GROUP OF TWENTY

GLOBAL PROSPECTS AND POLICY CHALLENGES

Meetings of G-20 Finance Ministers and Central Bank Governors
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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

Recent policy actions have led to some easing in financial stress and economic conditions may be stabilizing. Following actions by major central banks and EU governments, financial markets have experienced welcome respite recently and there are signs that the pace of activity has picked up relative to the second quarter. Nonetheless, the global economy remains vulnerable to new setbacks. In the euro area, activity remains weak, implementation challenges are large, financial conditions remain fragile, and high funding costs in the periphery hinder their growth and adjustment. Political impasse on dealing with large fiscal imbalances in the United States and Japan also contributes to lack of clarity and weighs on business confidence. Meanwhile, activity in major emerging economies—a main driver of global growth—has decelerated on the back of spillovers from advanced economies and the unwinding of credit booms in some countries, but the extent is not fully known.

The outlook for growth remains weak with appreciable downside risks. Prospects are for a modest reacceleration of global activity, provided policies are implemented decisively in the euro area and fiscal mistakes are avoided in the United States. But downside risks remain considerable. Despite strong ECB actions, a re-escalation of the euro area crisis remains a threat. Major risks also originate in the United States from the "fiscal cliff," a looming debate on raising the debt ceiling, and the absence of an agreed-upon fiscal roadmap. Potential growth may disappoint going forward in both advanced and emerging economies, reflecting the legacy of the financial crisis in the former and the unwinding of credit booms in the latter. But growth could also be stronger if policymakers acted promptly to further strengthen policies.

While progress has been made, resolving the euro area crisis will require timely and resolute policy implementation. Access to funding at reasonable costs is essential to allow economies to adjust successfully. Countries under pressure should implement adjustment plans and, if needed, request appropriate support from the EFSF/ESM. This would allow the ECB to intervene by using the newly-established OMT framework. Where financial conditions permit, automatic stabilizers should be allowed to operate. Anti-crisis measures should also be paired with a clearer roadmap toward banking union and greater fiscal integration to strengthen EMU. Such a union should rest on a single supervisory mechanism; a pan euro area resolution mechanism with common backstops; and a pan euro area deposit guarantee scheme. Finally, continued implementation of structural, fiscal and financial reforms, that will still take many years to complete, is essential.

Fiscal consolidation in advanced economies should proceed in a sustained and gradual manner, while central banks should stand ready to do more if needed. Fiscal policy should adhere to cyclically-adjusted targets unless activity falls significantly short of projections, in which case adjustment should be smoothed in countries that can afford it. In the United States, the imperatives are to agree to and implement a credible medium-term fiscal adjustment roadmap. In Japan, the plan should be strengthened considerably, notwithstanding the recent approval of a timetable for consumption tax increase. Central banks should continue managing downside risks to growth while addressing factors that hinder the effectiveness of monetary transmission.

Appropriate policy responses in emerging economies vary widely reflecting differing conditions. For those with low public debt or pursuing policies to move further from externally- to domestically-driven growth, placing consolidation on hold is appropriate in light of the weaker outlook. Others should rebuild fiscal room for maneuver over time. Where inflation is tame, monetary policy can remain on hold or be eased. However, monetary policy needs to be more cautious where inflationary pressures remain elevated and should be supported by macro-prudential measures where credit growth and real estate prices are high.

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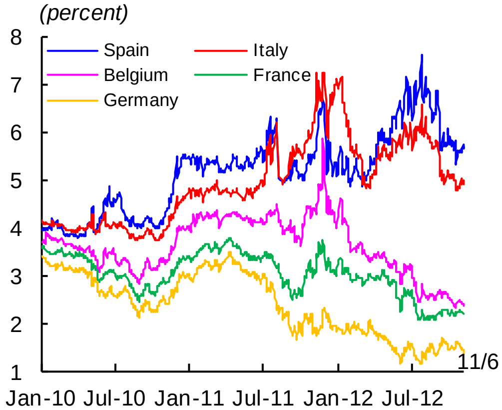
I. RECENT DEVELOPMENTS

Recent developments point to some stabilization of financial markets and global growth, owing to policy actions of major central banks and EU governments. Despite these improvements, global recovery remains weak and fragile under the weight of lingering policy uncertainty, ongoing economic and fiscal adjustment in advanced countries, and the unwinding of credit booms in emerging economies. Notwithstanding recent improvements, levels of financial stress remain elevated in the euro area periphery, hindering growth and balance sheet repair.

1. **Financial markets have improved since September and global growth appears to be stabilizing**. While the first half of 2012 was marked by a global loss of growth momentum and an intensification of financial and economic stress in the euro area (see IMF's October 2012 World Economic Outlook), recent developments point to stabilization, following further policy actions:

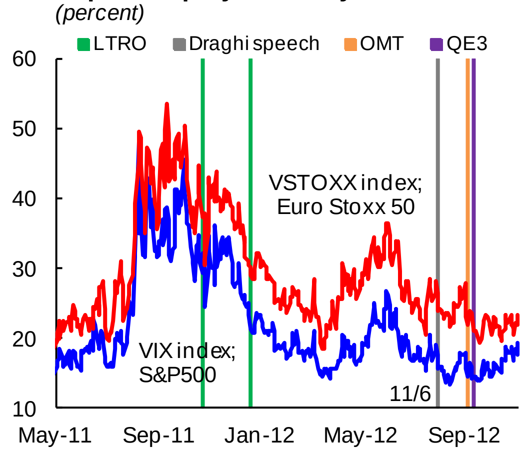
- European equities are trading higher. Bond yields in Italy and Spain have come down significantly, though they remain at relatively high levels. Periphery bank CDS spreads have also fallen somewhat and there has been some pickup in bank debt issuance, especially by stronger institutions. There are some early indications that acute capital outflow pressures from the periphery may have begun to ease, as reflected by the slight narrowing of TARGET2 imbalances. In the United States, the announcement of QE3 led to a strong decline in MBS yields, which may help support the housing recovery, and a fall of short-term interest rate expectations due to the extension of the forward guidance.

Euro Area: 10-year Bond Yields in Selected Countries
(percent)



Source: Bloomberg L.P.

