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Global Prospects

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The IMF in its latest World Economic Outlook presents a positive view of the state of the world economy and commends governments for their proactive policies that have helped to bring their economies back on the rails.

While it does explain in detail the rollback measures pursued by several central banks and governments both in terms of interest rates and quantitative easing, it does suggest that they should work in cohesion depending on the state of the country's economy to ensure that the tempo is maintained in a stable manner. In particular, this should be done keeping in mind the overall debt situation of a country.

World GDP is forecast to expand by 4.8% in 2010 and 4.2% in 2011, with a temporary slowdown during the second half of 2010 and the first half of 2011. Output of emerging and developing economies is projected to expand at rates of 7.1% and 6.4% in 2010 and 2011, respectively. In advanced economies, however, growth is projected to be only 2.7% and 2.2%, respectively.

Inflation is not yet an issue for advanced economies which can hence have that much more flexibility with monetary policy. Emerging markets have been projected to have higher inflation numbers. Tackling inflation will need joint effort from the central banks and governments to ensure that it does not come in the way of fostering growth.

Sustained healthy recovery rests on two rebalancing acts: internal rebalancing, with a strengthening of private demand in advanced economies, allowing for fiscal consolidation; and external rebalancing, with an increase in net exports in deficit countries and a decrease in net exports in surplus countries, notably emerging Asia.

Global view

Economic recovery continued to strengthen during the first half of 2010, but global financial stability suffered a major setback with the turmoil in sovereign debt markets in the second quarter. The world economy expanded at an annual rate of about 5.25% during the first half of the year while industrial production is estimated to have been around 15% and global trade over 40%.

Emerging economies

The extent of economic recovery differs across regions, with Asia being the leader once again. Asia, other than Japan, has enjoyed strong growth benefiting from the global rebound in trade. As a result, their output is already above pre-crisis levels. Growth in emerging Asia reached about 9.5%, as robust domestic demand spread from China, India, and Indonesia to other Asian economies. In China, major fiscal stimulus, large expansion of credit, and a number of specific measures to boost household incomes and consumption increased domestic demand growth to close to 13% in 2009, contributing to a large decline in the current account surplus. The recovery is now well established, and a transition from public stimulus to private-sector-led growth is under way.

Latin America has also recovered strongly, with real GDP growth at about 7% led mainly by Brazil, where real GDP growth has been close to 10% since the third quarter of 2009. In fact, this economy is showing signs of overheating. A number of other economies have also returned to solid growth and the only laggard is Mexico partly because of its strong trade linkages with the USA.

Advanced economies

Growth in advanced economies reached about 3.5%. A surge in inventory and fixed investment accounted for a dramatic rise in manufacturing and global trade. Low consumer confidence and reduced household incomes and wealth are holding consumption down in many advanced economies. The USA and Japan experienced a noticeable slowdown during the Q2-2010, while growth accelerated in Europe.

In the USA investment in business equipment and software has been rising helped by foreign demand, rebounding profits, and normalizing financial conditions. However, this has not yet triggered a sustained, solid recovery in employment and real estate activity remains very weak. Financial conditions have begun to normalize, but institutions and markets are still fragile. In general, volatility in financial, currency, and commodity markets remains elevated.

In Japan, fiscal stimulus and the rebound in global trade and strong demand elsewhere in Asia have boosted output growth since the Q4-2009, but activity weakened significantly in the second quarter of 2010.

In the euro area, led by Germany, activity showed significant strength only in Q2-2010. The area's dependence on bank credit is restraining demand, as banks continue to be unusually cautious in lending.

