GROUP OF TWENTY

# Global Prospects and Policy Challenges

G-20 Finance Ministers and Central Bank Governors Meeting
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Prepared by Staff of the

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

# EXECUTIVE SUMMARY

**An uneven global recovery continues, despite setbacks this year**. Global growth in the first half of 2014 was weaker than expected in the April WEO. Disappointing growth largely reflects a surprisingly soft first quarter in the United States, before negative one-off factors faded and activity picked up in Q2; but also continuing weak performance in Latin America; downward surprises in the euro area, where activity stagnated in the second quarter, and Japan, where output contracted more than expected following the VAT increase; and weaker activity in Russia. In China, after a weaker-than-expected Q1, authorities took policy action to support activity.

**Alongside supportive central bank policies, financial conditions have continued easing over the last few months**. Sovereign bond yields have edged further down and equity prices have generally risen. Sentiment toward emerging markets has improved, as reflected in resilient portfolio inflows and stable or stronger currencies. Implied volatility measures fell to the very low levels prevailing before the May 2013 tapering remarks. This raises concerns that excessive risk taking may be building up, which could sharply reverse in the run-up to U.S. rate hikes or should geopolitical events trigger higher risk aversion.

**Looking forward, the global recovery should regain strength but downside risks have risen**. Exceptionally supportive financial conditions, moderating fiscal consolidation, and strengthening balance sheets should support the recovery in the remainder of 2014 and into 2015. Global growth in 2014 would remain below the April WEO forecast, however, reflecting the weaker first part of the year. Downside risks have increased. Heightened geopolitical tensions and a sharp reversal of recent risk spread and volatility compression pose new risks to growth, while other downside risks remain, including those related to U.S. monetary policy normalization challenges, low inflation/deflation in some advanced economies, and, in the medium run, the possibility of growth stagnation more broadly.

**Policy priorities are as follows**:

- *Advanced economies* should continue accommodative monetary policies, given still large output gaps and very low inflation. Reflecting the uneven recovery, challenges are becoming increasingly different across major central banks. While monetary policy normalization will be coming to the forefront in the United States, the euro area and Japan have to continue fighting low inflation. To mitigate financial stability risks from a prolonged period of low interest rates and prevent premature monetary tightening, macro-prudential tools should be the first line of defense. The pace and composition of fiscal adjustment should also be better attuned to supporting the recovery and long-term growth.
- In *emerging economies*, the focus of macroeconomic policies should remain on rebuilding buffers and addressing vulnerabilities, in preparation for an environment characterized by higher interest rates and tighter external financing conditions.
- Decisive *structural reforms* are needed across G20 economies to boost potential output and help ensure that growth is more sustainable. In a number of *surplus* countries, the focus should be on boosting domestic demand or modifying its composition. In a number of *deficit* economies, including euro area countries that switched to surplus recently, structural reform is needed to improve competitiveness.
- Finally, *infrastructure investment* in economies with clearly identified needs and economic slack, current conditions are favorable for increasing public infrastructure investment. However, while infrastructure investment is needed to support economic development in some economies, efficiency of the investment process and comfortable debt positions to mitigate the potential trade-off between higher output and higher public-debt-to-GDP ratios are important to maximize the growth dividend.

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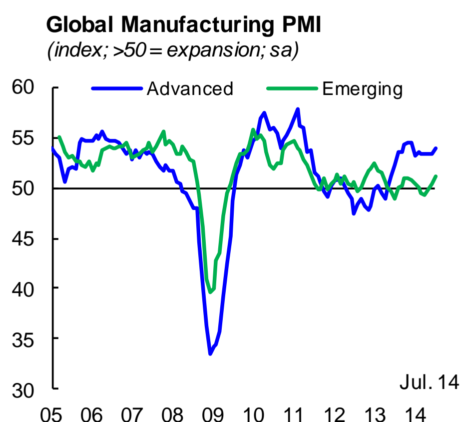
# DEVELOPMENTS, OUTLOOK, AND RISKS

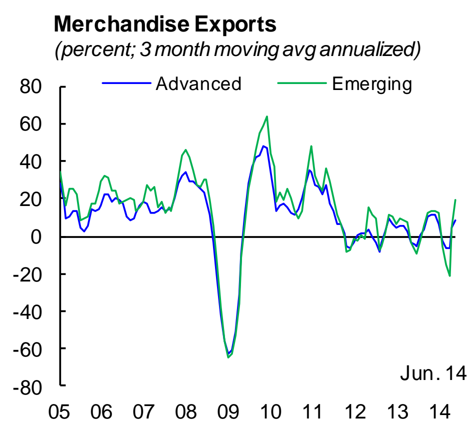
*An uneven global recovery continues, despite setbacks this year. Activity has regained momentum from its weak start in 2014Q1, led by the United States and China, but overall performance in the first half of the year was weaker than projected in the April WEO. With financial conditions exceptionally supportive and fiscal consolidation moderating, the recovery is projected to continue, albeit at a moderate and uneven pace. New downside risks associated with geopolitical tensions and increasing risk taking are arising. Other risks stem from low inflation, secular stagnation in advanced economies, lower growth in emerging economies, and the challenge of monetary policy normalization in the United States, in particular the possibility of financial instability due to abrupt market corrections.*

1. **Despite setbacks this year, global recovery is proceeding but remains unbalanced.** In many advanced economies, legacies of the boom and subsequent crisis—including high private and public debt—still weigh on the recovery despite relaxed financial conditions. Emerging markets continue adjusting to slower economic growth than both the pre-crisis boom and the post-crisis recovery. New shocks, including heightened geopolitical uncertainty, have also hit the global economy.

