G R O U P   O F   T W E N T Y

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Global Economic Prospects and Policy Changes

Prepared by Staff of the International Monetary Fund*

I N T E R N A T I O N A L   M O N E T A R Y   F U N D

* Does not necessarily reflect the views of the IMF Executive Board.

EXECUTIVE SUMMARY

The global recovery is being threatened by intensified sovereign, financial, and real sector feedback loops. Activity will lose steam through 2012, but a collapse should be avoided. In *G-20 advanced economies*, the euro area will experience a mild recession through 2012. In the United States, growth is expected to moderate following the recent pick-up, which was supported in part by lower household saving. Other major advanced economies will suffer from weak and uneven growth. In *G-20 emerging economies*, the moderation in growth from high levels is expected to continue in 2012, reflecting past policy tightening and adverse spillovers from advanced economies.

Downside risks to global growth have escalated. The overarching risk remains an intensified "paradox of thrift" as households, firms, and governments globally reduce demand. The prospect of multiple equilibria—particularly with respect to market perceptions of sovereign debt sustainability in the euro area—has intensified this risk. Other key risks include hard landings in emerging economies and a sharply higher oil price, driven by geopolitical-related disruptions to the supply of crude oil.

***Europe* must pursue its move beyond its piecemeal approach and achieve a successful resolution of the crisis through four key steps**. *Fiscal consolidation* structured and paced to avoid a collapse in demand, with the focus on the size of the cyclically-adjusted effort; countries with policy space should consider holding off adjustment in 2012. *Stronger growth*, by offsetting the adverse effect of fiscal consolidation on growth with other policies: easier monetary policy, including lower ECB policy rates; bank recapitalization; and structural reforms to address the root causes of the crisis and bolster market confidence. *Enhanced crisis management*, by providing sufficient funding through expanded use of the ECB's balance sheet and adding real resources for the European Financial Stability Facility (EFSF) and the European Stability Mechanism (ESM). *Deeper fiscal and financial integration across Europe* to underpin the sustainability of the common currency.

In other *G-20 advanced economies*, there remains an urgent priority to set out a *credible path for fiscal consolidation* over the medium term. In the near term, sufficient adjustment is planned in most advanced economies. If downside risks to growth materialize, countries with adequate space should allow automatic stabilizers to operate fully, and those that can afford it, may consider slowing the pace of near-term consolidation, while maintaining their commitment to credible medium-term consolidation. *Monetary policy should remain highly accommodative*, and policymakers should stand ready to continue or expand unconventional measures, if needed.

In *G-20 emerging economies*, the immediate policy priority is to ensure a soft landing as domestic growth and demand from advanced economies moderate. Monetary policies can be eased in economies with diminishing inflationary pressure (e.g., Latin America), but with sufficient safeguards to insure against overheating in some sectors (e.g., real estate). Social spending can be increased in economies where inflation is low, public debt is not high, and external surpluses are large (e.g., China). Policy space is more limited in those economies that suffer from both relatively high inflation and public debt, warranting a more cautious stance toward policy easing (e.g., India).

Collective action to address persistent global imbalances can better guarantee a return to strong, sustainable, and balanced global growth. This will require further deleveraging of households in *advanced deficit economies* and more inclusive growth and lower saving in *emerging surplus economies*. The latter can be achieved by alleviating distortions, notably financial sector reform as well as enhanced pension, healthcare, and education systems, complemented with less intervention in foreign exchange markets.

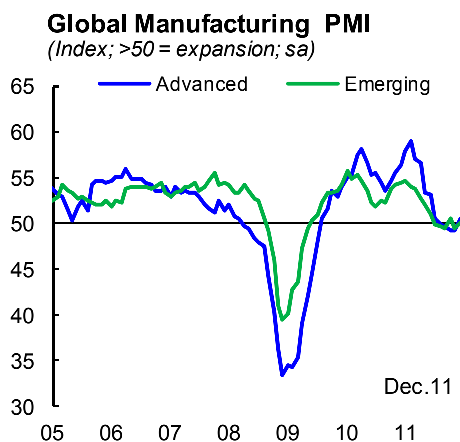
Prepared by a team from the IMF's Research Department, led by Emil Stavrev and including Shaun Roache, Thomas Helbling, Eric Bang, and Anne Lalramnghakhleli Moses.

I. GLOBAL CONJUNCTURE

The global recovery is under threat. Financial conditions have deteriorated, global growth prospects for 2012 have dimmed, and downside risks have escalated, notably the threat of intensified sovereign-financial feedback and financial sector deleveraging that could inflict widespread damage to the real economy. The euro area has entered recession and other G-20 advanced economies are experiencing weak and bumpy growth, reflecting legacies from the crisis and spillovers from Europe. G-20 emerging economies are slowing by more than expected, as the effects of past policy tightening are hitting their economies at the same time as spillovers from advanced economies.

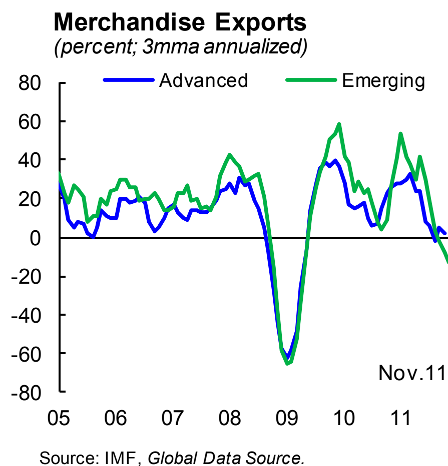
1. **Global activity is slowing**. Recent indicators show a marked deterioration from the relatively robust third quarter of 2011, during which global GDP expanded at an annualized rate of 3½ percent. During this period, growth in the advanced economies surprised on the upside, as consumers in the United States unexpectedly lowered their saving rates and business fixed investment showed strength, supply-chain disruptions after the Japan earthquake unwound more quickly than anticipated, and stabilizing oil prices helped support consumption. But these factors are likely to boost growth only temporarily and financial conditions have worsened significantly in the meantime. Broad indicators of global activity—including trade—are confirming that growth during the final quarter of 2011 turned out lower than projected in the September 2011 WEO.