Implied Equity Volatility
(percent)



Source: Bloomberg L.P.

- The latest high-frequency indicators suggest that global GDP growth might be stabilizing, albeit at a sluggish rate. Recent economic indicators have been stronger-than-expected in the United States, as the recovery in the housing sector continued and consumer spending picked up, while in the euro area activity remains weak. However, unemployment remains unacceptably high in most advanced economies. There are signs that a broad recovery is underway in Brazil, as reflected in indicators of retail sales, industrial production, and confidence; India is benefitting from a financial markets rally after its announcement of reforms (to FDI and subsidies); and growth in China appears to be stabilizing. In contrast, growth in Russia has been decelerating since the second quarter of this year, amid weak external demand.

2. **Recent stabilization comes on the heels of further monetary policy easing and other supportive actions**. Unconventional monetary policy has been at the heart of the policy response in advanced economies, while emerging markets have also eased considerably.

- The firewall of the euro area has been strengthened with the activation of the European Stability Mechanism (ESM). The introduction of the ECB's Outright Monetary Transactions (OMT) expanded the policy armor in a significant way, allowing effective intervention in dislocated bond markets. Under the OMT, the ECB can purchase sovereign bonds in the secondary market without ex ante limit or seniority but under strict conditionality for countries with EFSF/ESM access. This is aimed at repairing the monetary policy transmission to the real economy throughout the euro area and addressing severe distortions in government bond markets originating from investor fears about EMU viability. EU leaders have also recently agreed on a single supervisory mechanism for euro area banks, which will open the possibility for the ESM to recapitalize banks directly, although complex issues still have to be resolved, including valuation of troubled assets. In the meantime, periphery countries are pressing ahead with significant fiscal adjustment and structural reform.

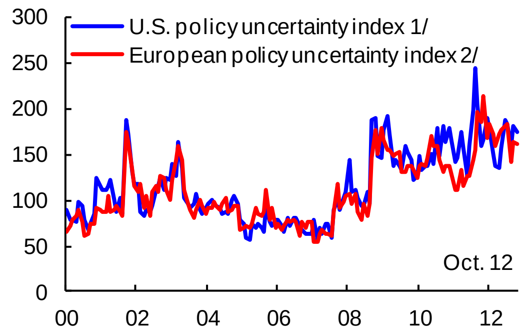
- Other major central banks have announced additional quantitative easing to support activity and demand. The Fed has announced it will start purchasing additional MBS at a pace of US$40 billion per month. It has also extended its forward guidance, noting that economic conditions are likely to warrant exceptionally low levels for the federal funds rate at least through mid-2015. The Bank of Japan recently further eased monetary policy through expanding its asset purchase program by about 2 percent of GDP. The Bank of England has expanded its quantitative easing program and launched an innovative Funding for Lending Scheme to encourage credit flow to the nonfinancial private sector.

- In G-20 emerging economies, many central banks have postponed anticipated monetary tightening and some—including Brazil, China and South Africa—have cut policy rates. Fiscal tightening was also postponed in several economies. In Russia, policy rates were raised in September, despite the growing signs of economic slowdown, to anchor inflation expectations amid rising headline inflation.

3. **Despite the latest improvements, recovery in advanced economies is being held back by lingering uncertainty about the course of policy, as well as tight financial conditions, balance sheet repair, and ongoing fiscal consolidation**.

- *Uncertainty about the policy course in major G-20 economies continues weighing on confidence, financial markets, and baseline growth*. While the announcement of OMT has supported market confidence and reduced convertibility risks within the euro area, uncertainties remain on its activation and further steps are needed toward establishing a banking union and greater fiscal integration. Moreover, market concerns remain heightened about economic fundamentals and policy adjustment in periphery countries. This uncertainty has resulted in high borrowing costs for both governments and private agents in several countries (Box 1). Political impasse on fiscal issues in the U.S. and Japan also creates further uncertainty, affecting business confidence. Critical decisions remain to be taken on both the short-term and long-term path of U.S. fiscal policy, and in Japan, budget funding problems should be resolved.

Economic Policy Uncertainty



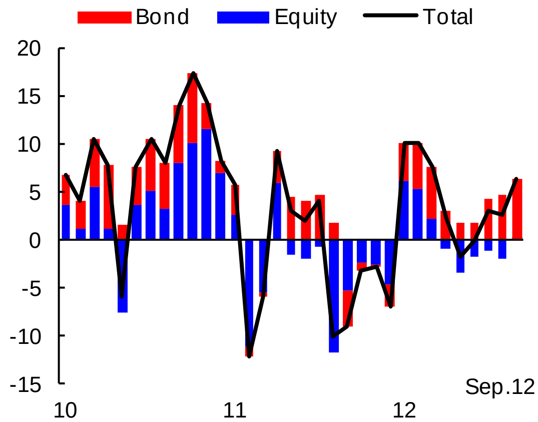
Source: http://www.policyuncertainty.com.
1/ The index is constructed from three types of underlying components: newspaper coverage of policy-related economic uncertainty, federal tax code provisions set to expire in future years, and disagreement among economic forecasters as a proxy for uncertainty.
2/ The index is constructed from two types of underlying components: newspaper coverage of policy-related economic uncertainty and disagreement among economic forecasters as a proxy for uncertainty.

- *At the same time, still weak private and public balance sheets are weighing on demand*. High household debt reduces creditworthiness and impels saving and caution with new borrowing, while banks maintain tight lending standards—partly in response to market and regulatory pressures to reduce leverage and strengthen capital buffers. As a result, both supply of and demand for credit are squeezed, depressing consumption and investment.

- *In addition, growth is weaker because of ongoing fiscal adjustment, which seems to be having more pronounced effects than anticipated*. This likely reflects multiple prevailing factors: policy rates are at or close to the zero bound in major advanced economies, limiting the space for monetary policy support to accompany consolidation; many countries are pursuing consolidation simultaneously, limiting offsets from external demand; and "crowding in" effects on other private spending may be weaker than otherwise, given uncertainty and balance sheet repair.