2. **Global activity has regained momentum in Q2, but it has been uneven and weaker than expected in the April WEO**. Growth rebounded in the U.S. but fell short of expectations in the euro area and Japan. In emerging economies, growth accelerated in China, supported by accommodative monetary and fiscal policies, with positive spillovers on other emerging Asian economies, while weaker-than-expected domestic demand weighed on growth in many Latin American countries. Following a soft patch in 2014Q1, exports growth regained momentum in both advanced and emerging markets economies. More specifically:




Source: IMF, *Global Data Source.*




Source: IMF, *Global Data Source.*

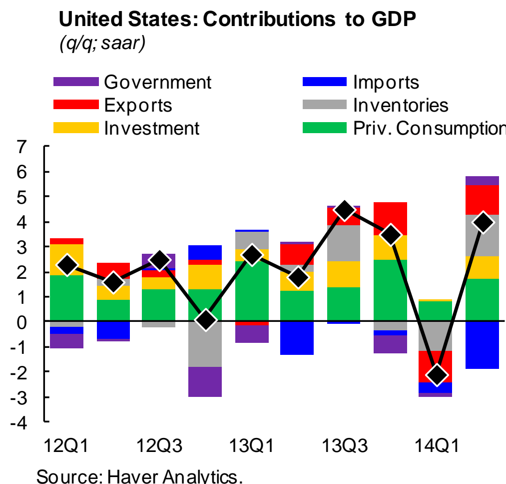
- *Economic prospects are shifting in **advanced economies**.*

    - In the *United States*, after a surprising decline in activity during the first quarter of 2014 (subsequently revised up), growth rebounded sharply in the second quarter. The rebound reflected a swing in inventories, stronger private consumption and fixed investment, as

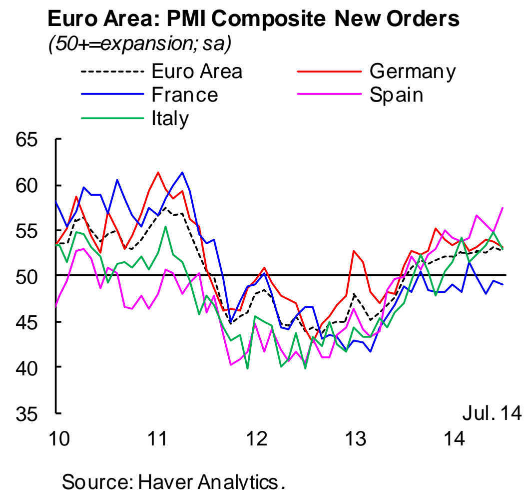
well as growth in state and local government spending. Job creation was also solid. While exports have improved, net exports continue to be a drag on growth. Activity in the housing sector remains sluggish.

- In the *euro area*, economic activity stalled in the second quarter of 2014. Growth was faster than expected in Spain, but weaker than expected elsewhere, notably in Germany and Italy—where GDP contracted, and in France—where activity continued to be flat. In Germany, the payback from one-off factors that supported growth in 2014Q1 (inventories, mild weather) likely played a role, but the outright decline in GDP indicates that other factors have also put downward pressure on activity.

- In *Japan*, the growth payback from one-off factors (VAT hike, emission taxes) that boosted consumption and investment in the first quarter was greater than anticipated. The outcome in the second quarter suggests that the strength in consumption observed in the first quarter was mostly related to temporary factors, but there are tentative signs of firming underlying momentum in investment.



Source: Haver Analytics.

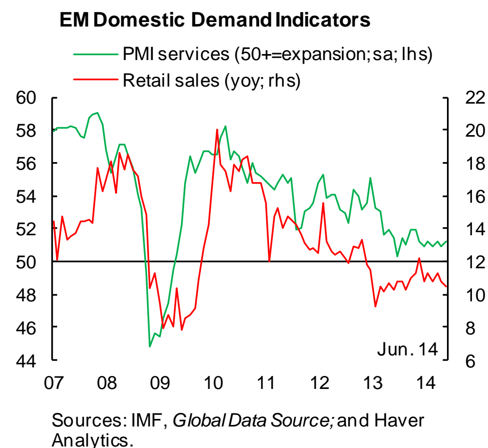


Source: Haver Analytics.

❖ *And the recovery has been unbalanced in **emerging economies**.*

- In *China*, accommodative policies implemented by the government in response to the weak first quarter supported faster growth in the second quarter, including infrastructure investment and private consumption. Exports also rebounded from seasonal disruptions in the first quarter. Some high frequency indicators suggest that the growth momentum would carry into the second half of the year.

