

## World Grows Gradually: WEO April '14

Global growth picked up in the second half of 2013, averaging 3¼% from the 2½% recorded during the previous six months partly driven by increases in inventory. This brings overall growth in 2013 to 3% for the global economy with advanced economies growing by 1.3% and emerging markets by 4.7%. Advanced economies accounted for much of the pickup, whereas growth in emerging markets increased only modestly. The strengthening in activity was mirrored in global trade and industrial production. IMF suggests a slight moderation in global growth in the first half of 2014. Overall, global growth is projected to strengthen to 3.6% in 2014 and 3.9% in 2015.

**Table 1: GDP projections (%)**

| Country                                  | 2012 | 2013 | 2014 | 2015 |
|--|------|------|------|------|
| <b>World</b>                             | 3.2  | 3.0  | 3.6  | 3.9  |
| <b>Advanced</b>                          | 1.4  | 1.3  | 2.2  | 2.3  |
| <b>USA</b>                               | 2.8  | 1.9  | 2.8  | 3.0  |
| <b>Euro</b>                              | -0.7 | -0.5 | 1.2  | 1.5  |
| <b>UK</b>                                | 0.3  | 1.8  | 2.9  | 2.5  |
| <b>Germany</b>                           | 0.9  | 0.5  | 1.7  | 1.6  |
| <b>France</b>                            | 0.0  | 0.3  | 1.0  | 1.5  |
| <b>Italy</b>                             | -2.4 | -1.9 | 0.6  | 1.1  |
| <b>Japan</b>                             | 1.4  | 1.5  | 1.4  | 1.0  |
| <b>Canada</b>                            | 1.7  | 2.0  | 2.3  | 2.4  |
| <b>Emerging and developing countries</b> | 5.0  | 4.7  | 4.9  | 5.3  |
| <b>China</b>                             | 7.7  | 7.7  | 7.5  | 7.3  |
| <b>India*</b>                            | 4.7  | 4.4  | 5.4  | 6.4  |
| <b>ASEAN</b>                             | 6.2  | 5.2  | 4.9  | 5.4  |
| <b>S Africa</b>                          | 2.5  | 1.9  | 2.3  | 2.7  |
| <b>Russia</b>                            | 3.4  | 1.3  | 1.3  | 2.3  |
| <b>Brazil</b>                            | 1.0  | 2.3  | 1.8  | 2.7  |
| <b>Mexico</b>                            | 3.9  | 1.1  | 3.0  | 3.5  |

\*: for fiscal years at market prices. At factor cost the numbers would be 4.6%, 5.4% and 6.4% for 2013,2014 and 2015 respectively

### ***Developments across the economic powers***

A major impulse to global growth came from USA where the economy grew at 3¼% in the second half of 2013. Some of this was due to strong export growth and temporary increases in inventory demand. This was also backed up by accommodative monetary conditions as well as the real estate sector, higher household wealth and easier bank lending conditions.

Growth in the euro area is projected to reach only 1.2% in 2014 and 1½% in 2015. This would be a turnaround from negative growth in 2012 and 2013. In Germany, supportive monetary conditions, robust labour market conditions, and improved confidence have resulted in a pickup in domestic demand which has gone along with a tentative revival in investment and housing. This has been supported by a sharp reduction in the pace of fiscal tightening from about 1% of GDP in 2013 to ¼%. However, growth in demand is expected to remain sluggish, given continued financial fragmentation, tight credit and a high corporate debt burden. Past credit supply shocks in some economies have not yet fully reversed and are still weighing on credit and growth.

In Japan, growth is expected in private investment and exports, given increased partner country growth and the substantial yen depreciation. Nevertheless, activity overall is projected to slow moderately in response to a tightening fiscal policy stance in 2014–15. The tightening is the result of a two-step increase in the consumption tax rate- to 8% from 5% in the second quarter of 2014 and then to 10% in the fourth quarter of 2015—and to the unwinding of reconstruction spending and the first stimulus package of the Abenomics program.

### ***The emerging markets scenario***

In emerging markets and developing economies, growth picked up slightly in the second half of 2013 but was weaker than that in advanced economies reflecting two factors:

- Exports increased on account of stronger activity in advanced economies and currency depreciation while fiscal policies are projected to be broadly neutral.
- Continued weakness in investment as external funding and domestic financial conditions tightened. Supply-side and other structural constraints on investment and potential output are issues in some economies.

