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Global Update

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IMF's latest update on state of world economy

IMF forecasts world growth to rise to 4.6% in 2010, as against 4.2% estimated earlier in April. This rate will be moderated to 4.3% in 2011. This news is assuring as the IMF's estimate is based after considering the Euro crisis and the revival package that has been implemented.

However, the world average does not fully reveal the large differences around the globe as they hide differences between and within advanced and emerging and developing economies: the United States is expected to grow at about 3.3% in 2010, the euro area at 1%, Japan at 2.4% and emerging and developing economies at 6.8%.

The IMF feels that going ahead rapid implementation of stabilization measures taken by the euro area government authorities will be a key component in calming financial markets. More generally:

- Government policies in advanced economies should focus on credible fiscal consolidation—notably measures to enhance medium-run growth prospects, such as reforms to entitlement and tax systems. Supported by accommodative monetary conditions, fiscal actions should be complemented by financial sector and structural reforms to enhance growth and competitiveness.
- Policies in emerging economies should also help rebalance global demand, including structural reforms and greater exchange rate flexibility.

The IMF has reiterated that while it will remain cautiously optimistic about the pace of recovery, there are some dangers ahead. The issues that come to mind are:

- How Europe deals with fiscal and financial problems,
- How advanced countries proceed with fiscal consolidation, and,
- How emerging market countries rebalance their economies?

Prospects for the Indian economy appear to be bright at 9.4% for 2010 according to the IMF. Better world growth prospects really means that Indian exports would be on target as there was earlier some concern about exports being affected by the Euro crisis. With the euro region expected to grow by 1%, there is relatively less worry for Indian exports going forward.

Overall scenario

Progress good so far…

The world economy expanded at an annualized rate of over 5% during the first quarter of 2010. This was better than expected due to robust growth in Asia. There were encouraging signs of growth in private demand and global indicators of real economic activity were strong through April and stabilized at a high level in May. Industrial production and trade posted double-digit growth, consumer confidence continued to improve, and employment growth resumed in advanced economies.

Risks however, remain…

Nevertheless, recent turbulence in financial markets—reflecting a drop in confidence about fiscal sustainability, policy responses, and future growth prospects—has cast a cloud over the outlook. Crucially, fiscal sustainability issues in advanced economies came to the fore during May, fuelled by initial concerns over fiscal positions and competitiveness in Greece and other vulnerable euro area economies. Concern over sovereign risk spilled over to banking sectors in Europe. *Funding pressure reemerged and spread through interbank markets, fed also by uncertainty about policy responses. At the same time, questions about sustainability of the strength of the global recovery surfaced.*

The renewed financial turbulence, it is believed, could spill over to the real economy through several channels, involving changes in domestic and external demand and relative exchange rates. The supply of bank credit could be curtailed by heightened uncertainty about financial sector exposure to sovereign risk as well as increased funding costs, notably in Europe. Moreover, lower consumer and business confidence could suppress private consumption and investment. Fiscal consolidation could also dampen domestic demand. To the extent that higher risk premiums were accompanied by depreciation of the euro, the latter would boost net exports and mitigate the overall negative effect on growth in Europe. However, the negative growth spillovers to other countries and regions could be substantial because of financial and trade linkages. Lower risk appetite could initially reduce capital flows to emerging and developing economies. But relatively more robust growth prospects and low public debt could eventually result in higher capital flows, as some emerging market economies become a more attractive investment destination than some advanced economies.

Assumptions made

The euro area projections hinges on the efficacy of the new European Stabilization Mechanism (aimed at preserving financial stability) and, the successful implementation of well-coordinated policies to rebuild confidence in the banking system. Contagion to other regions is assumed to be limited and the disruption in capital flows to emerging and developing economies to be temporary. But there is a downside scenario: further deterioration in financial conditions could have a much greater adverse effect on global growth as a result of cross-country spillovers through financial and trade channels.

Asian Scenario

- Asia's strong recovery from the global financial crisis continued in the first half of 2010, despite renewed tension in global financial markets.
- GDP results for the first quarter were generally stronger than anticipated and high-frequency indicators suggest that economic activity will be brisk during the second quarter.
- Economic activity in the region has been sustained by continued buoyancy in exports and private domestic demand.
    - Exports have been boosted by the global and domestic inventory cycles and by recovery of final demand in some advanced economies.
    - Private fixed investment has strengthened on the back of higher capacity utilization and the still relatively low cost of capital in Asia.
- Against this background, the IMF's GDP growth forecasts for Asia have been revised upward for 2010, from about 7% in April to about 7.3%. For 2011, when the inventory cycle will have run its full course and the stimulus is withdrawn in several countries, Asia's GDP growth overall is expected to settle to a more moderate but also more sustainable rate of about 6.8%.

Inflation to remain mostly subdued..

Prices of most commodities fell during the financial market shocks in May and early June, reflecting in part expectations for weakened global demand. Prices recovered some ground more recently, as concern about the real spillovers of the financial turbulence has eased. At the same time, waning appetite for risk prompted gold prices to settle higher. In line with futures market developments, the *IMF's crude oil price projection has been revised down to $75.3 a barrel for 2010 and $77.5 a barrel for 2011.*

How about monetary approach?

