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The Outlook

The latest IMF World Economic Outlook (WEO) Update paints a grim picture of the global economy (available at: http://www.imf.org/external/pubs/ft/weo/2012/update/01/index.htm). The global recovery is threatened by intensifying strains in the euro area and fragilities elsewhere. Financial conditions have deteriorated, growth prospects have dimmed, and downside risks have escalated.

Global output is projected to expand by 3¼ percent in 2012—a downward revision of about ¾ percentage point relative to the September 2011 WEO. This is largely because the euro area economy is now expected to go into a mild recession in 2012 as a result of the rise in sovereign yields, the effects of bank deleveraging on the real economy, and the impact of additional fiscal consolidation. With only limited policy room, growth in most other advanced economies is also lower, mainly due to adverse spillovers from the euro area via trade and financial channels that exacerbate the effects of existing weaknesses. For the United States, the growth impact of such spillovers is broadly offset by stronger underlying domestic demand dynamics in 2012. Nonetheless, activity slows from the pace reached during the second half of 2011, as higher risk aversion tightens financial conditions and fiscal policy turns more contractionary.

Given the depth of the 2009 recession, growth rates in advanced economies are too sluggish to make a major dent in very high unemployment. Although global growth remains respectable by historical standards, it is mainly driven by emerging and developing economies whose growth rate remains relatively high and who now account for a large share of global output. Nevertheless, growth in these economies is also slowing because of the worsening external environment and a weakening of internal demand. Developing Asia is projected to grow most rapidly at 7½ percent on average during 2012–13 and remains the bright spot in the global economy.

Global growth prospects dimmed and risks sharply escalated during the fourth quarter of 2011, as the euro area crisis entered a perilous new phase. Activity remained relatively robust throughout the third quarter, with global GDP expanding at an annualized rate of 3½ percent. Growth in the advanced economies surprised on the upside, as consumers in the United States unexpectedly lowered their saving rates and business fixed investment stayed strong. The bounce back from the supply-chain disruptions caused by the March 2011 Japanese earthquake was also stronger than anticipated. Additionally, stabilizing oil prices helped support consumption. These developments, however, are not expected to sustain significant momentum going forward. By contrast, growth in emerging and developing economies slowed more than forecast, possibly due to a greater-than-expected effect of macroeconomic policy tightening or weaker underlying growth.

But lately, the near-term outlook has noticeably deteriorated, as evidenced by worsening high-frequency indicators in the last quarter of 2011. The main reason is the escalating euro area crisis, which is interacting with financial fragilities elsewhere. Specifically, concerns about banking sector losses and fiscal sustainability widened sovereign spreads for many euro area countries, which reached highs not seen since the launch of the Economic and Monetary Union and bank funding all but dried up.

The updated WEO projections see global activity decelerating but not collapsing. Most advanced economies avoid falling back into a recession, while activity in emerging and developing economies slows from a high pace. However, this is predicated on the assumption that in the euro area, policymakers intensify efforts to address the crisis. If so, sovereign bond premiums stabilize near current levels and start to normalize in early 2013. If policies succeed in limiting deleveraging by euro area banks, credit and investment in the euro area contract only modestly, with limited financial and trade spillovers to other regions.

However, the WEO also contains a more pessimistic scenario in which downside risks materialize. The most immediate risk is intensification of the adverse feedback loops between sovereign and bank funding pressures in the euro area, resulting in much larger and more protracted bank deleveraging and sizable contractions in credit and output. It assumes that sovereign spreads temporarily rise. Increased concerns about fiscal sustainability force a more front-loaded fiscal consolidation, which depresses near-term demand and growth. Bank asset quality deteriorates by more than in the baseline, owing to higher losses on sovereign debt holdings and on loans to the private sector. As a result, euro area output contracts significantly more relative to the WEO forecast and global output will be lower than the WEO projections by about 2 percent.

One could add further downside risks. For example, one risk arises from insufficient progress in developing medium-term fiscal consolidation plans in the United States and Japan. In key emerging economies, risks relate to the possibility of a hard landing, especially in the context of uncertain (possibly slowing) potential output. In recent years, a number of major emerging economies experienced buoyant credit and asset price growth as well as rising financial vulnerabilities.

In this setting, there are three requirements for a more resilient recovery: sustained but gradual fiscal adjustment; ample liquidity and easy monetary policy, mainly in advanced economies; and restored confidence in policymakers' ability to act. Importantly, not all countries should adjust in the same way, to the same extent, or at the same time, lest their efforts become self-defeating. Through mutually consistent actions, policymakers can help anchor expectations and reestablish confidence.

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