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May 17, 2010

To: Members of the Executive Board

From: The Secretary

Subject: **Group of Twenty—Note by the Staff of the International Monetary Fund**

Attached for the **information** of Executive Directors is a brief update on the Global Conjuncture and Risks, prepared for the Group of Twenty (G-20) ahead of the meeting of Deputies in Berlin, Germany on May 19, 2010.

Questions on the note may be referred to Mr. Srinivasan (ext. 34589) and Mr. Scott (ext. 38169) in RES.

This paper will be published on the Fund's external website following the Deputies meeting.

This document will shortly be posted on the secure page of the extranet, a website for Executive Directors and member country authorities.

Att: (1)

*Cover note amended to correct typographical error in first sentence.

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G R O U P of T W E N T Y

Meeting of G-20 Deputies
May 19, 2010
Berlin, Germany

Global Conjuncture and Risks: An Update

Prepared by Staff of the International Monetary Fund

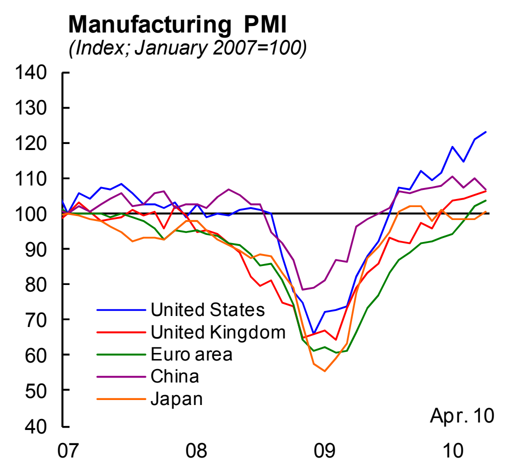
I N T E R N A T I O N A L M O N E T A R Y F U N D

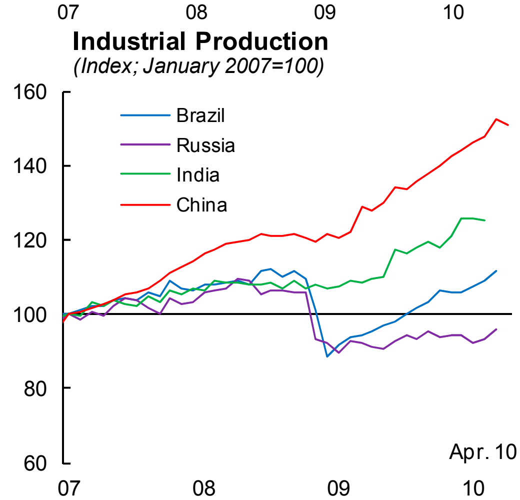
THE GLOBAL CONJUNCTURE AND RISKS: AN UPDATE[1]

Downside risks from financial sector turbulence and banking sector weaknesses have grown appreciably, following increasing concern over fiscal and external sustainability in certain European economies. Policymakers have provided substantial emergency funding, allowing some time to deploy comprehensive measures to rein in fiscal and external imbalances within the euro area. More generally, the turmoil of recent days demonstrates that governments in all economies with large public debt or deficits should take immediate steps to develop and communicate coherent strategies for long-term fiscal consolidation. Notwithstanding the turmoil in financial markets, developments in the United States, Japan, and the largest euro area economies have been consistent with expectations of a modest but steady recovery. In particular, there have been encouraging signs of growth in private demand. Activity in emerging Asia and Latin America has been expanding strongly, driven by a rebound in trade.

I. RECENT DEVELOPMENTS AND IMPLICATIONS FOR THE OUTLOOK

1. **Recent macroeconomic data have been consistent with expectations of a modest but steady recovery in most advanced economies.** In the United States, GDP, production, employment, and confidence survey data have pointed to some stabilization in the labor market and growing momentum in private demand. In Japan, a modest recovery is underway, although deflationary pressures may act as a drag. Data have been mixed for advanced European economies. There is some evidence for constraints on bank lending, which is particularly important for European economies. Nonetheless, growth is positive overall, with production, output and survey data indicating strong growth in Germany and, to a lesser extent, France, which together account for nearly half of euro area output.