4. **Activity in emerging economies is also being held back—by spillovers from advanced economies and domestic factors**. Weak external demand provides a challenging environment. In some cases, financial channels add to the pressure with international investors staying away from EM equity markets, though inflows into EM bonds continued through the year. At the same time, in a number of emerging economies domestic demand has weakened, particularly investment. In some cases (e.g., in China) the key factor has been the lagged effect of earlier policy tightening undertaken in response to rising inflationary pressures and threats of credit and asset price bubbles. In other cases, waning business confidence also plays an important role in pulling down investment, reflecting for instance increased policy and regulatory uncertainty as well as binding infrastructural bottlenecks in India. Recent steps toward reform in India are welcome in this respect.

Total Flows
(billions of U.S. dollars; mutual funds)



Source: Haver Analytics.

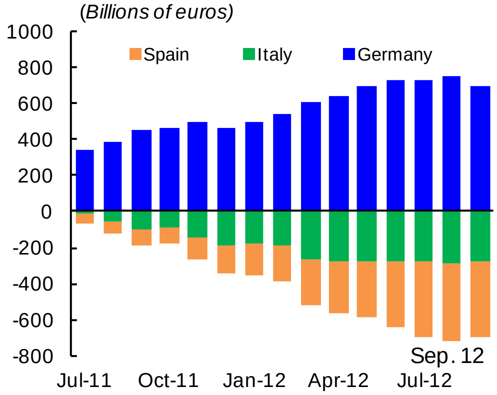
Box 1: Financial Fragmentation in the Euro Area

Despite some recent easing of capital outflows from the periphery and improved prospects, financial fragmentation in the euro area remains an issue.

Euro area financial fragmentation intensified in the first half of 2012, as capital flowed from periphery to core and outside the euro area. Investors reduced their exposure to periphery countries and hedged against convertibility risk by matching their periphery assets and liabilities country by country. Capital outflows from Spain and Italy were sizeable in the past year, though they started abating for Italy in the second quarter of 2012. Private capital outflows took the form of sharp reductions in cross-border bank lending, portfolio outflows (especially out of sovereign bonds but also corporate bonds in Spain) and deposit outflows from the periphery. Capital outflows gave rise to large TARGET2 (i.e., cross-border settlement) imbalances and private funding has been replaced mainly with periphery banks drawing on the Eurosystem through ECB liquidity operations. Financial fragmentation was also manifested in a large divergence of funding costs and CDS spreads for sovereigns, banks, and the non-financial corporate sector.

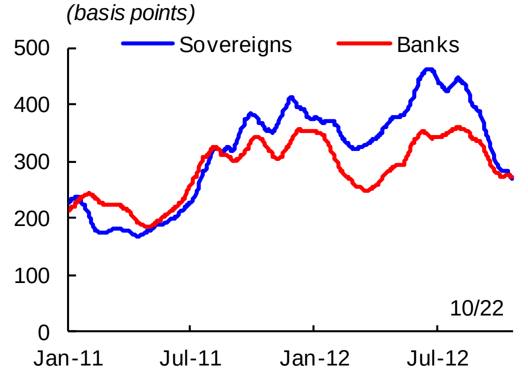
Following the ECB's announcement of OMT, there are early indications that capital outflow pressures in the periphery may have begun to ease—reflected in the latest data (i.e., narrower cross-border claims via the ECB under TARGET2). Sovereign and bank CDS spreads have also declined but remain elevated. This suggests financial fragmentation remains an issue and limits significantly the effectiveness of the common monetary policy and low policy rates.

Claims of euro area NCBs against the ECB
(Billions of euros)



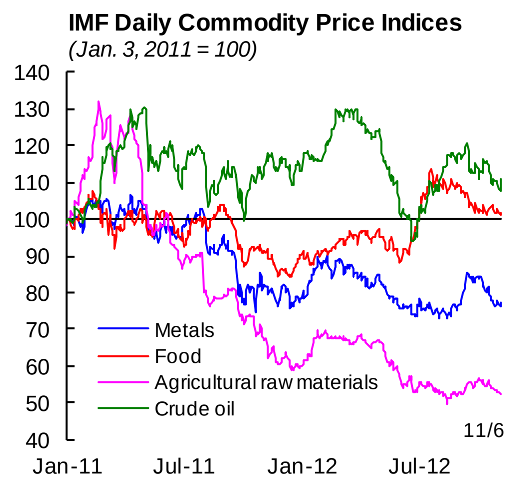
Source: Bloomberg.

Periphery Minus Core Credit Default Swap Spreads
(basis points)



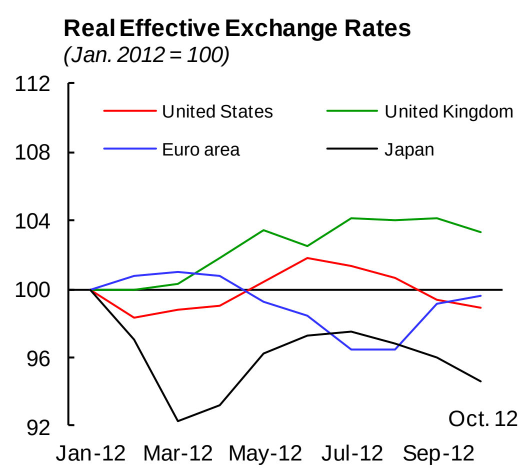
Sources: Bloomberg, L.P.; and IMF staff estimates.
Note: Sovereign index is weighted by GDP, the bank index is weighted by assets.

5. **There have also been a number of supply shocks, leading food and energy prices to escalate in the third quarter**. Setbacks to the global recovery, particularly in emerging markets, led to falling commodity prices in the second quarter but the third quarter was marred by supply shocks. In oil, prices have rebounded after Q2 as the market tightened again. This reflected a decline in oil supply due to maintenance issues at major fields in the North Sea; and reduced exports from Iran, as U.S. sanctions and the EU oil embargo have come into effect. In food, weather-related supply disruptions for key crops (soybean, corn, and wheat) led to higher food prices, and despite some recent relief, risks are tilted to the upside. The sharp increases in energy and food prices is denting purchasing power and complicating monetary and fiscal policy, especially in countries with large food and oil subsidies.



Source: Bloomberg L.P.