GDP growth (%)

Region	2008	2009	2010 (f)	2011 (f)
World	2.8	-0.6	4.8	4.2
Advanced nations	0.2	-3.2	2.7	2.2
USA	0.0	-2.6	2.6	2.3
Euro	0.5	-4.1	1.7	1.5
Germany	1.0	-4.7	3.3	2.0
France	0.1	-2.5	1.6	1.6
Italy	-1.3	-5.0	1.0	1.0
Spain	0.9	-3.7	-0.3	0.7
Japan	-1.2	-5.2	2.8	1.5
UK	-0.1	-4.9	1.7	2.0
Canada	0.5	-2.5	3.1	2.7
Emerging markets	6.0	2.5	7.1	6.4
Central. West Europe	3.0	-3.6	3.7	3.1
CIS	5.3	-6.5	4.3	4.6
Russia	5.2	-7.9	4.0	4.3
Developing Asia	7.7	6.9	9.4	8.4
China	9.0	9.1	10.5	9.6
India	6.4	5.7	9.7	8.4
ASEAN-5	4.7	1.7	6.6	5.4
Latin America	4.3	-1.7	5.7	4.0
Brazil	5.1	-0.2	7.5	4.1
Mexico	1.5	-6.5	5.0	3.9

Inflation outlook (%)

Region	2008	2009	2010 (f)	2011 (f)
Advanced economies	3.4	0.1	1.4	1.3
Emerging economies	9.2	5.2	6.2	5.2

(f): forecast

Financial markets

In recent months, financial conditions have eased as risks have been reduced by European policy initiatives such as ECB's Securities Markets Program (SMP) and Euro area governments' European Stabilization Mechanism along with fiscal adjustment.

- Sovereign bond auctions in the euro area have successfully rolled over substantial maturities, albeit at higher costs.
- The stress test exercise of the Committee of European Banking Supervisors did help to bring down the credit default swap spreads on euro area bank bonds. Subsequently bank stocks recovered and several banks successfully tapped bond markets.
- The recovery has helped improve the health of the banking system. Total bank write-downs and loan provisions are \$2.2 trillion, down from the April 2010 estimate of \$2.3 trillion. The average Tier 1 capital ratio in the global banking system rose to more than 10% at end 2009, although this mostly reflects government recapitalization, given that less than half the capital raised was from market sources.

However, underlying sovereign and banking vulnerabilities still pose a significant challenge amid lingering concerns about risks to the global recovery. Heightened economic uncertainty combined with deleveraging and sovereign spillovers imply that core banking systems would still remain vulnerable to confidence shocks and are heavily reliant on government or central bank support.

Currencies

Financial turbulence led to sharp currency movements in the first half of 2010. The euro depreciated by about 15% in real effective terms, although it has partially recovered and is currently trading at a level broadly in line with medium-term fundamentals. The dollar appreciated in real effective terms as risk aversion rose during May–June, but it has since returned to levels seen earlier in the year, on the strong side of medium term fundamentals. The yen weakened briefly in April but has been appreciating since and now stands more than 25% above 2007 levels, prompting the authorities to intervene in exchange markets due to concerns about disruptive yen movements. At current levels, the yen remains broadly in line with medium-term fundamentals.

With a few exceptions, emerging Asian currencies, including the Chinese renminbi, appreciated modestly in real effective terms. However, many remain undervalued relative to medium-term fundamentals.

Commodities

Commodity prices surrendered some of the strong gains realized during the initial phase of the recovery. These early gains reflected a combination of strong demand in emerging economies and low inventories for some commodities. Precious metals, however, continued to soar during the turbulence, amid heavy buying by risk-averse investors.

The weather-related downgrades in harvest expectations for some major exporters recently pushed up wheat prices. Although the market for wheat remains appreciably less tight than during the price spikes of 2007–08, and prices of other food and agricultural inputs (for example, fertilizer) have not risen much, policymakers may have to take action to protect the poor from sharp price increases in major food staples, such as wheat.

Monetary actions

Monetary policy remains appropriately supportive in most economies and markets are expecting a very gradual return to more normal interest rates.

