GROUP OF TWENTY

UPDATE ON GLOBAL PROSPECTS AND POLICY CHALLENGES

G-20 Leaders' Summit
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Prepared by Staff of the

INTERNATIONAL MONETARY FUND*

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

EXECUTIVE SUMMARY

This report provides an interim update of global developments and risks since the July Surveillance Note.

Global growth remains subdued but its underlying dynamics are changing. At the global level, major economies are seeing increasingly different growth dynamics and their relative cyclical positions are changing. Recent indicators point to stronger underlying activity in several advanced economies while key emerging economies have slowed. The impulse to global growth is expected to come mainly from the United States in the near term.

Against this background, financial conditions are generally tighter and market pressures have become acute for some emerging economies. Emerging economies were hardest hit following Fed "tapering" remarks and disappointing news about their growth. More recently, market pressures have been concentrated in certain emerging economies with important vulnerabilities. Both push and pull factors appear at work with respect to capital flow reversals and continued heightened market volatility for some—driven by changing expectations of monetary tightening in advanced economies and weaker fundamentals locally in key emerging economies.

Downside risks remain and some have become more prominent. Attention has heightened recently on risks related to recent growth disappointments in emerging economies that could interact with risks related to unwinding of unconventional monetary policies in some advanced economies. This raises more serious risks for certain emerging economies with higher macroeconomic and financial vulnerabilities. Although policymakers continue to show resolve to keep the global economy away from the precipice, the greatest worry may well be a prolonged period of sluggish global growth (a plausible downside).

Strengthened global action is needed to revitalize growth and better manage risks. In an environment of ongoing but incomplete transition to financial stability, changing growth dynamics and concerns about slow growth and high unemployment, achieving a better policy mix through implementation of priorities highlighted during the IMF Spring Meetings remains urgent. Specifically:

- ❖ In *advanced economies*, exceptional monetary accommodation continues to provide important support to demand but must be complemented by commensurate efforts and progress on other policies to succeed. In particular, a measured pace of fiscal tightening with good composition, anchored by credible debt reduction plans, including entitlement reform remains important; while in the euro area, reversing financial fragmentation and unlocking credit supply through repairing banks' balance sheets and advancing on a credible banking union remains crucial.
- ❖ In *emerging economies*, cyclical positions and vulnerabilities vary and policy responses will need to be country specific. Policymakers should allow exchange rates to respond to changing fundamentals but may need to guard against risks of disorderly adjustment, including through intervention to smooth excessive volatility. Where monetary policy frameworks are less credible, efforts may need to focus more on providing a stronger nominal anchor. With weaker growth prospects and potential problems from prolonged rapid credit growth, the policy framework must be ready to handle possible further increases in financial instability and risks to growth. Fiscal policy, generally, should allow stabilizers to work but avoid stimulus unless a major slowdown looms. Gradual consolidation should continue in countries with large deficits and debt, in part to rebuild buffers.

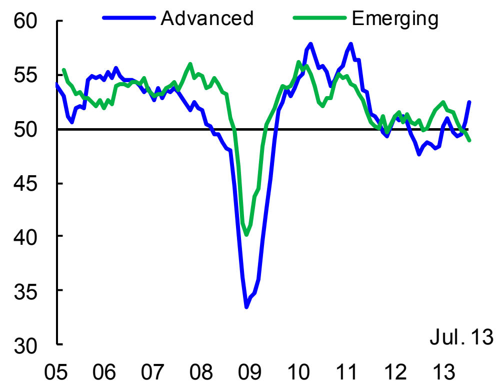
Prepared by a team from the IMF's Research Department led by Hamid Faruqee and Emil Stavrev, with support from Eric Bang and Shuda Li.

DEVELOPMENTS, OUTLOOK, AND RISKS

1. **Global growth remains subdued but its underlying dynamics are changing**. Global growth remains lackluster, averaging about 2¾ percent in the first half of 2013. Major economies are seeing increasingly different growth dynamics and their relative cyclical positions are changing. Recent indicators have been encouraging for advanced economies. U.S. private demand continues to strengthen with improving housing and labor markets. Euro area activity is growing again, while emerging economies have slowed. Looking ahead, global activity is expected to strengthen moderately, with global growth projected to increase in 2014 from 2013. Momentum is projected to come mainly from advanced economies, where output is expected to accelerate. This reflects a stronger U.S. economy, significantly less fiscal tightening (except in Japan), and highly accommodative monetary conditions. Specifically:

Global Manufacturing PMI

(index; >50 = expansion; sa)



Source: IMF, *Global Data Source*.