6. **Exchange rates have responded following recent central bank actions**. Most notably, the euro has strengthened in real effective terms recently, indicating that ECB action has so far been successful in reducing market concerns about convertibility risk within the euro area. Partly reflecting a stronger euro, the U.S. dollar and the Japanese yen have reversed part of their appreciations earlier this year. So far the currencies of emerging economies do not appear to have been affected much by announced additional quantitative easing measures by major central banks; however it may be too early to assess any direct implications on currencies (see Box 2 below). The currencies of Brazil and China have weakened somewhat in real effective terms recently, but some nominal appreciation pressures have reemerged in Brazil as the global financial market sentiment improved and Brazil's central bank has responded by intervening modestly. The Indian rupee has rebounded strongly but mostly on account of recent reform announcements. The Russian ruble has moved closely in line with oil prices, and the pickup in inflation also contributed to the recent considerable appreciation of the ruble in real effective terms.



Source: IMF, *Global Data Source*.

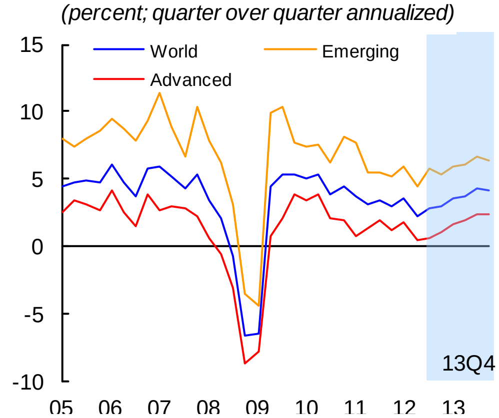
II. OUTLOOK & RISKS

The outlook is for a modest reacceleration of activity provided that major policy mistakes are avoided and efforts are made to further build on the commitments aimed at maintaining euro area integrity. Downside risks remain considerable, however. One risk is that policies are not implemented decisively enough in the euro area. Other risks stem from abrupt tightening of U.S. fiscal policy or uncertainty about raising the debt ceiling could hurt markets and growth. Risks also flow from the absence of sufficiently ambitious medium-term fiscal consolidation plans in the United States and Japan. Finally, potential output growth may have been overestimated in both advanced and emerging economies, and a reevaluation of future prospects could dampen current activity.

7. **A modest reacceleration of activity is expected, assuming policies are sufficiently supportive**. Recent developments so far support staff's projection of a slow reacceleration of growth. The WEO's forecast of a pickup in activity is however predicated on two critical assumptions. The first is that policies are implemented decisively in the euro area to gradually restore confidence and ease financial conditions. The second assumption is that U.S. policymakers will effectively avoid the fiscal cliff and raise the debt ceiling. Absent such actions, the world could slide into another downturn, with deep recession in the euro area periphery, and contraction or stagnation in the core and other advanced economies.

8. **Global output is projected to modestly expand by 3.3 percent in 2012 and 3.6 percent in 2013**. Both numbers are weaker than envisaged in April. *G-20 advanced economies* would only grow by 1.6 percent a year in both 2012 and 2013. *G-20 emerging economies* will remain an engine of growth, but the rate of expansion is expected to drop to 5.6 percent this year from 7.1 percent in 2011, before rebounding to 6.2 percent in 2013 in response to easier macroeconomic policies. However, growth could be much lower if either of the two critical policy assumptions is not satisfied.

Global Real GDP Growth
(percent; quarter over quarter annualized)



Sources: IMF, *Global Data Source;* and IMF staff estimates.

9. **Inflation is expected to continue moderating**. Core inflation has generally been subdued and steady in advanced economies at rates below target and has declined in emerging economies. There is concern, however, that swollen central bank balance sheets would ultimately lead to a significant rise of the money supply and thus inflation. Central banks though have sufficient tools to absorb the liquidity they create to forestall future inflation but will need to remain vigilant to such risks as economic slack diminishes. At the

current juncture, ample slack in many advanced economies and less pressure on capacity in emerging economies are likely to lead to further declines in inflation. However, this forecast is predicated on stable or declining commodity prices as predicted by futures markets. A reversal of food price increases is by no means guaranteed, partly due to low buffer stocks. Another important concern is the possibility of a sharp spike in oil prices triggered by geopolitical tensions (as discussed in the June 2012 *Global Risk Analysis* report).[1]

10. **Uncertainty about the outlook and downside risks remains considerable**. While downside risks may have diminished somewhat lately, they still appear much higher than half a year ago. The probability of global growth falling below 2 percent in 2013—a number consistent with recession in advanced economies and a serious slowdown in emerging market and developing economies—stood at about 17 percent in September, up from about 4 percent in April. Considerable threats to sustained recovery loom in different corners of the world.

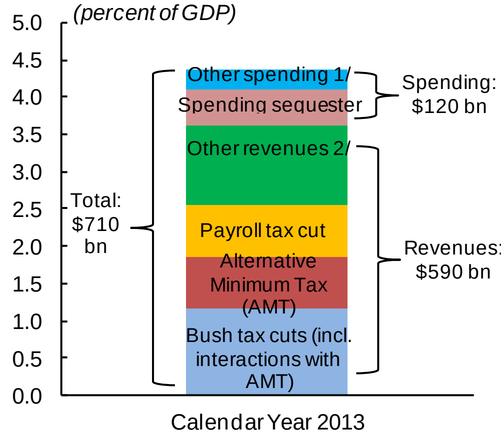
11. **Financial conditions in the euro area remain fragile and implementation risks are present**. While ECB action has taken some major tail risks off the table, political economy factors may prevent countries from requesting ESM programs and accessing the OMT in a timely fashion. Another risk is that austerity may become politically and socially untenable in periphery countries, as structural and fiscal reforms will still take years to complete. Moreover, the critical elements of establishing a banking union with common fiscal backstops will take some time to implement. A re-intensification of stresses would result in rising spreads and contracting credit, and governments under pressure would be forced to implement even further fiscal adjustment, resulting in larger GDP losses and significant spillovers on other economies.