Source: Haver Analytics.

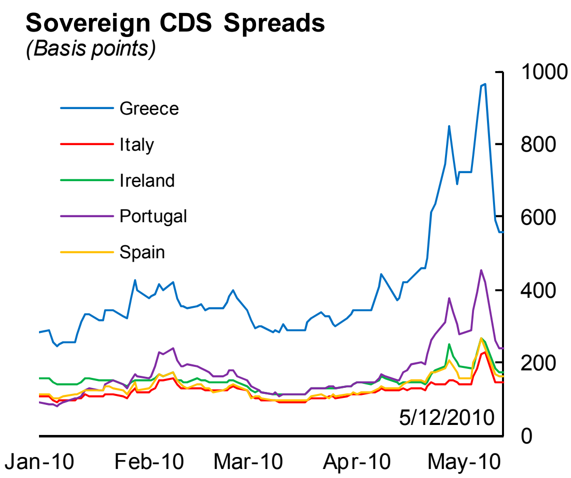
2. **Recent data for emerging and developing economies have been consistent with strong growth overall, particularly in emerging Asia.** Production has broadly recovered in Latin America and grown steadily in Asia. In particular, Asian trade has rebounded strongly following the precipitous decline in 2009, and is now at or above levels seen at the beginning of 2007. There are

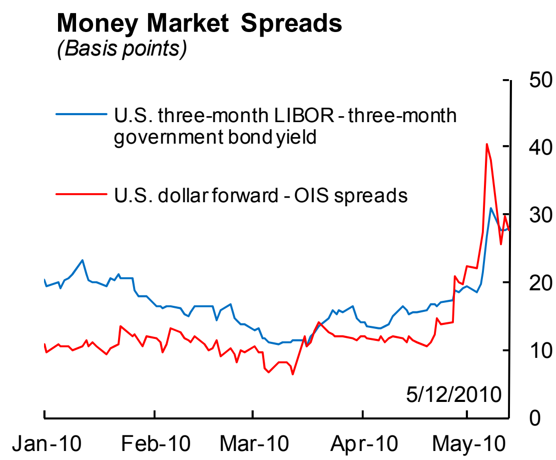
[1] This Note is an update to the Surveillance Note circulated for the meeting of G-20 Finance Ministers on April 23, 2010.

signs of recovery in Emerging Europe, CIS and Russia, albeit with considerable diversity.

3. **Following a period of turmoil, led by market concerns about fiscal sustainability in some European economies, indicators of financial market strains have partly receded and volatility remains elevated.**

- Steadily escalating concerns over fiscal positions and competitiveness in Greece and other European states came to the fore with a sharp rise in risk aversion during the period of 6-7 May. Euro funding spreads increased sharply, effectively shutting some banks in some European economies out of interbank markets. Cross-currency swap bases widened to levels last seen in early 2009, as dollar funding became scarce. Bond and CDS spreads for a number of European economies widened rapidly and euro-denominated assets were sold off. Other credit classes, including emerging markets, also experienced substantial sell-offs.





- In response, on May 9, the EU announced a bold package of measures (the European Stabilization Mechanism) aimed at alleviating market and financial sector strains and curbing contagion. The package included a special purpose fund of up to €440bn from euro area members, a European Commission facility of up to €60bn, ECB purchases of euro government securities in the secondary market, a change in refinance operations to allow for full allotment of bids, and reactivation of dollar swap lines between central banks.

- The Fund has provided Greece a three-year €30 billion Stand-By Arrangement in support of the authorities' economic adjustment and transformation program, and as part of a cooperative package of financing with the European Union amounting to €110 bn. The package is a multi-year program involving fiscal adjustment. Fiscal consolidation—on top of adjustment already under way—will total 11 percent of

GDP over three years, with the adjustment designed to get the general government deficit under 3 percent of GDP by 2014 (compared with 13.6 percent in 2009).