Global Manufacturing PMI
(Index; >50 = expansion; sa)



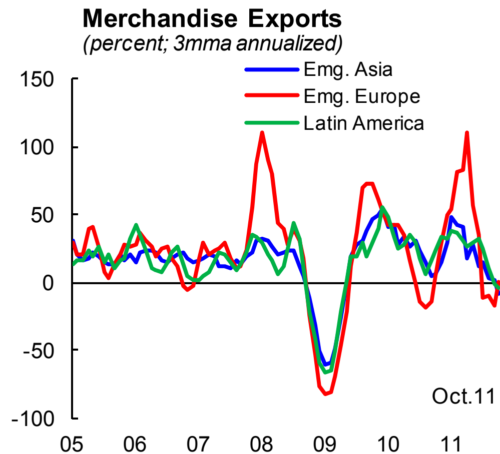
Source: IMF, *Global Data Source.*

Merchandise Exports
(percent; 3mma annualized)

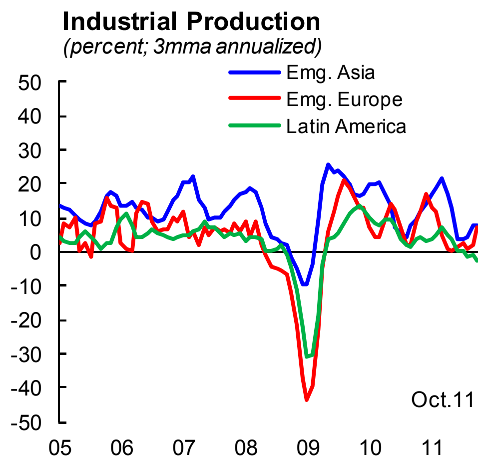


Source: IMF, *Global Data Source.*

2. **Growth in *G-20 emerging economies* is slowing more than expected**. This may reflect past policy tightening and weaker fundamental growth. At the same time, adverse spillovers from *G-20 advanced economies* are beginning to wash ashore. In some major emerging economies domestic demand has cooled more than expected. These effects have been amplified by weaker confidence in the outlook for growth as the external environment has deteriorated. Indeed, evidence of adverse spillovers from advanced economies is building, with trade serving as the main transmission channel. Export growth for emerging economies is now contracting at an annual rate after expanding by between 30–40 percent earlier in 2011. The sharpest declines have been recorded in *emerging Europe*, reflecting close linkages to the euro area.



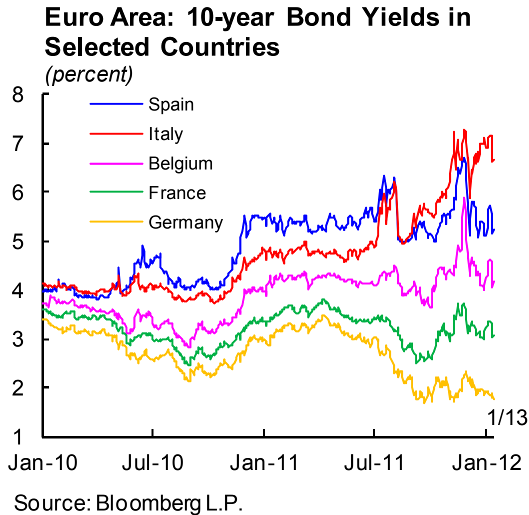
Source: IMF, *Global Data Source.*



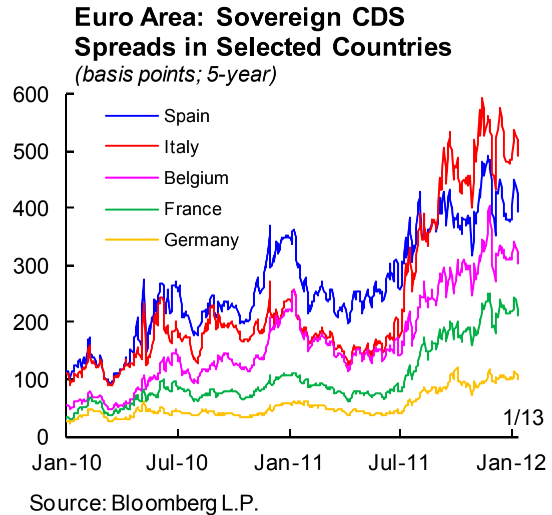
Source: IMF, *Global Data Source.*

3. **Recent policy advances in the euro area, in response to market pressures, have prevented a calamitous collapse in confidence and financial stability so far**. The most tangible effect has come from the enhanced liquidity facilities offered by the ECB, including extended refinancing operations and the acceptance of a broader range of collateral. With wholesale funding markets still tight, this has reduced the immediate pressure on banks by lowering the need to rollover. At the same time, the EU made commitments at the recent summit to strengthen the euro area's policy framework. But the lack of a comprehensive approach to resolve the sovereign debt crisis, coupled with a weaker focus on measures to boost growth, have dampened the positive effect on market confidence.

4. **Sovereign stress in parts of the euro area remains very elevated, sustaining adverse feedback loops with the financial sector and the real economy**. Doubts about placing public finances on a sustainable track have kept sovereign yields in countries under market scrutiny high, putting pressure on banks' balance sheets. The ECB's long-term refinancing operation (LTRO) program, while designed to provide liquidity support to banks, appears to have offered some support at the short end of the sovereign yield curve for the euro area countries under market stress, largely reflecting increased demand for sovereign debt from the banks with enhanced access to funding (including for collateral). The effect on long-term bonds has been limited however, with yields remaining at dangerously high levels (at about 7 percent for Italy and somewhat lower for Spain). Sovereign CDS spreads have also remained high and near recent peaks, including for the core countries of the euro area. Higher sovereign yields are feeding through to increased private sector borrowing costs.

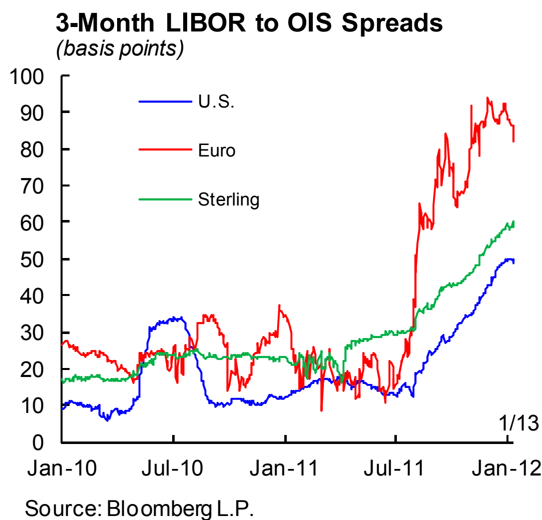


Source: Bloomberg L.P.