[1] http://www.imf.org/external/np/g20/pdf/map2012/annex1.pdf

12. **U.S. fiscal policy is another major source of risk that is fast approaching**. In particular:

- Current law implies automatic tax increases and spending cuts amounting to $700 billion in 2013—a tightening of around 4 ½ percent of GDP. If realized, this would push the country into a recession with large international spillovers. The severity of the economic effects would partly depend on the duration of the cliff. Even if the "fiscal cliff" were quickly unwound, the damage to the economy could be substantial, especially if consumers and businesses were faced with continued uncertainty about tax and spending policies.

Composition of U.S. Fiscal Cliff
(percent of GDP)



Sources: CBO and Fund staff estimates.
1/ Emergency unemployment benefits, Medicare payments to physicians.
2/ Bonus depreciation, health care reform, various tax credits.

- Moreover, the absence of a deal on raising the debt ceiling also conjures up the specter of a dramatic tightening or even technical default. Failing to do this in a timely fashion adds to risk of financial market volatility. While investors are treating such events as tail risks—as U.S. policymakers have in the past always been able to pull back from the brink—the shocks, if realized, will be very large.

- At the same time, U.S. debt dynamics are not sustainable over the long run. Failing to agree soon on a credible plan to put the federal debt on a sustainable path could exacerbate uncertainty and thereby detract from activity; over the medium to long-term, it could lead to a gradual erosion of the reserve currency status of the U.S. dollar and put upward pressure on Treasury bond yields.

13. **Japan's fiscal situation is also unsustainable, despite the approval of the phased increase in the consumption tax rate**. There are indications of investor concern about heightened exchange rate risk and interest rate volatility at longer horizons (even if current yields are at multi-year lows), given large holdings of public debt by the financial sector. Therefore, there is a risk of large and disorderly correction in market pricing of these risks.

14. **Potential growth may be lower in both advanced and emerging economies**. Recent growth disappointments may be symptomatic of deeper problems.

- In *advanced economies*, the impact of the financial crisis and prolonged economic slump on investment, labor supply, human capital and technological progress—and hence on potential output—may be larger than already assumed. The high share of long-term unemployed is losing valuable skills and attachment to the labor market. With growth in advanced economies expected to remain sluggish for some time and with risks of setbacks, this creates a very challenging environment for emerging and developing economies. Emerging Europe looks particularly vulnerable to spillovers from advanced economies given their limited policy space.

- In *emerging economies*, strong growth over the last few years may have been aided by favorable terms of trade, easy funding conditions, and difficult-to-sustain credit expansion, with actual growth getting ahead of underlying potential. Hence, with credit booms unwinding, domestic demand could be slowing fast and could be amplified by a reevaluation of medium-term growth prospects and risks, both via income expectations and because of heightened concerns about banks and the sustainability of adjustment efforts. Importantly, a slowdown in major emerging economies would have a noticeable impact on their trading partners as well as on commodity exporters.

15. **Growth could also be stronger—if policymakers act quickly to further strengthen policies**. In the euro area, presenting a credible roadmap toward a banking union with greater fiscal integration followed promptly by implementation—such as putting in place a bank resolution mechanism with common backstops, or concrete measures toward fiscal integration—would help reverse capital outflows from the periphery. In this scenario, funding costs could normalize, credit channels would reopen, and economic growth would return to the periphery and pick up in the core. Most other parts of the world would also see a noticeable output increase relative to the baseline. In the United States, early agreement on raising the debt ceiling and dealing with the "fiscal cliff"—in a manner that does not postpone the problem—could help strengthen baseline policies. In the United States and Japan, durably addressing their fiscal challenges quickly would help lift global uncertainty and boost global growth prospects, while solidifying their position as safe havens.

III. POLICY IMPERATIVES

The main challenge for policymakers is to act forcefully to address downside risks with strong policy implementation; durable medium-term fiscal adjustment; and targeted structural reform. In the euro area—building on OMT and ESM activation, further action is also needed to strengthen banks, address structural shortcomings and complete EMU. Circumstances vary across emerging markets, but many should act to restore fiscal buffers over time, use monetary policy to guard against downside risks, and rely on macro-prudential measures to safeguard financial stability. Continued demand rebalancing from deficit to surplus economies would strengthen global growth and, if done properly, would help resolve their internal imbalances.

16. **In the euro area, robust action and follow-through are required on multiple fronts**. Sovereigns under stress need to continue to adjust and request appropriate EFSF/ESM support if needed; and support for them and their banks provided via the ESM would relieve funding pressures and break the adverse feedback loops between sovereigns and banks. Meanwhile, the ECB's commitment to act on secondary markets via the OMT is critical to address elevated risk premia due to convertibility concerns within the euro area, while maintaining a very accommodative monetary policy should support demand. Anti-crisis measures need to be anchored by a vision of—as well as a reasonably fast and tangible progress toward—a more complete monetary union, supported by a banking union and greater fiscal integration.

- *Access to funding at reasonable costs is essential to allow economies to adjust successfully*. While economies in the periphery must continue to adjust their fiscal balances at a pace they can bear, in the current fragile environment, putting in place the right policies may not be sufficient to fully restore the confidence of markets, not least because of implementation risks. Lower interest rates and easier financial conditions are key factors to facilitate balance sheet repair and support growth in the periphery. Common resources can be channeled via the ESM, and additional support should be provided through the OMT for eligible euro area members.

- *Further repairing banks' balance sheets while avoiding a pro-cyclical financial tightening are also crucial in the near term*. While viable banks should be recapitalized, non-viable ones should be resolved, in a least-cost manner. Where recapitalization of banks threatens public debt sustainability and/or financial stability, direct equity injections into banks are instrumental for cutting adverse bank-sovereign loops and could be done through the ESM. Clarity on the specific terms of ESM bank recapitalization options is needed soon. For this to happen, common bank supervision—a precondition for ESM taking stakes in banks—should be established without delay. While the recapitalization exercise launched by the EBA in October 2011 has helped strengthen the capital position of many European banks, they should aim at further rebuilding of capital levels to restore market confidence, especially in periphery countries, where the sharp deteriorations of the outlook could further test the adequacy of capital buffers. For this, external support may be instrumental to avoid an even deeper credit crunch.

