and then reduce public debt-to-GDP ratios. Plans that credibly deliver savings tomorrow can allow a gradual adjustment today, thus achieving durable balance sheet repair while taking cyclical conditions into account.

- In the case of the United States, the proposed American Jobs Act would provide needed short-run support to the economy. However, it remains essential to adopt, in parallel, a credible medium-term fiscal adjustment plan that raises revenues

and contains the growth of entitlement spending.

- In Japan, the pace and scope of fiscal adjustment envisaged for the short term is appropriate, but it should be strengthened significantly over the medium term.
- In most other economies (e.g., Canada, Germany, Korea, and the United Kingdom), current plans are appropriate, but near-term tightening should 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.

11. **The composition of fiscal measures should be targeted at raising growth.** Those enacted to ensure medium-term fiscal sustainability should aim to raise potential growth (which is crucial for durable fiscal adjustment). Examples include widening tax bases by cutting tax expenditures rather than increasing rates, removing tax distortions, and cutting low-productivity spending. Entitlement reforms are essential in many economies, and, properly executed (e.g., increases in statutory retirement ages; improved incentives in health care), are likely to have minimal impact on short-run demand. Short-run expansionary measures should have large multipliers (such as infrastructure spending), while contractionary measures should have small multipliers.

12. **Household balance sheet repair:** In the United States, halting the spiral of foreclosures, falling house prices and deteriorating household spending is essential. Options include supporting write-downs of unrecoverable loans, including increased mortgage principal modifications, facilitated by the introduction of "cramdowns" into the personal bankruptcy regime. This would help put a floor on consumption.

13. **Monetary policy: maintain accommodative conditions.** Given falling confidence and activity as well as well-anchored inflation expectations, monetary policy conditions in advanced economies should remain very accommodative. The ECB should ease monetary policy if downside risks to growth and inflation persist, and continue to support orderly markets in sovereign debt. The Federal Reserve, Bank of England, and Bank of Japan should stand ready to deploy more unconventional measures. Prudential authorities will need to be watchful of risks flowing from low interest rates.

14. **Emerging and low income economies: be nimble in dealing with potentially adverse spillovers from advanced economies, and continue to strengthen macroeconomic policy frameworks**. In many economies with external deficits and appreciated exchange rates, tighter fiscal policy is needed to rebuild policy space and lower overheating pressures. Monetary

tightening can pause in the face of rising downside risks, as long as inflationary pressure is in check. Macro-prudential tools aimed at reducing leverage can help to contain financial stability risks from strong capital inflows.

- Many economies with external surpluses, notably China, can support domestic demand by reducing the pace of fiscal consolidation in the face of weakening external demand, provided their public finances are in good order.
- Most emerging economies need to bolster their financial stability frameworks to cope with capital flows. The secular trend for capital to shift from advanced to emerging economies is likely to continue, as are pressures to "search for yield" in emerging economies. But capital flows are also likely to remain volatile. Financial sector supervisors should carefully monitor developments in credit markets and the build-up of foreign-denominated debt. Capital flow management tools are useful for changing the composition of capital inflows. But the first lines of defense against speculative inflows should be appropriate macroeconomic and prudential policies.
- In the event of a sharp global downturn, those LICs that have fiscal space should again aim to pursue countercyclical policies to support growth and protect spending. For those with more limited scope for action, fiscal measures should be targeted to protect the poor, with the international community helping to provide funding for social support.

COLLECTIVE ACTION

15. **Collective action can set the stage for a return to strong, sustainable, and balanced growth.** Policies clearly need to be tailored to 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.