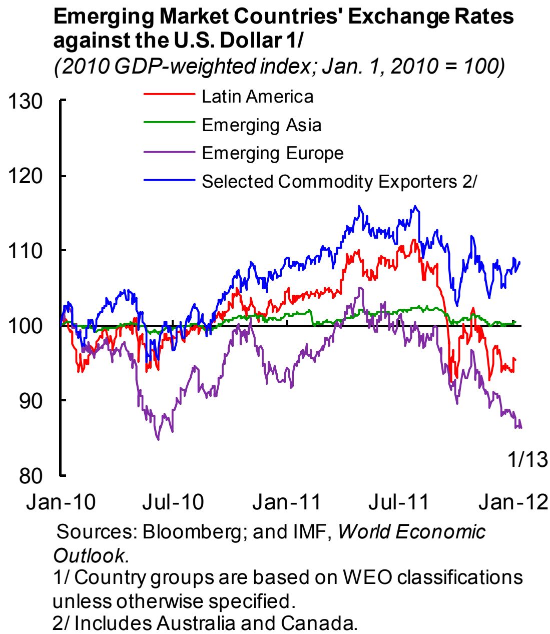
Source: Bloomberg L.P.

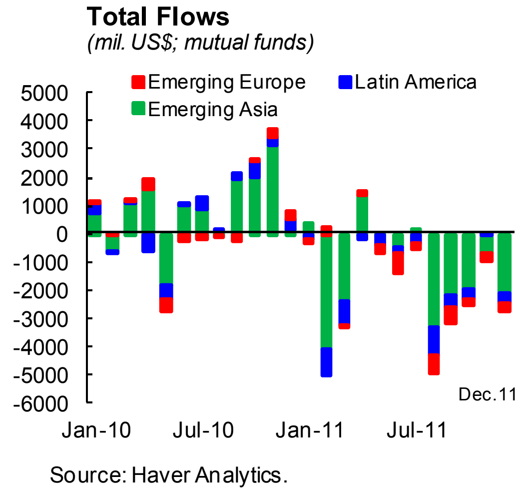
5. **Intense funding pressure on European banks continues even as regulatory policies to bolster capital buffers have been put in place**. About two-thirds of the current shortfall in bank capital buffers is due to higher capital requirements, with the remainder due to mark-to-market losses on sovereign debt holdings. However, some banks have responded to European Banking Association (EBA) calls for banks to build capital buffers by reducing risk-weighted assets (to increase capital adequacy ratios) rather than increasing the level of capital. To avoid excessive deleveraging, the EBA has stated that any reductions in risk weighted assets as a means of attaining the target should be agreed only insofar as these are effected through the sale of selected assets.



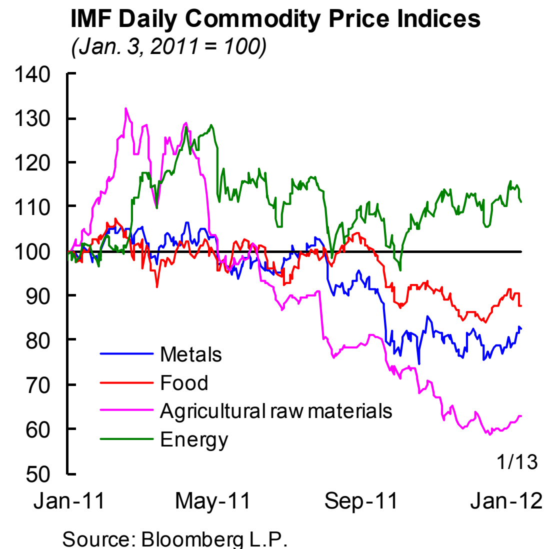
Source: Bloomberg L.P.

6. **Amid a general flight to safety, emerging market exchange rates have resumed their depreciation against the U.S. dollar and asset prices have fallen**. Depreciations have been broad across countries with flexible exchange rates, with particular currency weakness in those economies in close geographical proximity to the euro area. At the same time, portfolio capital is still flowing out of emerging markets, but at a markedly slower pace than during late 2008 or during August-September 2011. This is contributing to a modest worsening in financial conditions, as reflected in lower equity prices and higher external bond spreads.





7. **Crude oil prices have held up in the face of lower global growth and demand prospects, but other commodity prices have extended their decline**. The oil market has remained relatively tight, due mainly to temporary supply constraints in non-OPEC producers. At the same time, geopolitical risks have increased, raising precautionary demand for oil inventories and adding a risk premium to spot prices. Other commodity markets have been quick to price-in weaker demand, particularly base metals, while food prices have declined mainly due to the prospects for buoyant supply in 2012.



II. PROSPECTS

8. **Recovery will stall in many economies during 2012, but a collapse should be avoided**. The euro area is entering a mild recession that will endure through 2012. Other advanced major economies will suffer from weak and uneven growth. Emerging economies will experience a further moderation in the pace of recovery. But this baseline is predicated on the assumption that policymakers in the euro area meet their commitments with increased urgency to stabilize the crisis in 2012. This would allow for a gradual normalization of sovereign bond premiums and would limit the deleveraging by euro area. Credit and investment in the euro area contract modestly, with limited financial and trade spillovers to other regions.

- *Global output* is projected to expand by about 3½ percent in 2012 (Table 1)—a downward revision of about ¾ percentage points relative to the September 2011 *World Economic Outlook* (WEO). Growth has been marked down for both advanced and emerging economies, with a large divergence in the growth levels persisting between both regions.