- *An integrated regulatory and supervisory structure—a banking union—is indispensable for smooth functioning of integrated financial markets in EMU*. Such a union should rest on a single supervisory-regulatory framework; a pan euro area resolution mechanism with common backstops; and a pan euro area deposit guarantee scheme. Some building blocks are already shaping up, but there can be no let up in the momentum to put in place the complete structure and reaching agreement on contentious but critical components. Also, agreement would be needed on governance arrangements and voice for non euro area EU members who may wish to opt into a banking union (given close financial ties and the potential benefits) but who do not necessarily adopt the euro.

- *Fiscal integration would provide critical tools to backstop a banking union; help prevent idiosyncratic shocks from becoming systemic; and constrain imprudent policies*. The immediate priority is to establish a common fiscal backstop and resolution framework for a banking union anchored by a single supervisory mechanism. Beyond that, larger fiscal buffers at the national level would go some way toward smoothing the impact of adverse country-specific shocks. But given their magnitude, and recognizing the greater political complexity of fiscal union, some form of risk sharing at the euro area level might also be warranted within the union. Greater fiscal integration would also help manage perceived default risks that have arisen from sovereign-bank stresses in economies under market pressure and their spillovers to other members. Crucially, mutual support needs to be complemented by stricter and more robustly enforced rules and greater coordination of national policies—including through swift approval and implementation of the Fiscal Compact (at the country level).

17. **Fiscal consolidation should be gradual and sustained**. Considerable adjustment has already occurred, but many advanced economies still have a long way to go. On average, in advanced economies, the ratio of cyclically-adjusted general government balances to potential GDP is projected to improve by about ¾ percent of potential GDP in 2012 and 1 percent in 2013. In emerging economies as a group, no substantial consolidation is envisaged for this year or next.

- *It is essential to calibrate the pace of adjustment with both the state of the economy and funding pressures in mind*. The amount of planned fiscal consolidation in advanced economies appears relatively sizable over the near term—consistent with high debt and the slight increase in economic growth projected in the WEO—although with significant differences across countries. Where financial conditions permit, automatic stabilizers should be allowed to operate, and fiscal targets should be specified in cyclically-adjusted or structural terms. In case of large negative shocks or growth disappointments, the pace of consolidation should be smoothed in countries that can afford it.

- *U.S. authorities should act early to avoid the fiscal cliff and raise the debt ceiling*. While markets view a major disruption associated with these issues as a tail risk, the uncertainty about when and how they will be resolved may be weighing on demand. Importantly, a last minute deal that relies on suboptimal fixes or largely "kicks the can down the road" may ultimately prove harmful. Moreover, if contrary to the expectations a resolution is not found, confidence in U.S. policymakers will erode—which could have large domestic and international ramifications.

- *Fiscal adjustment must be anchored by concrete and ambitious medium-term consolidation plans*. At the moment, the U.S. lacks agreement on such a plan, and Japan's plan needs to be strengthened further despite the recent welcome approval of a timetable for doubling the consumption tax rate. Adjustments would be required on both expenditure and revenue sides of the ledger. It is important to move early to reduce the growth of aging-related expenditures—and while some measures have been enacted in Europe to reduce retirement costs, more can be done in all advanced economies, particularly to lower health-related spending. More robust fiscal frameworks would support the credibility of adjustment plans.

- *Emerging markets are generally in better fiscal position but some still need to rebuild room for maneuver*. On average, G-20 emerging economies have much lower public debt than advanced economies. However, historically, market tolerance though toward EM debt has also been lower, and fiscal buffers could thus be usefully restored over time. In particular, medium-term fiscal targets should be more ambitious in Russia (to reduce the non-oil deficit and improve intergenerational equity) and Turkey (to support external adjustment and reduce pressure on the central bank). India needs to adopt substantial fiscal reforms to anchor medium-term fiscal consolidation. While fiscal consolidation has stalled this year, a high level commission has presented a new medium-term road map. Recent steps to reduce fuel subsidies are also welcome. By contrast, economies that have sufficient fiscal space (e.g., China) can use discretionary fiscal stimulus with a view of promoting, or at least not hindering, the needed rebalancing of the economy towards consumption, should downside risks materialize.

18. **Monetary policy should continue to aid recovery**. Central banks have been at the forefront of the policy response to the recent global slowdown, and should continue supporting the recovery, while managing risks to price stability (Box 2).

- *In advanced economies, monetary policy should remain very accommodative and central banks should stand ready to do more if needed.*

- *In Japan, further monetary easing may also be needed to reach the 1 percent inflation goal*. The effectiveness of the easing in Japan would be enhanced by broadening asset purchases to include more equities and corporate bonds and government bonds with longer maturities and by simultaneously adopting broad structural and fiscal reforms to achieve a sustained recovery. In the U.S., improving the transmission of the monetary easing would require resolution of the household debt overhang. In the euro area, restoring the transmission channel requires addressing counterparty risk in the interbank market and the redenomination risk. Central banks should also carefully monitor unintended consequences their policies might have, for instance on sovereign-bank linkages, corporate leverage, and financial innovation as well as external spillovers.

- *Policy requirements differ vastly among emerging economies, but many can afford to stay on hold or ease if downside risks materialize given the receding inflation pressures.* Nevertheless, some countries in Asia and Latin America face late-cycle credit risks as nonperforming loans have started to turn up, which constrains space for financial policies. Some countries (e.g., Argentina and India) should remain watchful of inflationary pressures and cannot afford to lower interest rates further. In Brazil, policymakers should stand ready to start unwinding monetary stimulus as the recovery proceeds in order to securely anchor inflation expectations. Room for monetary easing may also be limited where a strong credit expansion continues or where currencies are undervalued. If needed to support demand, fiscal policy—provided space is available—may be the appropriate tool in such cases.

Box 2: Unconventional Monetary Policies—How Might They Work?

Major central banks have announced new unconventional policy measures recently: the ECB's Outright Monetary Transactions (OMT), the Fed's QE3, the BOE's extension of its QE and new Funding for Lending Scheme (FLS), and the BOJ's expansion of its asset purchase program. While broadly grouped under "unconventional monetary policy", they vary in design and rationale. For instance, in the United States, QE1 was undertaken to intervene directly in specific dislocated segments of the credit markets (i.e., "credit easing"), but the purpose of QE2, Operation Twist (OT), and recent QE3 was mainly to lower long-term yields. Several ECB measures—SMP, LTROs, and the recent OMT—have aimed to remove multiple equilibria and reduce rollover or convertibility risks within the euro area as part of broader crisis management measures. The main goal of the BOJ's monetary easing policies is to defeat deflation, and the BOE intends to ease bank credit conditions by intervening through its new FLS.