- Given subdued inflation pressures, monetary conditions should be accommodative in most advanced economies. This will help mitigate the adverse effects on growth of earlier and larger fiscal consolidations as well as of financial market jitters. Moreover, if downside risks to growth materialize, monetary policy should be the first line of defense in many advanced economies. In such a scenario, **with policy interest rates already near zero in several major economies, central banks may need to again rely more strongly on using their balance sheets to further ease monetary conditions.**
- Monetary policy requirements are more diverse for emerging and developing economies. Some of the larger, fast-growing emerging economies, faced with rising inflation or asset price pressures, have appropriately tightened monetary conditions, and markets are pricing in further moves *(India would come in this category)*. But monetary policy actions must remain responsive in both directions. In particular, should downside risks to global growth materialize, there may need to be a swift policy reversal.

Exchange rate also to be monitored

In emerging economies with excessive external surpluses, monetary tightening should be supported with nominal effective exchange rate appreciation as excess demand pressures build, including in response to continued fiscal support to facilitate demand rebalancing or renewed capital flows. In this context, any concerns about exchange rate overshooting could be addressed by fiscal tightening to ease pressure on interest rates, by some buildup of reserves, and possibly by stricter controls on capital inflows—mindful of the potential to create new distortions—or looser controls on outflows.

Above all, financial reforms must continue…

- Recently renewed financial strains underscore the urgent need to reform financial systems and restore the health of banking systems. In many advanced economies, more progress is needed on bank recapitalization; bank consolidation, resolution, and restructuring; and regulatory reform. In some cases, larger capital buffers are required to absorb the ongoing and potential future deterioration in credit quality and to meet expected higher capital standards. In the absence of complete banking sector recapitalization and restructuring, the flow of credit to the economy will continue to be impaired.
- Greater transparency is also a priority. Resolving uncertainty about bank exposures, including to sovereign debt, could alleviate pressure in the European interbank markets and help improve market sentiment.
- There is also a pressing need to reduce ongoing uncertainty about the regulatory environment and to implement long-awaited reforms. Otherwise, policy opacity could hinder banks' willingness to supply credit and support the recovery. Hence, credible and consistent plans and timetables for implementing regulatory reform need to be developed and to reduce uncertainty. Unilateral measures should be avoided as they could have unintended consequences, especially if market confidence suffers.

Message for India

The global economic prospects, which include robust growth in India, are suggestive that we should keep our policy options open on growth as the government should keep in mind that the world economy could slip and that policies would have to be accommodative. Credit flows, especially trade credit, should be easier now with global trade picking up. The RBI can be more open to currency appreciation as a measure to balance capital inflows. The present focus on inflation can continue until a change is observed in the global economy.

Latest IMF projections

The world economy is recovering better than expected, but at varying speeds for different regions.

(percent change unless otherwise noted)

			Projections		Difference from April 2010 WEO projections	
	2008	2009	2010	2011	2010	2011
World Output	**3.0**	**-0.6**	**4.6**	**4.3**	**0.4**	**0.0**
Advanced Economies	**0.5**	**-3.2**	**2.6**	**2.4**	**0.3**	**0.0**
United States	0.4	-2.4	3.3	2.9	0.2	0.3
Euro Area	0.6	-4.1	1.0	1.3	0.0	-0.2
Germany	1.2	-4.9	1.4	1.6	0.2	-0.1
France	0.1	-2.5	1.4	1.6	-0.1	-0.2
Italy	-1.3	-5.0	0.9	1.1	0.1	-0.1
Spain	0.9	-3.6	-0.4	0.6	0.0	-0.3
Japan	-1.2	-5.2	2.4	1.8	0.5	-0.2
United Kingdom	0.5	-4.9	1.2	2.1	-0.1	-0.4
Canada	0.5	-2.5	3.6	2.8	0.5	-0.4
Other Advanced Economies	1.7	-1.2	4.6	3.7	0.9	-0.2
Newly Industrialized Asian Economies	1.8	-0.9	6.7	4.7	1.5	-0.2
Emerging and Developing Economies	**6.1**	**2.5**	**6.8**	**6.4**	**0.5**	**-0.1**
Central and Eastern Europe	3.1	-3.6	3.2	3.4	0.4	0.0
Commonwealth of Independent States	5.5	-6.6	4.3	4.3	0.3	0.7
Russia	5.6	-7.9	4.3	4.1	0.3	0.8
Excluding Russia	5.3	-3.4	4.4	4.7	0.5	0.2
Developing Asia	7.7	6.9	9.2	8.5	0.5	-0.2
China	9.6	9.1	10.5	9.6	0.5	-0.3
India	6.4	5.7	9.4	8.4	0.6	0.0
ASEAN-5[1]	4.7	1.7	6.4	5.5	1.0	-0.1
Middle East and North Africa	5.3	2.4	4.5	4.9	0.0	0.1
Sub-Saharan Africa	5.6	2.2	5.0	5.9	0.3	0.0
Western Hemisphere	4.2	-1.8	4.8	4.0	0.8	0.0
Brazil	5.1	-0.2	7.1	4.2	1.6	0.1
Mexico	1.5	-6.5	4.5	4.4	0.3	-0.1

Source: IMF, *World Economic Outlook*, July 2010.

[1] Indonesia, Malaysia, Philippines, Thailand, and Vietnam.