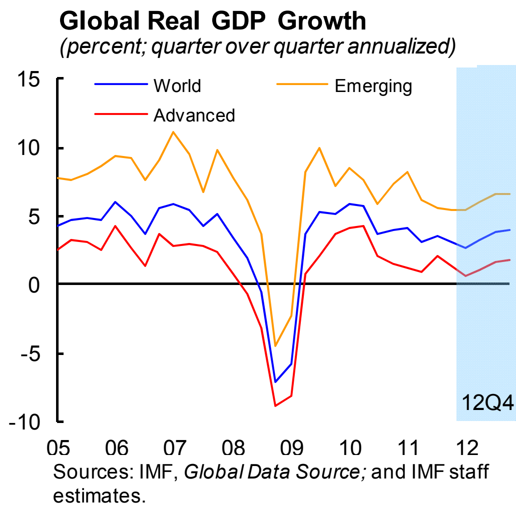
- The *euro area* is expected to enter a recession with activity projected to contract by ½ percent in 2012. Contributing factors include the increase of sovereign and corporate bond yields and an accelerated program of fiscal consolidation. Sovereign-financial sector feedback is amplifying these effects, as banks exposed to government bonds and weakening real economies delever their balance sheets, further tightening credit conditions.

- Growth in the *United States* is expected to slow during the course of 2012, after stronger domestic dynamics initially make up for negative spillovers from the euro area. The recent pick-up in private consumption has been largely fueled by a decline in saving and is unlikely to be sustained in the absence of a marked improvement in the labor market and household incomes. At the same time, the recovery of household net wealth remains tepid on the back of broadly stagnating equity prices and house prices that remain close to their post-crisis lows. The prospect of stepped-up fiscal consolidation would also constrain growth.

- In *Japan* reconstruction following the earthquake will support activity, but at the same time weaker global trade growth and strong yen will mean that overall growth will remain low at about 1¾ percent in 2012, a downward revision of ½ percentage points from the September WEO.

- In *emerging and developing economies* growth is expected at 5¾ percent—a significant slowdown from the 6¾ percent growth registered in 2010-11 and about ½ percentage point lower than in the September 2011 WEO. This reflects past policy tightening (e.g., Brazil), domestic policy slippages that have hit confidence (such as India) and adverse spillovers from advanced economies. Stalling global trade growth, lower commodity prices, and reduced portfolio capital flows (and likely net outflows) will all further slow the pace

of recovery. The effects of these factors will vary somewhat across regions and countries, reflecting linkages with advanced economies, but also the extent to which policies serve to cushion the impact. *China's* economy has, once again, shown its resilience and appears to be coasting to a modest slowdown. Nevertheless, the external environment is weakening and growth is projected to moderate by about 1 percentage point to 8¼ percent in 2012.



9. **Inflation should ease as demand softens and commodities price declines feed through to prices, but risks of damaging deflation have increased in some *G-20 advanced economies*.** Futures markets now anticipate that most key commodity prices will remain broadly unchanged, while risks for non-energy commodities are broadly on the downside.

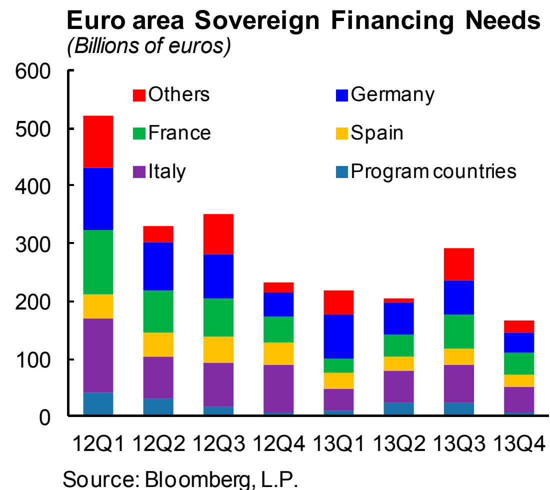
- In *G-20 advanced economies*, ample economic slack and well-anchored inflation expectations will keep inflation pressures subdued, as the effect of last year's higher commodity prices wanes. Inflation is projected to recede to close to 1½ percent during 2012, down from a peak of about 2¾ percent in 2011. Should growth turnout lower than expected, there is a risk that very large output gaps would lead to deflation in some countries, with damaging consequences where debt burdens remain high.

In *G-20 emerging economies*, inflationary pressures are also expected to drop, as growth slows and food price inflation declines. However, inflation is expected to remain persistent in some regions. Overall, consumer prices in these economies are projected to decelerate, with inflation reaching 6¼ percent in the course of 2012, down from 7½ percent last year.

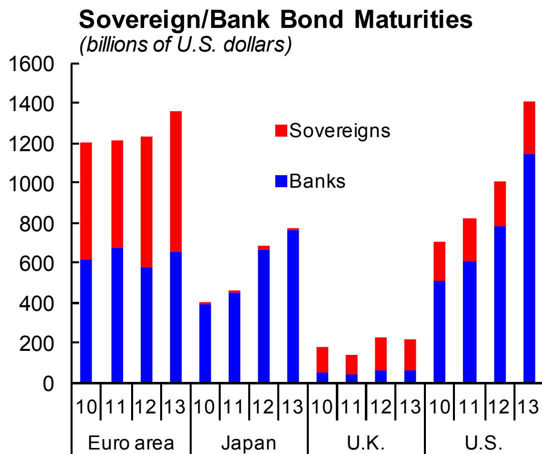
III. KEY RISKS

Downside risks to global growth have escalated. The overarching risk remains an intensified global "paradox of thrift" as households, firms, and governments around the world reduce demand, with many advanced economies unable to lower policy rates further. Credibility issues and fertile ground for multiple equilibria—self-fulfilling outcomes of pessimism or optimism, particularly with respect to sovereign debt sustainability in the euro area—have only intensified this risk. Emerging economies now face greater risks of a hard landing, stemming from home-grown vulnerabilities and adverse spillovers from advanced economies.

10. **The key risk remains that policies fail to shift Europe gradually towards a "good equilibrium", failing to break the adverse feedback loops between real, fiscal, and financial sectors**. This risk is immediate as euro area public sector and bank debt rollover needs during 2012 are large (cumulative at about 16 percent of GDP). Successful debt issuance will require a durable recovery of market confidence about the prospects for both growth and fiscal sustainability across the euro area.