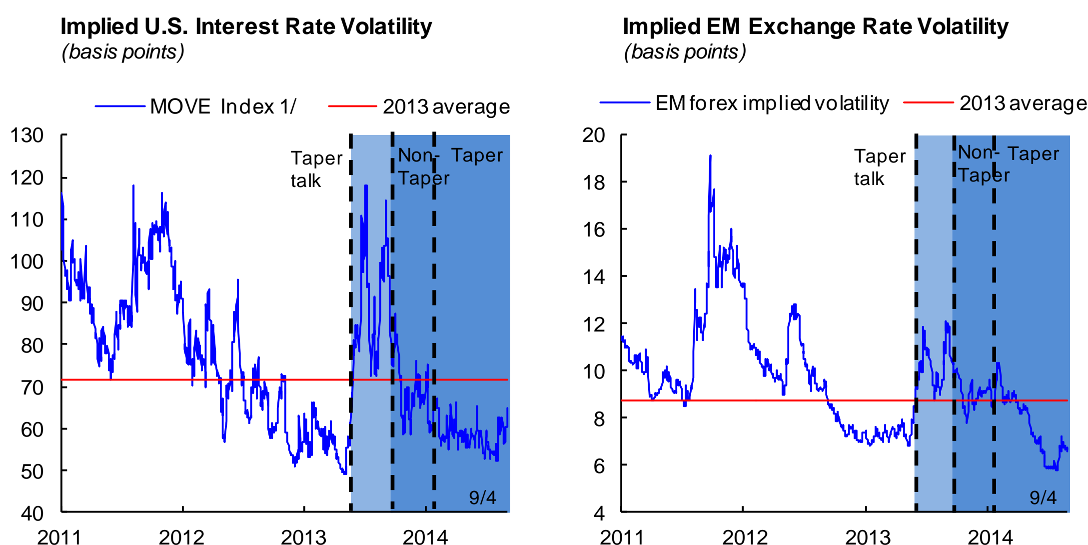
- Elsewhere in *emerging Asia*, external demand has recovered, aided by the growth rebound in China and the United States, while domestic demand should start picking up (e.g., Indonesia, India).



Sources: IMF, *Global Data Source;* and Haver Analytics.

- Growth in *Latin America* remains below trend, notably in Brazil, where activity contracted in the second quarter as investment declined and consumption lost steam, but also elsewhere. In Mexico, growth has been firming up in line with the U.S. rebound in the second quarter.

3. **Financial conditions continued to ease, reflecting supportive central bank policies**. Valuations in virtually all major asset classes are stretched relative to past norms. Long-term bond yields have declined further especially in the euro area but also in the United States and in most emerging economies. Equity valuations have continued to edge higher, as investor sentiment has remained positive despite mixed evidence on the strength of the recovery and geopolitical tensions. Against this backdrop, capital flows into emerging economies have remained positive, despite generally weaker activity, thus currencies and equity prices have stabilized or strengthened in many of these economies since the April 2014 WEO. The effects of geopolitical tensions with Russia/Ukraine, intensified conflicts in the MENA region, and the Argentina default appear contained so far. However, implied volatilities across asset classes have continued to decline, reaching levels prevailing before the Fed tapering talk. This raises concerns of a buildup of excessive leverage and under-pricing of credit risk which could be abruptly corrected in the run-up to U.S. rate hikes or because of higher global risk aversion.




Sources: Bloomberg, L.P.; and IMF staff calculations.
1/ A weighted average index of the normalized implied volatility on 1-month Treasury options (weights on 1-month options for 2y, 5y, 10y and 30y instruments are 0.2, 0.2, 0.4, and 0.2, respectively).

4. **Looking forward, while the recovery is projected to regain some strength in the remainder of 2014 and 2015, it would be weaker than foreseen in the spring**. The key drivers supporting the recovery identified in the July WEO update remain in place, including moderating fiscal consolidation, highly accommodative monetary policy in most advanced economies, and strengthening balance sheets. The global outlook for 2014 is weaker than in the April WEO, on account of the investment weakness observed at the global level in the first half of the year. Moreover, there are concerns that the sluggish recovery in the euro area may be stalling.

- In ***advanced economies***, growth is generally expected to strengthen in 2014–2015. An exception is *Japan,* where the planned unwinding of the fiscal stimulus would leave growth broadly unchanged in 2014 and 2015. The *United States* is expected to experience the strongest rebound, and growth is also expected to remain solid in the *United Kingdom, Australia, Canada, and other Asian advanced economies*. In the *euro area*, growth should strengthen more gradually and unevenly as the crisis-legacy brakes ease only slowly. Moderating fiscal consolidation, further monetary easing through near zero policy interest rates and private asset purchase program by the ECB, and improving lending conditions, including the sharp compression in spreads for stressed economies and record low long-term interest rates in core countries, should all support the recovery of the euro area.