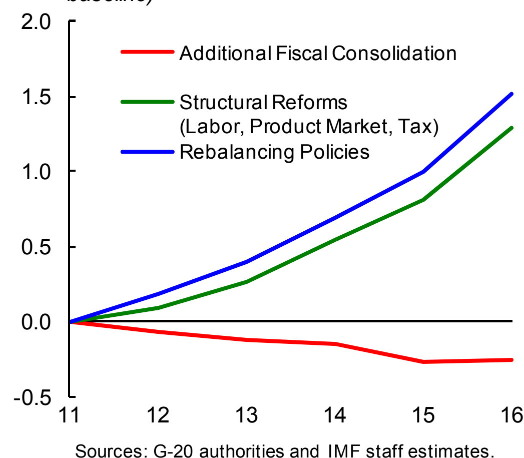
- In the short run, the main challenge is to raise growth in core advanced economies. This, in turn, requires addressing the balance sheet vulnerabilities discussed above, so as to advance internal rebalancing.
- Over the medium run, external rebalancing is now more important than ever. Even as private demand in major advanced economies remains weak, a number of governments have started significant near-term fiscal tightening. Structural reforms are important to support fiscal policies by raising long-run growth potential, but their immediate impact on demand is likely to be limited. To offset weaker demand in major advanced partner economies, internal demand will need

to increase elsewhere, notably emerging surplus economies. However, so far, external rebalancing has been driven mainly by weak domestic demand in advanced deficit economies, rather than strong demand in emerging surplus economies.

16. **External rebalancing requires collective action.** Going forward, it is essential that households in advanced deficit economies continue deleveraging. This will 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—including through a removal of distortions, better pension, healthcare, and education systems, together with less (sterilized) intervention in foreign exchange markets—can help support global growth. In China's case, lowering national saving, by addressing key distortions, and accelerating the pace of exchange rate appreciation by slowing the pace of reserve accumulation would help shift growth away from exports and investment toward private consumption. In other economies, notably in the MENA region, policymakers need to develop an inclusive growth agenda that empowers the private sector to become the engine of growth, strengthens education systems and labor market institutions to spur job creation, is based on well-targeted social programs that replace existing large-scale subsidy schemes, and tackles long-standing governance issues. In LICs, policymakers need to rebuild resilience against future shocks by expanding the fiscal revenue base; ensuring the efficiency of public investment; and pursuing structural reforms to deepen the financial sector, develop social protection systems, and diversify the economy.

17. **Coordinated policies could achieve impressive gains for the global economy.** Fiscal plans in advanced economies that are as "growth accommodating" as possible, together with targeted structural reforms in product and labor markets, could yield significant growth benefits. Rebalancing policies to reduce domestic distortions and boost internal demand in key emerging surplus economies would further lift growth. Simulations prepared by IMF staff in collaboration with OECD staff suggest that joint actions by G-20 members consistent with the three policy layers described above could result in an overall increase of world GDP by 1½ percent by 2016 and an additional 20 million jobs relative to WEO projections.

Figure 7. G-20 MAP: Upside Scenario
(world real GDP; percent deviation from baseline)



Sources: G-20 authorities and IMF staff estimates.

18. **Coordination is also essential to reduce the likelihood and impact of another crisis and alleviate regulatory uncertainty.** Significant progress has been made on the regulatory front. But countries urgently need to implement these reforms quickly, while enhancing prudential supervision and domestic resolution toolkits. Multilateral consistency is crucial for three issues. First, systemic capital surcharges for global-systemically important banks need to be implemented consistently, and complemented with improvements to the "resolvability" of these institutions. Second, coordinated multilateral frameworks for crisis management need to be developed with clear principles to guide information exchange and cross-border bank resolutions. Third, there should be greater transparency of the shadow banking system and, as appropriate, expansion of the supervisory perimeter. Making progress on these issues will require difficult policy decisions and increased cooperation from all stakeholders involved.

19. **Progress is also needed on the global policy architecture (see Action Plan) and reform of global trade.** Global risk sharing mechanisms need to be bolstered in light of the vast increase in the size of global financial markets. To ensure that trade remains supportive of the global recovery, policymakers must continue to resist protectionist pressures. Just as important, the long-running World Trade Organization (WTO) Doha Round must be brought to a successful close. Failure of the round could lead to fragmentation of the global trading system and a weakening of the WTO and multilateralism.

20. **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. This is what is needed to secure strong, sustainable, and balanced growth.