- In advanced economies, the central banks of Australia, Canada, Israel, Korea, New Zealand, Norway, and Sweden have recently raised policy interest rates. However, rates in these economies remain very low by historical standards, except where recovery is already more entrenched.
- The Federal Reserve, Bank of Japan, ECB, and Bank of England have kept the main policy rate near the zero bound, with the Fed indicating that conditions warrant exceptionally low interest rates for an extended period. The market response to concerns about the sustainability and pace of recovery has been

- a sharp decline in longer-term government yields. As financial institutions and markets heal, low interest rates should exert stronger stimulus.
- A number of emerging economies have effected monetary tightening, with rate hikes (Brazil, India, Malaysia, Peru), increased cash reserve requirements (China, India, Turkey), or direct limits on credit growth (China). The tightening is expected to proceed at a gradual pace, as inflation is contained. The more pressing concern in a few economies is high credit growth for real estate purchases. In various Asian economies, the authorities have successfully intervened to slow such credit growth with prudential regulations. In some economies in emerging Europe, by contrast, central banks have cut rates in response to diminishing price pressures and growing uncertainty in Western Europe (Hungary, Romania, and Russia).

Central banks had employed unconventional support measures during the crisis to help stabilize banks and markets. Some of these such as the provision of a large quantity of excess reserves to the banking system were designed to effect a general easing of credit when short-term interest rates were at the zero floor level. Others such as the purchase of nontraditional financial assets were designed to foster confidence and liquidity in specific markets that had broken down also called qualitative easing. Central banks have appropriately terminated many of their unconventional support programs, but there have also been reversals.

Quantitative easing or tightening?

- The Fed has rightly wound down most of its emergency facilities (for example, the Term Asset-Backed Securities Loan Facility expired June 30, 2010) and has also ended an asset purchase program. However, it recently decided to reinvest principal payments on its portfolio of government-sponsored-enterprise (GSE) debt and mortgage-backed securities into longer-term Treasury bills. Although the quantitative impact of this measure is limited, it signals the Fed's resolve to maintain supportive monetary conditions for an extended period.
- Renewed financial turmoil led the ECB to step into government bond markets through purchases of about €60 billion which helped lower volatility and have now been pared back in response to stabilizing conditions. The ECB has stopped its program of making limited purchases of covered bonds as well as its 12-month long-term refinancing operation. However, many banks remain highly dependent on ECB financing facilities, and moving away from fixed-rate, full-allotment operations and tightening collateral requirements would be risky. This underscores the need to make rapid progress with recapitalization at the national level.
- The Bank of Japan ended its limited commercial paper and corporate bond purchasing program and expanded a fund-supplying facility aimed at reducing term premiums. However, with the appreciation of the yen and declining equity prices, financial conditions have tightened and deflation remains a threat.
- The Bank of England halted its program of reserve-financed government bond purchases in February 2010. This was appropriate, given normalization in many parts of the financial sector, low long-term interest rates on

government paper, and continued above-target inflation (due to price-level shocks).

What needs to be done?

According to the IMF, policies need to become more proactive to achieve the required internal and external rebalance.

- Some of the adjustments that need to be made pertain to the need to strengthen household balance sheets, stabilize and subsequently reduce high public debt, and repair and reform their financial sectors.
- Monetary policy should stay highly supportive in most of the advanced economies and should be the first line of defense against any larger-than-projected weakening of activity as fiscal support diminishes. With policy rates already near zero in the large advanced economies, monetary policymakers may have to resort to further unconventional measures if private demand weakens unexpectedly as fiscal support wanes.
- Fiscal adjustment needs to start in 2011. If global growth threatens to slow appreciably more than expected, countries with fiscal room could postpone some of the planned consolidation. One of the most urgent challenges for advanced economies is to legislate plans that help achieve sustainable fiscal positions before the end of the decade.

This task is now more pressing than it was six months ago to rebuild room for fiscal policy maneuver in the face of still-volatile sovereign debt markets. Such room could be needed because monetary policy alone might not be able to provide sufficient support to counter the threat of a weakening of activity that is markedly more pronounced than expected.

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