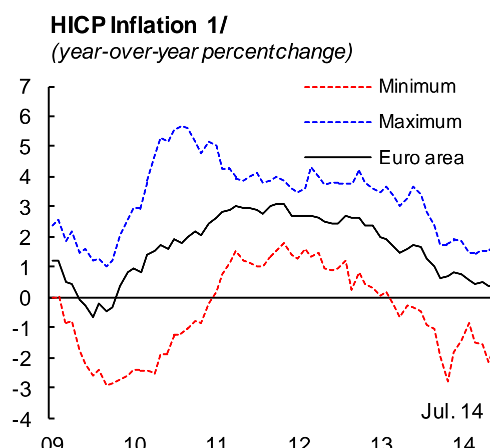
- In most ***emerging economies***, growth is expected to increase moderately in the second half of 2014 and into 2015, reflecting the waning of some temporary factors holding back growth in the first half of this year, stronger demand from advanced economies, and still-favorable global financial conditions. *China*'s growth, however, is projected to moderate slightly in 2015, as the economy transitions to a more sustainable path, and residential investment slows further. The growth outlook for *Latin America* is likely to be marked down relative to the April WEO for both 2014 and 2015: investment and consumption growth weakened in *Brazil* largely owing to declining business and consumer confidence in the run up to the elections, with some additional drag from lower growth in some trading partners; in *Mexico*, after a weak first quarter, growth has picked up driven by robust external demand, and is expected to remain strong in 2015 as the impact of structural reforms kick in; while in *Argentina*, weak macroeconomic policies and policy uncertainties, including from the situation with holdout creditors, are taking a toll on activity. In *Russia*, geopolitical tensions are further undermining confidence, investment, and economic activity; the central bank has raised its policy rates to contain increasing inflation pressure.

5. **Downside risks have increased as new ones have arisen and old ones remain**. While some of the crisis induced risks are fading, two new ones are rising: (i) increasing risk taking and financial market optimism that could eventually trigger abrupt corrections, and (ii) geopolitical risks. A faster-than-expected increase in U.S. interest rates and low inflation in some advanced economies could also raise challenges going forward. In the medium run, key risks include secular stagnation in advanced economies and disappointing potential growth in both advanced and emerging economies.

- *Geopolitical tensions* with Ukraine and Russia heightened through August and may increase further as the effect of additional sanctions is felt. In addition to being a drag on economic growth for the region and beyond, further unrest could also trigger large spillovers on activity in other parts of the world, through a renewed bout of increased risk aversion in global financial markets, higher public spending or revenue losses, or disruptions to commodity markets, trade, and finance due to intensification of sanctions and countersanctions. Moreover, even if there is no major escalation of the conflict, this may have a significant impact on business confidence. Similarly, heightened geopolitical risks in the

Middle East could lead to disruption of oil production and a sharp rise in oil prices, with negative spillovers to the global economy.

- *Risks to activity from low inflation* remain relevant for the euro area and, to a lesser extent, Japan. Inflation continues to undershoot and remain below central bank targets in many advanced economies. In the euro area, in particular, inflation expectations have recently drifted down. With policy rates in several cases close to or at the zero bound, the room to lower rates is limited and negative shocks can lower inflation or expectations further or even push the economy into deflation, raising real rates, which would hamper the recovery and increase debt burdens.




Source: IMF, *Global Data Source*.
1/ Figure reports euro area aggregate, and maximum and minimum of euro area economies.

- *Sudden reversal of risk premia and volatility compression in global financial markets* due to growth disappointments or other triggers. An increase in global risk aversion can be associated with a decline in U.S. long-term yields but still lead to a significant tightening of global financial conditions, capital flow reversals, and exchange rate pressures in emerging markets, as well as negative effects on equity prices.

- As the recovery proceeds, there are risks related to the *normalization of the U.S. (and U.K.) monetary policy*. The U.S. labor market has been strengthening more rapidly than forecast and inflation has begun to rise (though it remains well below the Fed's longer-term objective of 2 percent), increasing the probability that monetary policy will need to be tightened faster than previously envisaged or the risk of monetary surprises or sudden shifts in expectations about the path of policy normalization. Against the backdrop of increased financial market optimism—reflected in the compression of risk spreads and volatility indicators—such surprises could trigger abrupt financial market corrections. As shown in the Annex, the source of the tightening in financial conditions matters: better growth prospects in advanced economies would have benign spillovers, despite the tightening of global financial conditions, while a unexpected tightening unrelated to stronger growth in advanced economies should have negative spillovers.

- In the medium term, the risk of *secular stagnation* (a prolonged period of low growth and weak demand) in the major advanced economies, especially the euro area and Japan, cannot be ruled out. In the euro area, robust momentum has not yet emerged despite continued very low interest rates and easing of brakes to the recovery, including from fiscal consolidation and tight financial conditions. In turn, a protracted period of weak growth and large negative output gaps can erode the growth potential of advanced economies, through lower investment, R&D, and hysteresis effects of unemployment. Several years of slowing growth prospects brings to the forefront the need for some emerging market economies to tackle structural reforms to raise growth decisively in order to reduce the risk that *potential*

*growth could disappoint further*, especially given the risk of secular stagnation in advanced markets mentioned above.