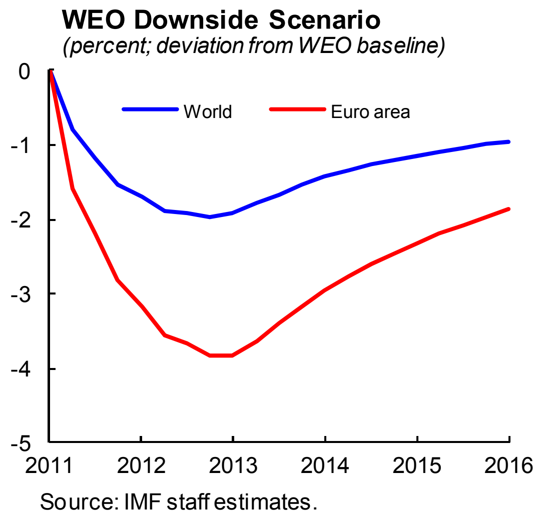
Source: Bloomberg, L.P.



Source: Dealogic.

11. **Intensified adverse sovereign-financial feedback loops in the euro area would accelerate bank deleveraging, entailing sizeable contractions in credit and output, and potentially large global spillovers**. The scenario embodies an additional contraction in credit (€500 billion) coinciding with sharp fall in private investment (almost 2 percent of GDP). The resulting adverse impact on growth intensifies fiscal sustainability concerns, driving up sovereign risks premia (by 100 basis points from present levels) and forcing even more front-loaded fiscal consolidation (1 percent of GDP). The adverse impact of these developments is amplified by the fact that monetary policy is constrained by the zero lower bound on interest rates. As a result, the level of euro area output is lower by about 4 percent

relative to the WEO forecast after 2 years (see Table 1 for the WEO baseline). Assuming that financial contagion to the rest of the world is intense but weaker than following the collapse of Lehman Brothers in 2008 and considering spillovers via international trade, the level of global output is lower than the WEO projects by about 2 percent after 2 years.



12. **Debt sustainability remains a threat to the outlook in the United States and Japan**. In the short run, this risk might be mitigated as the turbulence in the euro area makes government debt of these economies more attractive for investors. However, as long as public debt levels are projected to rise over the medium term, and in the absence of well-defined and credible fiscal consolidation strategies, there is the possibility of turmoil in global bond and currency markets. As developments in the *euro area* have shown, market confidence can be lost quickly with damaging consequences for growth and financial stability, underscoring that time is of the essence.

- In the *United States*, policymakers have so far failed to make progress towards a strong, credible medium-term fiscal adjustment plan. The already-approved consolidation measures would go some way toward reducing the budget deficits, but they do not address the underlying spending pressures from public health care and pension programs, and do not raise any new revenue. An accident-prone political economy could result in damaging fiscal tightening in the short run, as key measures to support the economy lapse in the face of a political impasse.

- In *Japan*, while the immediate priority should be to repair damaged infrastructure and get the recovery back on track, credible medium-term consolidation plan needs to be tabled to ensure debt ratios begin falling by mid-decade. In that regard, the government's proposal for tax and social security reform bill is welcome, but an agreement on the details needs still to be reached. More importantly, further fiscal consolidation to the one proposed in the bill is needed to secure fiscal sustainability.

13. **In key emerging economies the risks stem from the possibility of a hard landing, on the back of uncertain potential growth, and spillovers from advanced economies**. In a number of major emerging economies credit expanded at a brisk pace over the past couple of years, increasing financial vulnerabilities. The resulting buoyant demand may have led to an overestimation of underlying growth in these economies. If the gains in real estate prices and credit were to unwind, triggered by a loss of confidence, the impact on activity could be damaging. The effect could be exacerbated by adverse external developments. Export growth in

emerging economies has already stalled (particularly for emerging Asia), and weaker-than-expected demand from advanced economies, as the experience of 2008-09 showed, could trigger much sharper falls. Substantially weaker global demand would also lower oil and commodity prices, adversely affecting exporters. Until now, the financial spillovers from turbulence in advanced economies have been modest, but previous experience underscores that financial conditions can change quickly. A sudden stop or reversal of capital flows, reduced availability of trade finance, or liquidity pressures in domestic financial systems due to widespread counterparty risk aversion could rapidly materialize.

14. **Emerging economies also face risks of domestic policy missteps**. Specifically:

- *Policy space* is much reduced compared to 2008 and the capacity of emerging economies to respond forcefully to adverse spillovers is lower. In some economies, fiscal space is reduced by relatively high deficits and debt levels that increased due to aggressive stimulus during the crisis (e.g., India). In others, monetary stimulus could further exacerbate imbalances in the economy that built up during 2009-10 (including a credit, property, and construction boom in China).

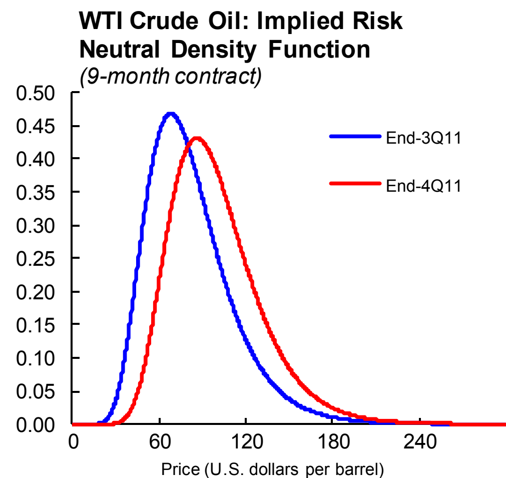
- The global environment has become less forgiving of *policy slippages*, including on structural reforms that correct domestic distortions and contribute to balanced growth. Delayed implementation of structural reforms (including India's recent decision to delay liberalization of its domestic multi-brand retail sector) has adversely impacted domestic confidence at the same time as uncertainties regarding external demand have increased.

Box. Oil Price Risks

Concerns about geopolitical oil supply risks are again increasing. Iran-related risks stand out since the International Atomic Energy Agency (IAEA) released its update on the country's nuclear program in mid-November, although geopolitical risks are broader and also apply to Iraq, Syria, South Sudan, and Nigeria.