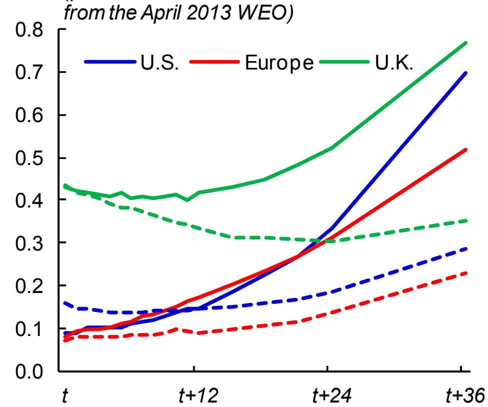
- *The U.S. and Japan are broadly advancing as expected.* U.S. growth surprised on the downside in Q1, but private demand remains relatively robust in the face of fiscal tightening. Growth is projected to pick up next year as fiscal policy becomes less restrictive. In Japan, the adoption of fiscal stimulus and aggressive monetary easing has led to an impressive pick-up in output. However, growth will be more subdued in 2014, as stimulus and reconstruction spending unwind and the first stage of the consumption tax increase is implemented.

- *The euro area is emerging from recession but activity is expected to remain subdued*. After six quarters of contraction, activity expanded in Q2 (by 0.3 percent qoq). While this partly reflects one-off effects (e.g., weather related factors), recent indicators show a continued improvement in business indicators, suggesting a continuation of the recovery in Q3. The fiscal drag will moderate in 2014 (¼ percent of GDP versus 1 percent in 2013), but impediments to growth persist, especially in the periphery where financial fragmentation continues to hinder credit flows.

- *Emerging and developing economies show slower momentum*. Staff's growth projections for the near term are being revised downward for emerging economies with risks still to the downside. Emerging economy growth is some 2½ percentage points below 2010 levels, with Brazil, China and India mainly accounting for this growth slowdown. The outlook for many commodity exporters (including those among the BRICS) has also deteriorated due to lower commodity prices.

2. **Against this background, financial conditions are generally tighter and market pressures continue for some emerging economies**. Emerging economies were hardest hit following Fed "tapering" remarks and external financing pressures remain heightened in some economies (e.g., Brazil, India, Indonesia, Turkey and South Africa). Initially, portfolio outflows from emerging markets in May-June was more broad based, while more recently market pressures have been more concentrated on particular economies with important financial or macroeconomic vulnerabilities. Volatility and local bond yields increased sharply, equity markets and currencies fell (depreciating 6½ percent on average since May 22), and some emerging economies saw liquidity pressures and a reversal of capital flows. Recent financial turbulence and continued market pressures in some economies appear to be driven by both *push* and *pull* factors.

Policy Rate Expectations 1/
(percent; months on x-axis; dashed lines are from the April 2013 WEO)

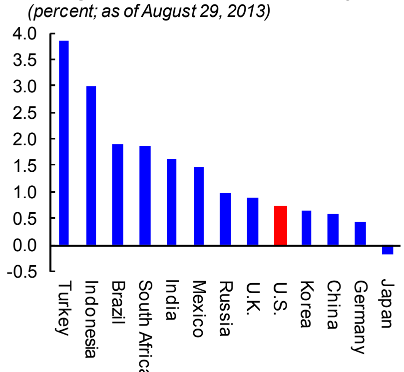


Source: Bloomberg, L.P.
1/ Expectations are based on the federal funds rate for the United States, the sterling overnight interbank average rate for the United Kingdom, and the euro interbank offered forward rate for Europe; updated August 29, 2013.

- On the *push* side, global financial conditions have tightened as market conviction has increased that U.S. monetary policy is approaching a turning point and expectations of policy rate hikes have been brought forward. Fed "tapering" is now seen as a possibility as early as September. U.S. 10-year yields are up by 80 bps to nearly 3 percent since May 22nd. Capital is being attracted to major developed markets by higher nominal yields. In Europe, long-term interest rates have increased modestly in the U.K. and core euro area countries, while periphery spreads (excl. Portugal) have stabilized since June.

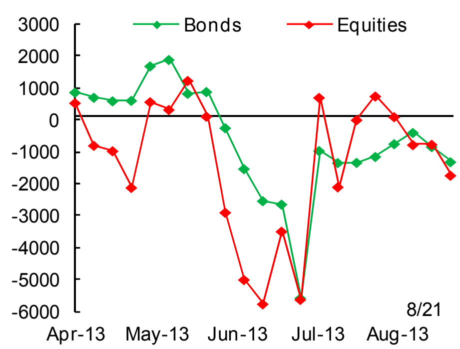
- On the *pull* side, deteriorating fundamentals in some emerging economies have also played a role. Recent indicators point to lower growth driven by weaker domestic and external demand. Increases in interest rates (i.e., changes in risk premia) and exchange rate depreciation pressures have been differentiated across countries, with high inflation or high external deficit economies being most affected. Some continue to see heightened market pressure. In particular, the situation has been exacerbated by disappointing news about emerging market growth and existing or rising domestic financial and/or macroeconomic vulnerabilities (e.g., high inflation, balance of payment pressures, India, Brazil, Indonesia, Turkey, South Africa; still rapid credit growth, Brazil, China, Turkey).

Change in 10 Year Bonds since May 22
(percent; as of August 29, 2013)



Source: Bloomberg, L.P.

EM Bond and Equity Flows
(USD in millions; EPFR data)



Source: Haver analytics.