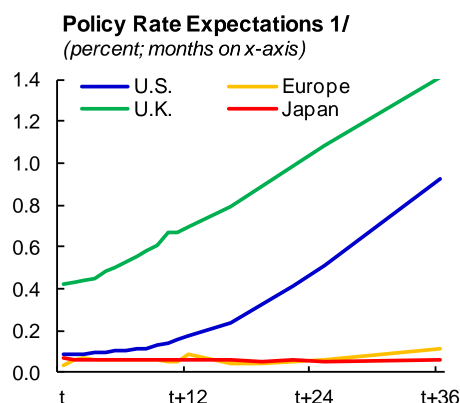
# POLICIES TO BOOST GROWTH

*Policy priorities center on supporting demand, while managing key risks, in the near term and strengthening supply over time. Macroeconomic policies need to continue supporting the recovery in advanced economies, given still large output gaps and very low inflation. Macro-prudential policies are an important first line of defense to address potential financial stability threats associated with too low for too long rates. In emerging economies, macroeconomic policies should continue preparing for a new environment characterized by tighter external financial conditions. Decisive structural reforms are needed for all countries to address the challenge of enhancing their growth potential and in some, rebalancing the economy remains crucial to ensure sustainability of growth in the medium term.*

### ADVANCED ECONOMIES NEED TO FIGHT LOW INFLATION AND SUSTAIN THE RECOVERY

6. **While monetary policy should continue supporting the recovery, challenges are increasingly different across countries**. With output gaps still large, and inflation running below target, accommodative monetary conditions remain essential for advanced economies, including in the United States, to avoid cyclical impediments to growth from becoming structural. However, given the unevenness of the recovery across economies, challenges faced by central banks are different. In the United States and the United Kingdom, where the recovery is stronger, the challenge is to manage exit from exceptionally accommodative monetary policies as output gaps shrink. In contrast, monetary policy in the euro area and Japan is expected to remain more accommodative for an extended period as they fight low inflation (euro area) or try to persistently raise inflation and inflation expectations (Japan). As some start exiting UMP, well-calibrated communication and cooperation will be key to avoid or manage bouts of financial market volatility. Specifically:

**Policy Rate Expectations 1/**
*(percent; months on x-axis)*




Source: Bloomberg, L.P.
1/ As of August 6, 2014. Policy rate expectations derived from Overnight Indexed Swaps (OIS), for Euro area (EONIA rate), U.K. (SONIA rate), U.S. (FED Funds rate), and Japan (TONAR rate).

- In the *United States*, the main challenge is to reach the appropriate speed of monetary policy normalization, which is made difficult by uncertainties about the cyclical position and monetary transmission. Current plans to end tapering later this year and increase policy rates from the middle of next year appear appropriate, given the sizable slack. However, the timing of the increase in policy rates may have to be adjusted in function of developments on the inflation and unemployment fronts. The *United Kingdom* faces similar challenges: while monetary policy should stay accommodative for now, it might, however, have to be

tightened quickly if costs run ahead of productivity growth or slack is absorbed, or Tightening could also be considered if macroprudential tools prove insufficient to deal with financial stability risks with due consideration to the tradeoffs involved vis-à-vis the real economy.

- In the *euro area*, the ECB's recent actions—policy rate cuts in June and September, negative deposit rates, targeted support for bank lending to non-financial corporates, and private asset purchase program—and its willingness to do more, if necessary, have underlined its commitment to raising inflation towards target. Given evidence that inflation expectations are drifting down, the recent ECB's measures are strongly welcomed and will substantially expand its balance sheet and should reinforce its forward guidance to help counteract the dangers posed by an extended period of low inflation. This should boost confidence, improve private sector balance sheets, and help stimulate bank lending. Finally, to tackle fragmentation, decisively mending banks' balance sheets and completing the banking union are critical. The ECB should continue to urge banks to be proactive in raising capital ahead of the completion of the Asset Quality Review and associated stress tests.

- In *Japan*, monetary policy has helped lift inflation and inflation expectations towards the 2-percent target. Given that the current aggressive pace of monetary easing may need to be maintained for an extended period, providing more information about asset purchases beyond end-2014 could further enhance transparency. In case actual or expected inflation stagnate or growth disappoints, the Bank of Japan should act swiftly through further and/or longer-dated asset purchases. There is also room to expand the Loan Support Program in order to further enhance the monetary policy transmission. Finally, communication should focus on the overarching goal of achieving the inflation target in a stable manner through a more transparent presentation of the BoJ's forecast and underlying assumptions.

7. **Financial stability risks related to a prolonged period of low interest rates bring macro-prudential policies to the forefront**. Excessive risk-taking may be building in some sectors (U.S. corporate credit and insurance markets, housing price booms in a number of smaller advanced economies) after more than five years of exceptionally low rates (see annex). Completing the reform of financial regulation and deploying macro-prudential tools as a first line of defense, as needed, are essential to limit financial risks. This will also reduce the risk of premature monetary policy tightening not warranted by the cyclical position. It will also make systemic institutions more resilient, help contain pro-cyclical asset price and credit dynamics, and cushion the consequences of liquidity squeezes if volatility spikes.