The likelihood of an Iran-related supply disruption remains difficult to determine, but recent price developments suggest that oil markets assign a low, albeit rising, probability (chart). Concerns about large-scale, potentially unprecedented disruptions are based on the following considerations:

- *Iran is the world's 5th largest producer*, extracting 3½ million barrels a day (mbd), around 5 percent of global production and the 3rd largest exporter of crude oil.
- *Iran's location at a key oil supply route* (the Strait of Hormuz), where production capacity is concentrated and through which about 40 percent of global oil exports and one-fourth of global production is shipped. A blockade would also neutralize a large part of current OPEC spare capacity. Alternative routes exist, but only for a tiny fraction of the amounts shipped through the Strait, and they may take some time to operationalize while transportation costs would rise significantly.



Source: IMF staff estimates.

The oil market impact of intensified concerns about an Iran-related oil supply shock (or an actual disruption) would be large, if not compensated by supply increases elsewhere. Financial flow sanctions imposed by some OECD countries against Iran may be tantamount to an oil embargo and would imply supply declines of around 1.5 mbd, comparable with the average decline during major disruptions since the first oil shock and to the setbacks to Libyan production in 2011. A blockade of the Strait of Hormuz would constitute, and be perceived by markets to presage, sharply heightened global geopolitical tension involving a much larger and unprecedented disruption. A supply disruption would likely have a large effect on prices, not only reflecting relatively insensitive supply and demand in the short run but also the current state of oil market buffers. In particular, *OECD inventory buffers are below average* due to tight oil market conditions through much of 2011, and excluding Iran, spare capacity of OPEC *producers is close to the average of the past decade*, at about 3.8 mbd (5.2 percent of global crude oil production). A halt of Iran's exports to OECD economies without offset from other sources would likely trigger an initial oil price increase of around 20-30 percent (about $20-30 a barrel currently), with other producers or emergency stock releases likely providing some offset over time. A Strait of Hormuz closure could trigger a much larger price spike, including by limiting offsetting supplies from other producers in the region.

IV. POLICIES

The three requirements for a more resilient recovery are sustained but gradual adjustment; ample liquidity and easy monetary policy, mainly in advanced economies; and more confidence in policymakers' ability to act decisively. 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. Countries with relatively strong fiscal and external positions, for example, should not adjust to the same extent as countries facing market pressures. A successful resolution of the current crisis will thus require a cohesive, comprehensive, and cooperative package of policies across the G-20.

15. **The focus is understandably on Europe, but other G-20 countries must play their part in supporting growth and minimizing adverse spillovers**. The call for greater policy cohesion, cooperation, and determination applies across the G-20.

16. **A successful resolution of the crisis in Europe requires much more decisive action on four fronts**: fiscal sustainability; stronger growth; an enhanced crisis management toolkit; and deepening integration. Decisive, consistent, and predictive actions on these fronts would improve consumer confidence and investor sentiment.

17. **Fiscal consolidation must continue in many euro area economies, but it should be structured and paced to avoid a collapse in demand and growth**. Sufficient near-term fiscal adjustment is in train in most economies. Countries should allow automatic stabilizers operate freely, provided they can secure funding for higher deficits; those facing very low funding costs should consider a slower pace of consolidation. Overdoing fiscal adjustment in the short run to counter cyclical revenue losses will undercut activity further, diminish popular support for adjustment, and further undermine market confidence. Countries with policy space might consider slowing structural fiscal adjustment in 2012, while maintaining their commitment to a credible medium-term consolidation plan.

18. **The adverse effect of fiscal consolidation on near-term growth should be offset with other policies**. This will require a comprehensive and coordinated set of policies in the following priority areas.

- *Bank recapitalization*. Some deleveraging is unavoidable, but the way it is achieved matters—there is "good" and "bad deleveraging. For example, if banks shed legacy assets or sell non-core businesses to strong institutions, it would not reduce credit to the economy. However, credit to the real economy is most affected when banks curtail new loan originations and let credit lines and loans run off. Countries, working together with host supervisors should monitor and limit deleveraging of their banks at home and abroad. To limit "bad" deleveraging and avoid a devastating credit crunch, banks' capital buffers need to be replenished quickly. This may require the use of public funds, including the European Financial Stability Facility (EFSF) in economies under market pressure. To sever the link between escalating banking, sovereign, and growth problems at the national level, supervisors

will need to do what is possible to avoid excessively fast deleveraging. For countries under pressure, this may well require recourse to euro-wide resources to facilitate bank recapitalization.

- *Easier monetary policy*. The adverse feedback loops between low growth, deteriorating public finances, and banking sector stress could lead to a prolong period of asset and consumer price deflation. To forestall this adverse circuit, the ECB's monetary policy should be highly accommodative, consistent with its mandate of ensuring price stability. This could be achieved by lower ECB monetary policy interest rates, for which room exists, and, as needed, further unconventional measures.

- *Structural reforms*. Fiscal consolidation needs to go hand in hand with reforms to entitlement programs and product and labor markets. These policies will pay off in the medium term by helping to address underlying internal imbalances and competitiveness problems, which are the root causes of current travails. They can also contribute in the short term, largely by bolstering market confidence in the prospects for growth.

19. **Deeper fiscal and financial integration over the medium term across Europe will underpin the sustainability of the common currency**. But progress on these objectives now would help avoid perceptions of an incomplete response to current challenges.

- Policymakers must quickly implement the "fiscal compact" agreed at the December 2011 EU summit.

- Then policymakers should build on this compact. In particular, fiscal rules should be strengthened beyond current plans and accompanied by a transparent and credible framework of public finance risk sharing.

- Efforts should concentrate on addressing the "weak tail" and repairing financial institutions' balance sheets. It is important over the medium term to implement a restructuring strategy that addresses nonperforming assets and nonviable banks. A companion to repairing balance sheets should be improved disclosure of prudential information; for example, EBA should evolve to provide a consistent regime for disclosure of problematic assets.

- Europe must move towards a comprehensive model of common financial sector supervision and resolution, with a common backstop and deposit insurance. This will help build a stronger euro-area financial system and break the adverse feedback loops between banks and sovereigns. In the meantime, more effective resolution tools that facilitate the orderly closing of cross-border banks are required to restore financial stability. Moving expeditiously on this reform agenda, including adopting rules for cross-border burden-sharing, requires a high degree of political commitment.

