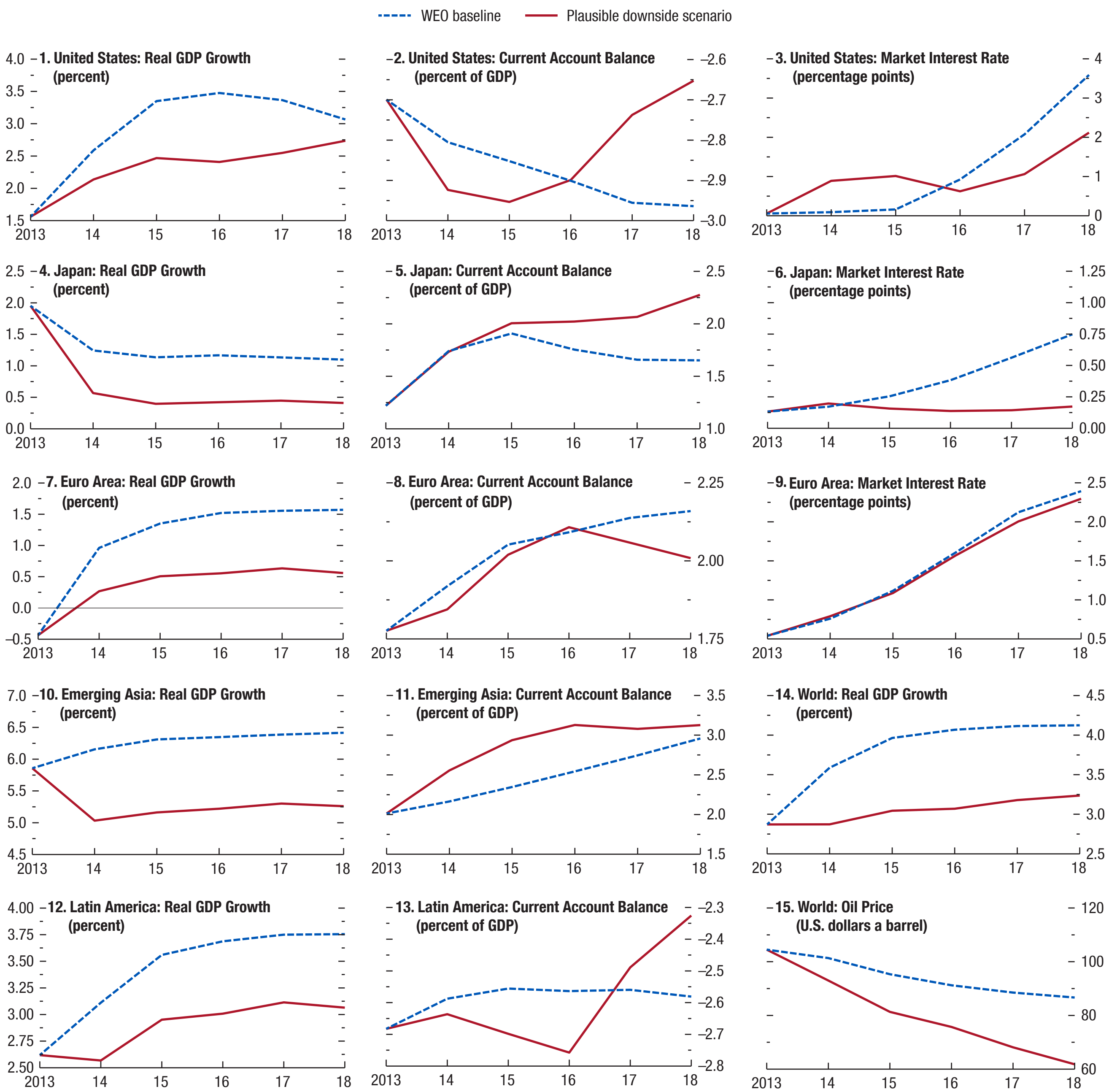
## Figure 1.17. Plausible Downside Scenario

This scenario uses The Euro Area Model (EUROMOD) to consider a plausible downside scenario. The scenario is based on four main drivers. First, the market is assumed to misperceive the future pace of tightening in U.S. monetary policy and delivers higher-than-baseline interest rates, notably in the first few years of the WEO horizon when there is little or no scope for the monetary policy rate to be easing to offset it. In addition, the recovery in investment in the United States is more subdued relative to the WEO baseline and, consequently, productivity growth is slower over the entire WEO horizon. Second, weaker than expected macro outcomes in the euro area, owing primarily to weaker investment and heightened fiscal sustainability concerns, lead to rising risk premiums and additional fiscal tightening. This process is ongoing, with continued surprises each year of the WEO horizon and growth outcomes that are weaker than expected. Third, emerging market economies do not recover to their precrisis growth paths. In emerging Asia, particularly China, slower growth would be driven by weaker investment and would translate into weaker employment, incomes, and consumption, possibly driven by either policy measures to help shift to more sustainable growth or by weaker export prospects. In other emerging markets, slower growth in the euro area and emerging Asia and the repercussions via lower commodity prices will slow investment and growth. Overall, lower growth in emerging market economies will lead to mild capital outflows and tightening in financial conditions, with the United States benefiting marginally. Finally, in Japan, less than successful implementation of the three-pronged recovery strategy will diminish growth. Less will be done on the structural reform front, and even tighter fiscal conditions will be required to help stabilize public debt and prevent a sharp increase in the risk premium, which, in turn, will undermine achievement of the new inflation target. The zero-interest-rate floor binds in 2014 for the United States, the euro area, and Japan. Beyond 2014, monetary policy rates are allowed to ease only as much as the policy space permits in the WEO baseline.




Source: IMF staff estimates.