8. **The pace and composition of fiscal adjustment should be attuned to supporting both the recovery and long-term growth**. Fiscal consolidation should continue to proceed gradually, anchored in credible medium-term plans, which are still lacking in some countries (notably, in Japan and the United States). At the same time, the design of fiscal policy should better support the long-run growth potential of the economy, including by enhancing infrastructure investment, provided that infrastructure needs have been identified, there is slack in the economy, monetary policy is accommodative, investment processes are relatively efficient, and debt-to-GDP ratios are not already high. Specifically:

- In the *United States*, reaching an agreement on a credible, medium-term consolidation plan that puts debt on a downward trajectory should be a high priority. This should include steps to contain health care costs, reform social security, and increase revenues. In the absence of such a comprehensive agreement, efforts should still focus on identifying more modest opportunities to relax the near term budget envelope, paid for with future fiscal savings. In particular, frontloading infrastructure spending would be a good candidate, given the urgent need to upgrade the quality of U.S. infrastructure. The United States should also consider some changes to budget procedures to lessen fiscal policy uncertainty, including: (i) reaching bipartisan agreement on a clear and simple medium-term fiscal objective, (ii) an automatic process that raises the debt ceiling once agreement is reached on the broad budget parameters, and (iii) a budget cycle where annual spending levels are agreed for a two-year period.
- In the *euro area*, the overall fiscal stance is broadly neutral, although a number of countries are still tightening, even if at a slower pace. This strikes the right balance between demand support and debt reduction. Nevertheless, Germany, which has completed its fiscal consolidation, could afford to finance much-needed public investment in infrastructure, without violating fiscal rules. Large negative growth surprises in euro area countries should not trigger additional consolidation efforts, which would be self-defeating. Moreover, if deflation risks materialize and monetary policy options are depleted, the escape clauses in the fiscal framework may need to be used to respond in these circumstances.
- In *Japan*, the second stage of the consumption tax increase should proceed with a uniform rate (from 8 to 10 percent in October 2015). Concerns that it could harm low-income households should be addressed through targeted subsidies instead of reducing tax rates on essential items. The pace of fiscal withdrawal in 2014–15 is broadly appropriate, but a concrete post-2015 fiscal consolidation plan remains urgently needed, which would allow more near-term flexibility to respond to downside risks. Plans to lower the corporate tax rate would likely have growth benefits, but would require offsetting fiscal measures to prevent a further rise in fiscal risks.

## EMERGING ECONOMIES HAVE TO ADAPT TO A CHANGING ENVIRONMENT

9. **The focus of macroeconomic policies should remain on addressing vulnerabilities and rebuilding policy buffers**. The strengthening of activity in advanced economies and looming normalization of monetary policy in some implies that external financial conditions—both availability of capital flows and borrowing costs—will eventually tighten. When risk sentiment changes, having stronger macroeconomic fundamentals as well as the policy space and credibility to react have proven to be critical to reduce volatility and negative spillovers (see Annex). Exchange rate flexibility, alongside credible macroeconomic policies and frameworks, has also proven to be an essential tool in coping with volatile capital flows.

10. **The appropriate course for policy to balance fostering growth and managing vulnerabilities will be country-specific.** Countries should continue to rebuild monetary and fiscal policy space where it is limited—considering possible tradeoffs between building buffers

and slowing growth—and strengthen policy frameworks where their credibility has come into question. Specifically:

- In *Brazil*, slowing economic conditions will make it difficult to achieve the original budget targets for 2014. Nevertheless, working towards meeting the official primary surplus target with sustainable policies while continuing to wind down policy lending is important to put gross public debt on a firmly downward path and boost market confidence. With inflation still elevated, monetary tightening may have to be stepped up should inflation expectations worsen.
- In *India*, more efforts are needed to continue reducing stubbornly high inflation and the large fiscal deficit. While the new government's emphasis on continued fiscal consolidation is welcome, the quality and durability of the consolidation remain of concern. The government should articulate structural measures to underpin the consolidation path, including subsidy reform and progress on the Goods and Services Tax. Sustainably lowering inflation will also require further increases in the policy rate and a simpler monetary framework with clear objectives and operational autonomy for the RBI.
- In *China*, the challenge is to reduce the vulnerabilities accumulated through five years of credit-fueled capital spending and transition to a more sustainable growth model (see below). The implementation of the structural reforms in the authorities' blueprint will help reorient the economy in the medium term. However, additional measures are also needed in the near term to contain risks, including a reduction in off-budget spending, further reduction in credit growth, and slower investment growth. While finding the right mix between reducing vulnerabilities and maintaining growth is an ongoing challenge, addressing vulnerabilities more forcefully would put the economy on a safer and more sustainable growth.
- Some emerging economies (e.g., South Africa), that rely heavily on private external financing should be ready to rapidly adjust policies if global financial conditions suddenly tightened. For Turkey, policies should aim to re-establish a nominal anchor and tighten the fiscal stance, while promoting national savings and competitiveness.