20. **Giving these policies a chance to exert their full effects will require deft crisis management**. Supplying sufficient liquidity will help prevent abnormal funding costs for banks and sovereigns and avoid contagion. This is best done through official

sources, which could include expanded use of the ECB's balance sheet and additional real resources for the EFSF and/or the European Stability Mechanism (ESM). Countries and institutions outside the euro area may usefully contribute to this process. At the same time, the ECB will need to continue providing liquidity and stay fully engaged in securities purchases to help improve the prospects for financial stability.

21. **In other *G-20 advanced economies*, there remains an urgent priority to set out a credible path for fiscal consolidation over the medium term**. In the near term, sufficient fiscal adjustment is planned in most advanced economies. Automatic stabilizers should be allowed to operate fully; in those economies that can afford to do so, the pace of near-term fiscal consolidation should slow. But medium-term risks to the sustainability remain unaddressed.

- In the *United States* and *Japan*, policymakers should redouble efforts to formulate and implement credible medium-term consolidation plans. Measures could include entitlement reforms including new health care and pension saving measures, caps on discretionary spending, and tax system reforms to boost fiscal revenue. Putting in place such plans will also reinforce policy room to support balance sheet repair, growth, and job creation during this period of heightened vulnerability.

- In the *United States*, there is a risk that political paralysis could lead to an excessively rapid pace of deficit reduction, including an early expiry of the existing stimulus measures such as the payroll tax cut. Such developments would further undermine the already weak recovery.

22. **Monetary policies in other *G-20 advanced economies* should remain highly accommodative**. The Federal Reserve, Bank of England, and Bank of Japan should stand ready to continue or expand their deployment of unconventional measures, if needed. In particular, to ensure that the transmission mechanism for monetary policy remains effective, efforts should be directed at devising targeted schemes that help ease credit constraints on firms and households.

23. **In *G-20 emerging economies*, the near-term focus should be on responding to moderating domestic and slowing external demand, while dealing with volatile capital flows**. As specific conditions and available policy space vary widely across these economies, the appropriate policy response differs as well. But, in general, inflation pressures have eased or are easing, credit growth has peaked, and capital inflows have diminished. Accordingly:

- *Monetary policies can be eased in economies with diminishing inflationary pressure but weaker fiscal fundamentals* (e.g., various economies in Latin America). But this must be accompanied by macro-prudential measures and enhanced financial supervision where there are risks of overheating in some sectors (such as real estate).

- *Additional social spending to support poorer households* should be pursued in economies where inflation is under control, public debt is not high, and external surpluses are large (e.g., China and selected emerging economies in Asia).

In China, fiscal support could continue to be provided to the economy by deferring fiscal consolidation plans, lowering social contributions and consumption taxes, and increasing social transfers. This would also be consistent with the authorities' objective to rebalance the economy over the medium term.

- *Policy space is more limited in those economies that suffer from both relatively high inflation and public debt*. In these cases, including India and some economies in the Middle East, a more cautious stance toward policy easing is required.

24. **Collective action to address persistent global imbalances can better guarantee that the global economy overcomes its immediate challenges and returns to strong, sustainable, and balanced growth**. Ensuring durable global rebalancing will require continued deleveraging of households in *advanced deficit economies*. In part, this would ensure that the ongoing fiscal consolidation is not fully offset by worsening of private sector investment-saving balance. This process should proceed together with sustained and more inclusive growth and lower saving in *emerging surplus economies*. The latter will require alleviating distortions with financial sector reform as well as enhanced pension, healthcare, and education systems, complemented with less intervention in foreign exchange markets.

Table 1. Real GDP Growth

(Percent change)

	Year over Year Averages				Q4 over Q4 1/	
			Projections		Projections	
	2009	2010	2011	2012	2011	2012
World 1/	**-0.6**	**5.2**	**3.8**	**3.3**	**3.2**	**3.4**
Advanced economies	-3.6	3.2	1.6	1.2	1.3	1.3
Euro area	-4.2	1.9	1.6	-0.5	0.7	-0.1
Emerging and developing economies 2/	2.8	7.3	6.2	5.5	5.8	6.1
Advanced G-20	-3.7	3.2	1.5	1.3	1.3	1.3
Emerging G-20	3.8	8.5	7.2	6.1	6.4	6.4
G-20 3/	-0.6	5.5	4.0	3.5	3.5	3.6
Argentina 4/	0.8	9.2	9.2	3.6	7.4	3.3
Australia	1.4	2.6	2.0	3.0	2.7	2.5
Brazil	-0.3	7.5	2.9	3.0	2.1	3.8
Canada	-2.8	3.2	2.3	1.7	2.1	1.7
China	9.2	10.4	9.1	8.2	8.3	8.8
France	-2.6	1.4	1.6	0.2	0.9	0.5
Germany	-5.1	3.6	3.0	0.3	1.8	0.7
India	6.8	9.9	7.4	7.0	6.8	6.9
Indonesia	4.6	6.1	6.4	6.1	6.0	6.1
Italy	-5.1	1.5	0.4	-2.2	-0.1	-2.7
Japan	-5.5	4.4	-0.9	1.7	-0.9	1.9
Korea	0.3	6.2	3.8	3.5	4.3	3.6
Mexico	-6.2	5.4	4.1	3.5	4.1	3.1
Russia	-7.8	4.0	4.1	3.3	3.5	2.8
Saudi Arabia	0.1	4.1	6.5	3.6	…	…
South Africa	-1.5	2.9	3.1	2.5	2.4	3.0
Turkey	-4.8	9.0	8.3	0.4	4.8	-0.2
United Kingdom	-4.4	2.1	0.9	0.6	0.8	1.0
United States	-3.5	3.0	1.8	1.8	1.8	1.5
European Union	-4.1	1.9	1.6	-0.1	0.9	0.3

Source: IMF, *World Economic Outlook,* update as of January 13, 2012.
1/ The quarterly estimates and projections account for 90 percent of the world purchasing-power-parity weights.
2/ The quarterly estimates and projections account for approximately 77 percent of the emerging and developing economies.
3/ G-20 aggregations exclude European Union and quarterly projections exclude Saudi Arabia and European Union.
4/ Private analysts' estimates of real GDP growth have generally been significantly lower than official figures from 2008 onward.

ANNEX. PROGRESS AGAINST POLICY COMMITMENTS IN THE G-20 CANNES ACTION PLAN

This annex describes recent policy developments against the commitments made in the Cannes Action Plan agreed in November 2011 for the seven countries selected by the Indicative Guidelines.