Quantitative easing has aimed at stimulating demand and preventing a sharper deterioration in financial conditions since the onset of the crisis. Measures operate through various channels. By lowering the "risk-free" rate, they may lead to asset reallocation toward risky assets and lower equilibrium risk premium (portfolio rebalancing effect). The corresponding rise in asset values can stimulate consumption through wealth effects and investment through a lower cost of capital (liquidity effect). They may also have signaling effect by anchoring market expectations that monetary stimulus will not be withdrawn until a durable recovery is in sight. Another channel is the exchange rate, though its strength is reduced when other central banks act at the same time. While there is a wide range of estimates, various studies have found that previous Fed's policies—QE1, QE2, and OT—reduced the 10-year Treasury yields meaningfully. Forward guidance on the path of the policy rate over a longer period also helped to lower rates across the yield curve. Although growth effects are difficult to ascertain, the impact on yields in the case of QE1 is estimated to have boosted growth by ¼ to ½ percentage points over two years. Similarly, the BOE's QE1 in 2009 lowered sovereign yields significantly, boosting GDP by an estimated 1½ to 2 percent. The BOE's QE2 in 2011–12 brought more muted market reactions, partly due to market anticipation ahead of the actual announcement. Staff studies find that BOJ's monetary easing through its new asset purchase program (currently totaling 17 percent of GDP), has been effective in supporting activity and inflation, lowering bond yields, and raising equity prices.

While policy benefits are often the focus, unintended consequences should be monitored closely. Very low interest rates can adversely affect short-term money market functioning and delay needed balance sheet restructuring of financial institutions. Beyond possible untoward domestic effects including excessive risk taking and leverage, very accommodative monetary policies of advanced economies (AEs) have raised concerns in emerging economies (EMs) about surges in capital inflows and upward pressures on exchange rates, especially in those with more open capital accounts. Staff analysis suggests that unconventional easing in AEs can impart temporary appreciation pressures in some EMs[1]; however, stronger demand in AEs can benefit them through higher exports and broader confidence effects. Studies also emphasize as much a role of pull factors (e.g., better growth outlook in EMs) as that of push factors (low interest rates in AEs) in international spillovers. However, one has to acknowledge that there may be risks of global credit mispricing, reflected by excessive tightening in EM credit spreads for some, due to the combination of low yields in AEs and rigidity of exchange rate policies in some EMs.

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[1]See, for example, 2011 U.S. spillover report (http://www.imf.org/external/pubs/ft/scr/2011/cr11203.pdf)

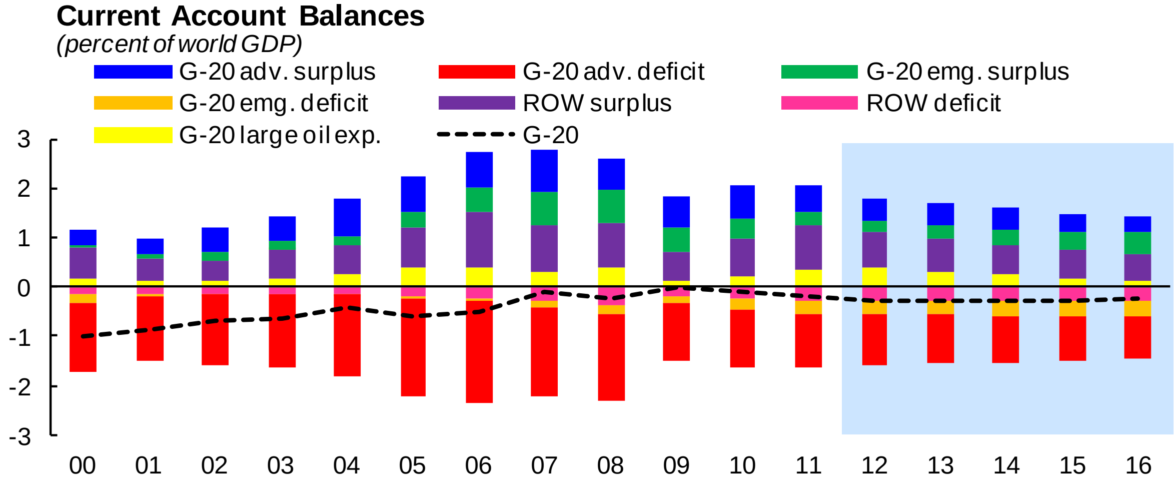
19. **Prudential authorities must control credit risks**. In *advanced economies*, prudential authorities must continue to push balance sheet repair and, where necessary, impose losses on bank stakeholders and force recapitalization, which may require using public funds. In *emerging economies*, supervisory and macro-prudential measures should be employed to counter possible credit bubbles, such as for real estate; countries exposed to volatile capital flows should strengthen their macroprudential frameworks. Such measures could also be used to smooth volatile capital flows.

20. **For emerging economies, rising food prices present particular challenges, given their high weight in consumption, notably for poorer households**. Central banks should not react to first-round effects of food price increases but should communicate clearly their intent to tighten if second-round pressures start building to prevent spillovers into core inflation, wages and expectations more generally. Vulnerable groups should be protected through targeted transfers rather than broad subsidies to contain fiscal costs, while meeting social objectives. Countries that face incipient trade pressures should access multilateral finance to support balance of payments needs. Food-exporting countries should avoid protective trade policies such as export bans and export taxes and quotas, which would further drive up food prices and volatility. International coordination of responses—including via G-20 initiatives—would help address the issue, if food prices continue to rise.

21. **The financial regulatory reform agenda has been advanced, but implementation is still in early stages and the global financial system is not appreciably safer than before the crisis**. Risks related to delayed or inconsistent implementation across economies could create opportunities for regulatory arbitrage, gaps, or conflicts in regulation—which could undermine financial stability and ultimately harm members' growth objectives. It is crucial to strike a proper balance between the necessary strengthening of the resilience of the financial system and the need to cushion the impact of the adjustment on economic activity. Key areas of attention for further progress include cross-border resolution and supervision, the too-important-to-fail issue, consistent implementation of the reforms in the over-the-counter derivatives market, and closing critical information gaps.