## DECISIVE ACTION IS NEEDED BY ALL MEMBERS FOR STRONGER AND MORE BALANCED GROWTH

11. **A challenge for all is to strengthen their growth potential, for which structural reforms will be critical**. The G-20 has set the objective of raising collective output by at least 2 percent above the October 2013 WEO baseline over the coming five years. In addition, growth–enhancing structural reform is particularly relevant over the medium term in emerging economies that have experienced a gradual, protracted and broad based slowdown over the past several years. Decisive actions are needed in various areas to achieve the membership's objective:

- In advanced economies with clearly identified *infrastructure investment* needs, economic slack and policy rates are at the zero lower bound, relatively efficient public investment processes, and manageable debt positions, current conditions are favorable for increasing public infrastructure investment (e.g. Germany and the United States). In many emerging

economies, infrastructure investment is needed to ease supply bottlenecks (e.g. Brazil, India) and support economic development. To maximize the growth dividend of public investment, though, large output gaps, increased efficiency of the investment process and comfortable debt positions are key.

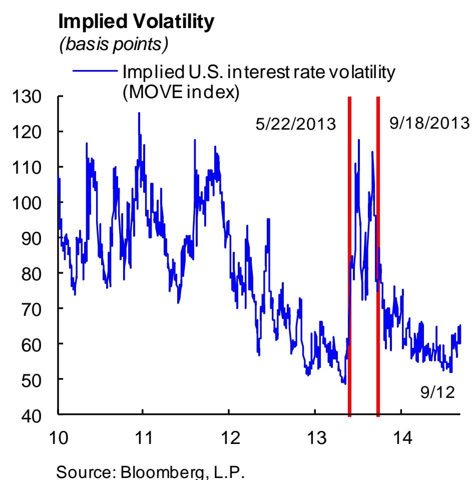
- Structural reforms to improve the functioning of *product markets*, specifically for non-tradable sectors in surplus economies (Germany, Japan, and Korea), and more generally for the whole economy in deficit countries, including euro area economies which recently switched into surplus (e.g., Italy). To enhance productivity, easing limits on trade and investment and improving business conditions (Indonesia, Russia, Turkey) would be instrumental.
- *Labor market reforms* are needed to raise participation of women and/or older workers in advanced economies undergoing population aging (Germany, Japan, Korea, and the United States) or where an important fraction of the population remains unemployed (South Africa). Actions to increase labor demand and remove impediments to employment are also needed in stressed euro area economies.

12. **Global current account imbalances have narrowed in 2013, but they are still larger than desirable**. Policy actions required to further narrow excessive imbalances vary but include medium term fiscal consolidation, limiting financial excesses, and structural reforms to facilitate adjustment in deficit economies. In some surplus economies, policies that support stronger domestic demand would help, including moving toward more market-based exchange rates, avoiding sustained, one-sided foreign exchange market policies, and reducing capital account restrictions. Taken as a whole, policy actions are needed on both sides of excess imbalances, and policy adjustments by all would be mutually supporting, with benefits in terms of growth and reduction of financial risks.

13. **Thus, rebalancing global growth is an essential condition for its sustainability in the medium term**. While systemic risk associated with global imbalances has decreased, in many countries external and internal rebalancing are essential to sustainable growth. In China, steadfast implementation of the announced reform blueprint—especially through improving financial intermediation, liberalizing the service sector, allowing more flexibility in the exchange rate by reducing intervention over time, and strengthening the social safety net—will move the economy to a more balanced and sustainable growth. To rebalance and boost its growth, *Germany* needs to raise investment, both public infrastructure and private investment, and continue with services sector liberalization. In a number of economies, adjusting their fiscal position or improving competitiveness (France, South Africa) and removing supply bottlenecks (Brazil, India, South Africa, and Turkey) would help improve the current account and lead to more sustainable growth. While the gains from reform stem mostly from policies that countries need to implement for their own good, joint action could produce beneficial growth and stability spillovers in the longer term.

# ANNEX. SPILLOVERS FROM UNWINDING MONETARY SUPPORT IN ADVANCED ECONOMIES

While unconventional monetary policy (UMP) has supported demand after the global crisis the recent decline in market volatility and the low term premium point to risks going forward. A prolonged period of low interest rates after the crisis had created incentives to search for yield—increasing leverage and credit risk—and eventually prompted a sharp market correction. Even though the episode was temporary, it brought financial stability issues to the forefront in the spring of 2013. In this context, the recent fall in implied volatility in market trading to the very low levels seen in early 2013, which were associated with one-sided market positioning, carries risks. Moreover, even after the adjustment during the taper episode, long-term interest rates still look low compared with historical levels. These two developments suggest that there are risks of abrupt market corrections going forward.




Against this background, with global financial conditions poised to tighten further as economic prospects improve in advanced economies, there are potential spillovers from monetary policy normalization. Spillovers will depend both on how well normalization is managed by major central banks—i.e., whether it triggers sudden adjustments in asset prices and market volatility—and on policy frameworks and fundamentals in recipient economies. Moreover, adverse spillovers from UMP exit in advanced economies may be exacerbated by further slowdown in emerging economies (EMs), which has been gradual so far, but protracted and synchronized in nature.