China

Exchange rate and financial sector reform:

- The exchange rate has been allowed to appreciate faster than in the past, with the real effective exchange rate appreciating in annualized terms by over 19 percent during the 3 months to early January 2012 (by over 8 percent during 2011). In addition, the pace of reserves accumulation has slowed since Cannes.
- The authorities need to continue to allow the exchange rate to appreciate closer to equilibrium and to move ahead with financial sector reform—both of these elements are key ingredients in, if not prerequisites to, the transformation of China's economic growth model.

Structural and trade reform:

- Progress has been made in expanding social safety nets, allocating greater resources to pension, healthcare, and education systems over recent years. The authorities recently implemented a reduction in import tariffs. Factor inputs costs (electricity prices) have been raised and a pilot program for a market-based pricing of natural gas has started.
- Additional efforts are needed to reduce high saving and promote a sustained rebalancing of the Chinese economy away from exports and investment towards private consumption. China now relies more on domestic investment than prior to the crisis and it is questionable whether high investment rates can be sustained.

France

Fiscal policies:

- The government announced fiscal measures for 2012-16 (later approved and somewhat strengthened by Parliament) in order to keep the planned fiscal adjustment profile consistent with the Toronto commitment. This medium term fiscal package includes all Cannes commitments, except the introduction of fiscal rules in the constitution.
- In principle, policies are well aligned, but projected outcomes rely on optimistic assumptions, particularly with respect to economic growth over the 2012–16 period.

Structural reforms:

- Plans to increase competition in retail, energy, telecommunication and real estate have been announced. A first draft of the reform was to be adopted by the Parliament before end 2011, but has not yet been approved. The government has set out to increase the number of young people on alternating work-study schemes from 600,000 now to 800,000 in 2015; additional incentives will be provided to encourage the hiring of jobseekers aged over 45 on "professionalization" contracts.

Germany

Fiscal policies:

- The recent fiscal consolidation plan announced by the German government and supported by the national fiscal rule is in line with the Toronto commitment.

Structural and tax reforms:

- The government identified education and research and development, as well as innovation as policy priority areas but the broad commitments for boosting productivity in the services sector, in particular, would benefit from more specificity.
- The government's tax reform agenda is generally aligned with the objective of making tax regime more employment friendly, but specific measures are still to be adopted.
- The government announced a small tax cut (0.2 percent of GDP in 2013 and 2014) as part of the adjustment of income tax brackets for inflation. These changes are too small and too late to make any material difference for the GDP growth in 2012, but they are moving in the direction of Cannes commitments.

India

Structural reforms:

- The authorities have announced some piecemeal measures to boost infrastructure investment (e.g., higher ceilings for foreign investment in infrastructure debt, relaxation of some maturity requirements for foreign investment in debt, a readjustment of debt ceilings to encourage secondary market trading).
- Additional efforts are needed on energy pricing, regulatory streamlining, and improving the overall business climate and governance. The authorities plan to introduce a Food Security Act which will broaden access to subsidized food for a broad share of the population; Fund staff supports this goal but no measures to improve targeting have been announced.

Japan

- The pace of reconstruction spending has been slower than initially expected but is now underway. Total reconstruction spending included in the earlier and FY2012 budgets amounts to about 4 percent of GDP spread across 2011 to 2013.
- The government recently announced a proposal to raise the consumption tax rate from the current level of 5 percent to 8 percent in 2014, and to 10 percent in late-2015, as part of a social security and tax reform plan which will require Diet approval. Further details on a timeframe for consumption tax increases beyond 2015 and reforms to entitlement spending are still needed.
- In terms of measures to boost private domestic demand, the government has announced that Japan would join negotiations for the Trans Pacific Partnership (TPP) regional free trade agreement. Beyond boosting exports, the TPP could revive domestic services through greater market liberalization, deregulation, and inward foreign direct investment. More progress is also needed in labor market reforms to raise participation by the young, elderly, and women.

United Kingdom

Monetary policy:
The Bank of England has undertaken appropriate measures to support price stability and recovery, including the announcement of additional asset purchases (QE) in Fall 2011.

Fiscal policies:

- The U.K. has a credible fiscal consolidation plan and remains committed to putting the government debt-to-GDP ratio on a downward path by 2016. While due to recent downgrades to the growth outlook, the authorities no longer project to halve the overall public-sector deficit between 2011–14 (the deficit is forecast to fall only from 9.3 to 6.0 percent of GDP), they have budgeted additional consolidation in 2015–17 to maintain their medium-term fiscal goals.
- Fiscal consolidation includes growth-friendly measures—the main corporate tax was reduced from 28 percent to 26 percent and will be reduced gradually to 23 percent by 2014. Modest cuts in spending with low multipliers have been announced (e.g., public employee wages) to fund higher spending on items with high multipliers (infrastructure spending).
- Plans have been announced to raise the pension age to 67 between 2026 and 2028 (previously, the pension age was to rise to 67 between 2034 and 2036), to address long-term spending pressures arising from changes in longevity.

United States

Fiscal policies:

- Certain expiring fiscal stimulus measures have been extended (a payroll tax cut, emergency unemployment benefits) in support of the weak recovery. These extensions have so far been legislated only for two months, but there is a bipartisan support in favor of a full-year 2012 extension pending an agreement on the budgetary offsets. The temporary extension of stimulus has not added to long-term deficits since the measures were financed by a modest increase in the Government Sponsored Enterprises mortgage loan guarantee fees, which should in turn marginally increase incentives for a greater private sector participation in housing finance, in line with the Cannes commitments.
- The President's Plan for Economic Growth and Deficit Reduction unveiled in September meets both the deficit and debt Toronto objectives, but under Fund staff's baseline, further measures are needed to ensure medium-term fiscal sustainability.
- The Congressional Joint Select Committee on Deficit Reduction failed to reach consensus on a medium-term consolidation plan in November While the August Budget Control Act locks in a $1.2 trillion in deficit reduction over 10 years through automatic spending cuts in lieu of the agreement (in addition to the roughly $1 trillion in discretionary savings already legislated), more progress is needed in the areas of revenue-raising measures and health and pension entitlements.