Overall, however, emerging market and developing economies continue to contribute more than two-thirds of global growth, and their growth is projected to increase from 4.7% in 2013 to 4.9% in 2014 and 5.3% in 2015.

- The forecast for China is that growth will remain broadly unchanged at about 7.5% in 2014–15 which is a marginal decline from 2012–13. This projection is predicated on the assumption that the authorities gradually rein in rapid credit growth and make progress in implementing their reform blue-print so as to put the economy on a more balanced and sustainable growth path.
- For India, real GDP growth is projected to strengthen to 5.4% in 2014 and 6.4% in 2015, assuming that government efforts to revive investment growth succeed and export growth strengthens after the recent rupee depreciation
- Elsewhere in emerging and developing Asia, growth is expected to remain at 5.3% in 2014 because of tighter domestic and external financial conditions before rising to 5.7% in 2015, helped by stronger external demand and weaker currencies.

Only a modest acceleration in activity is expected for regional growth in Latin America, with growth rising from 2.5% in 2014 to 3% in 2015. Some economies have recently faced strong market pressures and tighter financial conditions.

- In Mexico, growth is expected to strengthen to 3% in 2014, resulting from a more expansionary macroeconomic policy stance, a reversal of the special factors behind low growth in 2013, and spill overs

from higher U.S. growth. It is expected to increase to 3.5% in 2015, as the effect of major structural reforms takes hold.

- Activity in Brazil remains subdued. Demand is supported by the recent depreciation of the real and still-buoyant wage and consumption growth, but private investment continues to be weak, partly reflecting low business confidence.
- Near-term prospects in Argentina and Venezuela have deteriorated further. Both economies continue to grapple with difficult external funding conditions and the negative impact on output from pervasive exchange and administrative controls.

### ***Global inflation: Where is it heading?***

Inflation is in general projected to remain subdued in 2015 owing to a negative output gap in developing economies even as output remains almost close to its potential in emerging and developing economies.

- In USA and Eurozone, all inflation measures declined in FY13 and in particular remained close to zero in certain Eurozone countries. Moreover, in the Eurozone, the ECB is now increasingly concerned about the region entering a deflationary path in the absence of aggressive monetary action and intervention by the ECB. Going ahead, inflation is expected to rise gradually in these countries owing to strengthening recovery and a gradual decline in the output gap.
- In Japan on the other hand, inflation rose marginally as a result of the slightly stronger growth and depreciation of the Yen. The same should increase further in FY15 in light of the increased consumption tax introduced by the Government to reach the underlying 2% inflation target.
- In the emerging and developing economies, headline inflation is expected to slide down from 6% to 5.55 in FY15 under the premise that output remains above a certain threshold and that unemployment marks a fall in some of the emerging market countries.

### ***Monetary policy actions***

Monetary conditions have remained broadly supportive in advanced economies, but more so in the United States than in the euro area or Japan. Policy rates remain close to the zero lower bound, but they are expected to increase in 2015, especially in the United States, where household net worth and house prices have recovered. Household debt has broadly stabilized in the euro area relative to disposable income, and it has declined markedly in the United States. Credit to the non financial private sector in the euro area has continued to decline, reflecting tight lending standards and weak demand.

In emerging market economies, there has been a tightening of monetary and financial conditions since May 2013. This was due to the spill over from

- rising bond rates and better prospects in advanced economies,
- markets' reassessment of medium-term growth prospects, and,
- greater investor concerns about vulnerabilities.

Rates on longer-term local currency bonds in emerging market economies have risen more than those in advanced economies, as emerging market risk is re-priced when advanced economy rates increase. Equity prices

have moved sideways in local currency, whereas in U.S. dollar terms have declined substantially as a result of widespread currency depreciation. Still, the pass-through from higher local currency bond yields to lending rates has often been limited, credit growth has remained relatively high, and the depreciation of nominal exchange rates against the U.S. dollar and other major currencies has provided some offset.

### ***What has been the impact of the tapering effect?***

Despite some retrenchment in capital inflows since the Federal Reserve's surprise tapering-related announcement in May 2013, developments to date do not portend a sustained reversal of capital flows. In fact, capital inflows recovered moderately in the latter part of 2013 from the lows reached in summer 2013. However, they are estimated to have remained below pre-tapering levels.