3. **Downside risks remain and some have become more prominent**. Attention has heightened recently on risks related to recent growth disappointments in emerging economies that could interact with risks related to unwinding of unconventional monetary policies in some advanced economies. Fed tapering of asset purchases may trigger exchange rate and financial market overshooting in emerging market economies, while they are trying to cope with rising domestic vulnerabilities and slower growth. This raises more serious risks for certain emerging economies where macroeconomic and financial vulnerabilities are higher. In the euro area, despite some welcome stabilization, financial market stress could still re-emerge from incomplete delivery of policy commitments at the national or euro area level. In Japan, insufficient fiscal consolidation and structural reform over time in Japan could trigger serious downside risks. Overall, concerns about a prolonged period of sluggish global growth (a plausible downside scenario) remain elevated.

POLICIES FOR JOBS AND GROWTH

4. **More policy ambition and cooperation are needed to achieve the G-20's shared objectives of strong, sustainable, and balanced growth**. The problems facing the global economy are complex and joint action can help. In an environment of ongoing but incomplete transition to financial stability, changing growth dynamics and concerns about slow growth and high unemployment, achieving a better policy mix is important. A heavy reliance on unconventional monetary policy (UMP), for example, has had overall positive effects and has bought time but needs support from other policies to succeed. Widespread financial, fiscal, and structural impediments need to be addressed to bolster growth and financial stability.

- In ***advanced economies***, while exceptional *monetary accommodation*, including through UMP, continues to provide important support to the recovery, potential side effects should be monitored closely and addressed as needed. Clear communication of central bank intentions is vital to help avoid new financial excesses or abrupt reversals of capital flows. There is scope for better cooperation on withdrawal of UMP, especially through wider central bank discussions of exit plans. At the same time, progress on other fronts is crucial. In particular, implementing a *measured pace of fiscal tightening* (based on a consolidation mix that is supportive of medium-term growth) including entitlement reform remains central. This should be anchored by *credible plans* for debt reduction—notably, for the U.S. and Japan. For economies not under market pressure, achieving structural fiscal targets and allowing *automatic stabilizers* to play freely is key. In the euro area, bank balance sheet repair remain essential to restore confidence and revive credit growth, and policymakers should make further progress on *banking union* through a Single Supervisory Mechanism and a Single Resolution Mechanism, and advance structural reforms. Additional unconventional monetary support (targeted long term refinancing operations, lower collateral haircuts) could also help reduce fragmentation and restore *monetary transmission*.

- In ***emerging economies***, cyclical positions and vulnerabilities vary across countries, with some facing more intense market pressures, and policy responses will need to be country specific. In general, policy responses should be anchored by sound and credible monetary policy frameworks; allow exchange rate adjustment; and pursue structural reforms to boost jobs and growth, with the appropriate country-specific policy mix depending on their respective circumstances. In particular:

- Policymakers should allow *exchange rates* to respond to changes in fundamentals but may need to guard against risks of disorderly adjustment. *Liquidity provision* to maintain orderly conditions may be needed where very rapid flows lead to financial market disruption. Risks of disorderly conditions in currency markets are likely to be less acute for those economies that have strong policy frameworks, deeper financial markets, sound balance sheets, and limited non-resident portfolio investment. While some *intervention* to smooth current market volatility may be appropriate in countries with adequate reserves, it should not forestall underlying external adjustment for those economies where external deficits exceed levels warranted by fundamentals and desired policies.

- *Monetary policy* responses, more generally, to external pressures will depend on country conditions and frameworks. Cyclical weakening calls for monetary policy easing, or less tightening, for those economies where inflation and expectations are well anchored to provide room for maneuver. Where still high inflationary pressures persist, including from supply bottlenecks (e.g., Brazil, India, and Indonesia), the scope for easing the monetary stance may be very limited or it may need to be tightened; and more efforts to better anchor expectations may be required where strong nominal anchors are not well established.

- For countries with strong fiscal positions, fiscal policy, generally, should allow stabilizers to work but avoid stimulus unless a major slowdown looms. Given room for policy maneuver has tended to decline, in many of these countries, there is a broad need to rebuild buffers over time. Gradual consolidation should continue in countries with large deficits and debt.

- With weaker growth prospects and potential problems from prolonged rapid credit growth, the policy framework must be ready to handle possible further increases in financial instability and risks to growth. Key instruments should include stronger regulatory oversight and macroprudential policies, as a strong complement for prudent macroeconomic policies.

- ***Global demand rebalancing***. While global imbalances have narrowed last year, and, despite some further progress, policies have played a relatively minor role. To foster rebalancing that is supportive of growth, structural reforms that increase internal demand in surplus economies on a sustained basis (in particular, private consumption in China and private investment in Germany) and raise external competitiveness in deficit economies (e.g., Brazil, India, euro area periphery, and the United Kingdom) remain necessary. More broadly speaking, to raise productivity and employment, important structural reforms and full implementation of past commitments in key areas (e.g., infrastructure investment, removal of entry barriers in product and services markets) should be a priority for G-20 members.