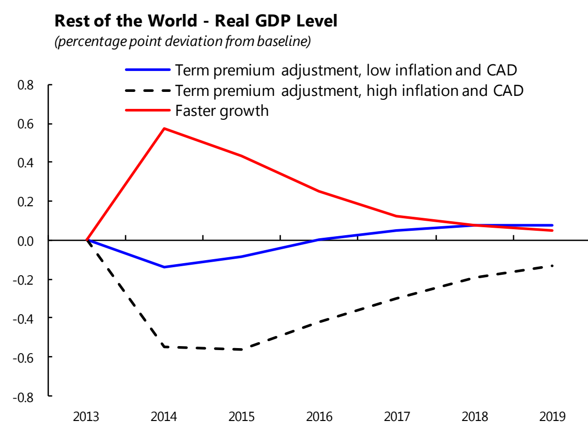
The 2014 spillover report[1] finds that the source of tightening financial conditions matters. Tightening unrelated to or ahead of better growth prospects causes a significant co-movement in long-term bond yields between source and recipient countries.[2] As capital flows out of EMs, currencies depreciate, stock prices fall, and industrial production declines. Tightening due to better growth prospects in advanced economies implies a much lower co-movement of yields. In this case, stronger external demand supports economic activity in EMs; and stock prices and industrial production increase. Hence, better prospects in advanced economies have benign spillovers, while unexpected financial tightening has a negative impact.

[1] http://www.imf.org/external/np/pp/eng/2014/062514.pdf

[2] This could involve shocks to the term premium, shifts in portfolio preferences toward higher demand for cash away from bonds and equity, and potential upward surprises in inflation unrelated to improved demand.

For recipient economies, spillover effects will likely differ across countries, depending on their fundamentals and policy frameworks. Past experience suggests that economies with relatively strong fundamentals—i.e., lower inflation, higher current account balances and reserves, and deeper financial markets—can better mitigate spillovers from higher interest rates abroad. The effects from these global shocks are milder in these economies, and credibility gives them more policy space to respond to the shock itself.

Scenario analysis suggests that stronger than expected growth in advanced economies would benefit global growth.[3] Overall, better growth prospects in the United States and United Kingdom compensate for the effects from the endogenous (in response to better growth) yield increase. The policy response in recipient countries depends on the impact on external demand and the initial conditions in the economy. The scenario suggests that GDP in the rest of the world will be about 1½ percent higher cumulatively than in the baseline by 2019 (red line). While all countries in the sample would experience a positive demand shock, countries with the strongest trade linkages with source countries would benefit the most.




In contrast, a 100 basis points increase in the term premium *not* associated with stronger growth would tighten financial conditions and have a negative impact on output. This scenario assumes that an increase in the term premium feeds into long-term bond yields in the United States and United Kingdom, although it is partially counteracted by implementation of UMP in the Euro Area. Tighter global financial conditions have a negative impact on growth. Overall, GDP in the rest of the world would be about 0.6 percent lower cumulatively relative to the baseline by 2019. Recipient countries with sound fundamentals—i.e., with the current account deficit and the inflation rate below the median for EMs—have policy space to lower domestic interest rates and mitigate spillovers, and their GDP would be only temporarily below the baseline (blue line). In contrast, countries with relatively weak fundamentals experience a 2¼ percent cumulative GDP loss by 2019 (black line).

Misperception of policy intentions in source countries or an autonomous slowdown in EMs may trigger larger spillover effects.[4] Should market participants misperceive central banks' policy intentions—which could potentially bring about financial volatility and temporary disruptions in short-term interest rates, as during the May 2013 taper episode—spillovers may be amplified, at

[3] The scenario assumes stronger growth that triggers an endogenous monetary tightening of 100 basis points in the policy rate.

[4] The scenario assumes good central bank communication in advanced economies. Should market misinterpret central bank policy intentions, spillovers from unwinding UMP could be amplified. The 2014 spillover report also examines the interactions of bumpy monetary normalization with an autonomous EM slowdown.

least initially. Moreover, a deceleration in EMs would exacerbate the global shock. Such a downside scenario is analyzed in the spillover report, which concludes that GDP could fall at the through by 1½–2 percent compared to the baseline.

The spillover report concludes that good communication in source countries and sound fundamentals in recipient economies will be critical. Well-crafted communications could avoid swings in asset prices or market misperceptions of policy intentions. Policy-makers should explain trade-offs and strategies carefully, clarifying the role of financial stability considerations on decision-making about policy rates and balance sheets. Sound fundamentals in recipient economies can dampen the transmission of external shocks and increase credibility and space to respond to them, especially through monetary policy. Letting the exchange rate adjust can act as a helpful buffer. Where international reserves are adequate, intervening to avoid a disorderly adjustment if macroeconomic policies fail to stabilize markets could be warranted.

At the international level, collaboration between advanced and emerging economies would help manage spillovers and risks of spillbacks. Insuring against market turbulence through liquidity lines, especially for more vulnerable economies, can limit the downside risks and possible wider turmoil.