The WEO baseline projections assume that capital inflows to emerging market economies will remain lower in 2014 than they were in 2013, before recovering modestly in 2015. The projections also assume that the additional re-pricing of bonds and equities in some emerging market economies since October 2013 was largely a one-off increase in risk premiums on EM's assets. Much of the recent yield increases and asset price declines will thus be lasting. This constitutes a broad-based tightening in financial conditions, which is expected to dampen domestic demand growth in 2014-15.

### ***What has happened in EMs?***

Financial conditions in emerging market economies have tightened recently in response to a more difficult external financial environment.

- Monetary conditions have tightened in many emerging market economies,
- Bank credit growth has started to slow in many economies, but remains at double-digit rates in some, exceeding GDP growth by substantial margins.
- Bond rates and spreads have increased while equity markets have moved sideways.
- Gross capital inflows have declined and exchange rates have depreciated.
- Cost of capital in emerging market economies has increased, which will dampen investment and growth, although increased exports to advanced economies are expected to provide compensation
- The pace of reserve accumulation in emerging market and developing economies slowed in 2013, reflecting lower capital inflows and reserve losses from foreign exchange intervention.

### ***Advanced economy risks***

- Risks to activity from low inflation. With current inflation lower than expected in many advanced economies, there is a risk, albeit a declining one, of treading into deflation in the event of adverse shocks to activity.
- Reduced appetite for completing national and euro-area-wide reforms as a result of improved growth prospects and reduced market pressures.
- Risks related to the normalization of monetary policy in the United States.
- Upside risks to global growth from advanced economies includes stronger-than-expected growth outcomes in the second half of 2013 in advanced economies raise this possibility.

**Emerging market economy risks**

- Risks of further growth disappointments in emerging market economies as fiscal conditions have tightened in response to difficult external financial environment. Further, bond rates and spreads have inched up and equity markets can move either ways going ahead subject to capital inflows in the countries. Overall, the risks may be offset slightly by the increase in exports to advanced economies expected in FY15.
- Comparatively lower growth in China. The country also faces certain large scale asset quality problem which ought to be corrected by timely intervention. Fixed capital formation will be the key for growth if it is to pick up. However, the risks associated with asset quality related balance sheet continue to loom large over the financial sector.
- Geopolitical risks related to Ukraine and its spill over in emerging eastern European countries. Oil prices are also likely to be influenced by the Ukraine crisis which will factor into the inflation estimations of emerging countries.

**What should be done?**

- In the euro area, the monetary policy rate is close to zero, and the IMF suggests that more monetary easing, including use of unconventional measures, is still required.
- The Bank of Japan should continue with its aggressive quantitative easing policy and further strengthen its communication strategy, especially in view of the challenge of assessing underlying inflation following the consumption tax increase.
- Progress has been made in repairing bank balance sheets. However, banks have continued to deleverage which will mean that credit to the private sector would contract.
- A banking union in the euro area is critical to reduce financial fragmentation and weaken sovereign-bank links.

**View on India**

India's growth is expected to recover from 4.4% in 2013 to 5.4% in 2014, supported by slightly stronger global growth, improving export competitiveness juxtaposed with the recently depreciating rupee and implementation of recently approved investment projects.

- A pickup in exports in recent months and measures to curb gold imports has contributed to lowering the current account deficit.
- Policy measures to bolster capital flows have further helped reduce external vulnerabilities.
- Overall growth is expected to firm up on policies supporting investment and a confidence boost from recent policy actions.
- Further tightening of the monetary stance might be needed for a durable reduction in inflation and inflation expectations.
- Continued fiscal consolidation will be essential to lower macroeconomic imbalances.
- Policymakers must also concentrate on structural reforms to support investment, which has slowed markedly and focus also on clearing out supply bottlenecks.
  - o Priorities include market-based pricing of natural resources to boost investment, addressing delays in the implementation of infrastructure projects, improving policy frameworks in the

power and mining sectors, reforming the extensive network of subsidies, and securing passage of the new goods and services tax to underpin medium-term fiscal consolidation.

- Consumer price inflation is expected to remain an important challenge, but should continue to move onto a downward trajectory.

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