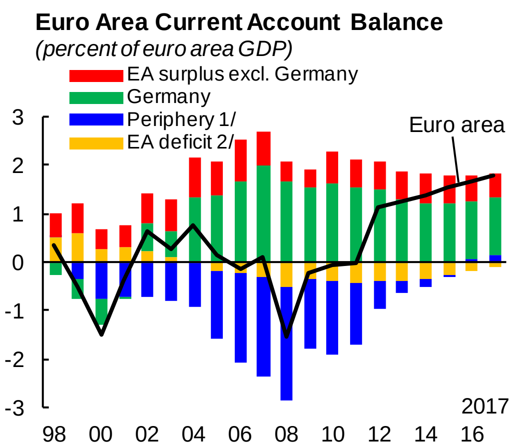
22. **Global imbalances have narrowed considerably, but largely on the back of slumping demand**. Much of the adjustment in current accounts came from demand compression in crisis-stricken deficit economies. More constructive influences—from the point of view of supporting global growth—include more robust domestic demand in China (although stronger consumption would have been preferable to a boost to already very high investment) and more social spending by oil exporters, as well as depreciation in several EM deficit currencies. Imbalances have narrowed within the euro area as well, with the main driver being lower demand in the periphery. However, there has also been progress with relative unit labor cost (ULC) adjustment, as ULC declined in crisis economies (though in part

through apparent productivity gains arising from labor shedding) and increased in some surplus countries.

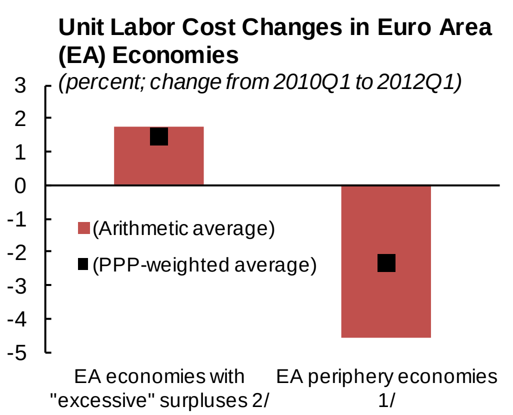


Source: IMF staff estimates.

23. **Policies that support growth and reduce domestic vulnerabilities would lead to a further reduction in imbalances**. As deficit economies continue necessary fiscal consolidation, global growth should be supported by stronger demand from surplus economies. That demand can be promoted by boosting investment in advanced surplus economies (where it has been lagging), broadening social safety nets in certain emerging economies, and, where appropriate, cutting back on reserve accumulation and allowing more exchange rate flexibility. Over time, structural reforms would help improve competitiveness in deficit economies—including the euro area periphery—and increase the reliance of growth on domestic sources in surplus ones. Importantly, these adjustments would be in the individual interests of countries concerned (surplus and deficit economies alike) and effectively lower global imbalances and related vulnerabilities.



Source: IMF, *World Economic Outlook.*
1/ Greece, Ireland, Italy, Portugal, Spain.
2/ Excludes five periphery economies.



Source: IMF, *World Economic Outlook.*
1/ Greece, Ireland, Italy, Portugal, Spain.
2/ Classifications based on the IMF Staff's *Pilot External Sector Report* (2012d).

Table 1. Real GDP Growth

(Percent change)

	Year over Year Averages				Q4 over Q4	
			Projections		Projections	
	2010	2011	2012	2013	2012	2013
World 1/	**5.1**	**3.8**	**3.3**	**3.6**	**3.0**	**4.0**
Advanced economies	3.0	1.6	1.3	1.5	1.1	2.1
Euro area	2.0	1.4	-0.4	0.2	-0.5	0.8
Emerging market and developing countries 2/	7.4	6.2	5.3	5.6	5.5	6.2
Advanced G-20	2.9	1.5	1.6	1.6	1.2	2.1
Emerging G-20	8.7	7.1	5.6	6.2	5.6	6.3
G-20 3/	5.4	4.0	3.4	3.8	3.2	4.0
Argentina 4/	9.2	8.9	2.6	3.1	2.0	3.5
Australia	2.5	2.1	3.3	3.0	2.3	4.4
Brazil	7.5	2.7	1.5	4.0	2.9	3.8
Canada	3.2	2.4	1.9	2.0	1.7	2.2
China	10.4	9.2	7.8	8.2	7.8	8.1
France	1.7	1.7	0.1	0.4	0.0	0.8
Germany	4.0	3.1	0.9	0.9	0.9	1.4
India	10.1	6.8	4.9	6.0	5.5	5.9
Indonesia	6.2	6.5	6.0	6.3	5.4	6.6
Italy	1.8	0.4	-2.3	-0.7	-2.3	0.0
Japan	4.5	-0.8	2.2	1.2	1.6	2.1
Korea	6.3	3.6	2.7	3.6	3.1	3.5
Mexico	5.6	3.9	3.8	3.5	3.2	4.1
Russia	4.3	4.3	3.7	3.8	2.5	4.8
Saudi Arabia	5.1	7.1	6.0	4.2	…	…
South Africa	2.9	3.1	2.6	3.0	2.7	3.3
Turkey	9.2	8.5	3.0	3.5	3.1	3.6
United Kingdom	1.8	0.8	-0.4	1.1	0.0	1.2
United States	2.4	1.8	2.2	2.1	1.7	2.5
European Union	2.1	1.6	-0.2	0.5	-0.2	1.2

Source: IMF, *World Economic Outlook* October 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 80 percent of the emerging market and developing countries.

3/ G-20 aggregations exclude European Union and quarterly projections exclude Saudi Arabia.

4/ Figures on real GDP growth are based on official data. The IMF has called on Argentina to adopt remedial measures to address the quality of the official GDP. The IMF staff is also using alternative measures of GDP growth, including data produced by private analysts, which have shown significantly lower real GDP growth than the official data since 2008.