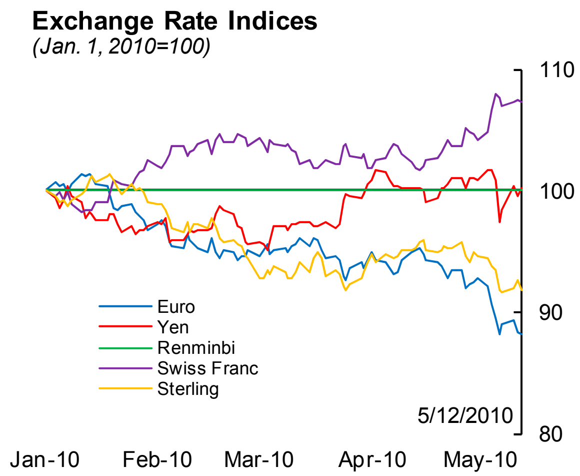
- The Spanish authorities have announced new fiscal measures to reduce the deficit by an additional 0.5 percent of GDP in 2010 and 1% of GDP in 2011, to 9.3 percent and 6 percent of GDP, respectively. Portugal has also presented an additional package of expenditure cuts and tax increases aimed at reducing the deficit to 7 percent of GDP in 2010 and 4.6 percent of GDP in 2011. Most recently, the European Commission has put forward various proposals to strengthen the Stability and Growth Pact and expand surveillance to include developments in competitiveness and macroeconomic imbalances.

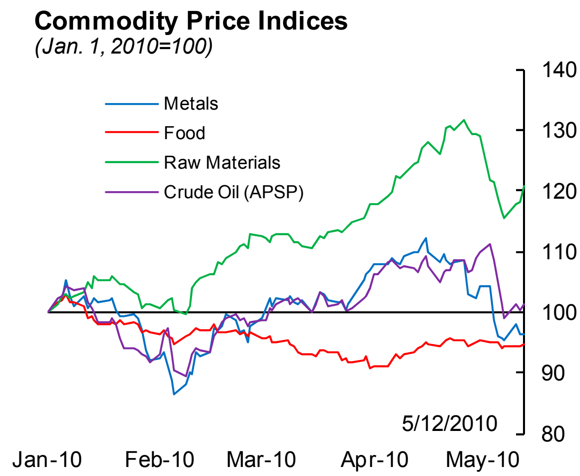
- While it is too early to assess the full impact of the EU/ECB package and budgetary measures announced by European authorities, the initial response of financial markets has been positive. Bond and CDS spreads have fallen from recent highs on 6 May, as European central banks commenced purchases of sovereign bonds in secondary markets. But funding strains continue in some interbank, cross-currency, and money markets, and the situation remains fragile.

4. **Commodity prices and exchange rates have also reflected risk aversion and concerns over demand.**

- The financial market turmoil included a sharp depreciation of the euro against the dollar. Even following the announcement of the stabilization package, the currency has fallen 14 percent from the beginning of the year to 14 May. Sterling has also depreciated, by 10 percent over the same period.

- After substantial rises this year, prices of most metals, raw materials and crude oil fell substantially, owing, in part, to increased risk aversion and its potential impact on global demand.





5. **Recent developments are broadly consistent with the outlook in the April 2010 *World Economic Outlook*.** Recent financial turmoil indicates the speed with which market sentiment can shift. Nonetheless, at the time of writing, macroeconomic developments subsequent to the release of the April *WEO* indicate that the global projections remain appropriate, with recent pressures on southern European economies balanced by generally favorable data releases for other regions, especially Asian and Latin American emerging economies.[2]

[2] The next *World Economic Outlook* update will be released in July.

Table 1. Overview of World Economic Outlook Projections 1/
(Percent change)

	Year over Year			
	2008	Est. 2009	2010	2011
World output	**3.0**	**-0.6**	**4.2**	**4.3**
Advanced economies	0.5	-3.2	2.3	2.4
Euro area	0.6	-4.1	1.0	1.5
Emerging and developing economies	6.1	2.4	6.3	6.5
G-20 2/	2.9	-0.5	4.6	4.5
Argentina	6.8	0.9	3.5	3.0
Australia	2.4	1.3	3.0	3.5
Brazil	5.1	-0.2	5.5	4.1
Canada	0.4	-2.6	3.1	3.2
China	9.6	8.7	10.0	9.9
France	0.3	-2.2	1.5	1.8
Germany	1.2	-5.0	1.2	1.7
India	7.3	5.7	8.8	8.4
Indonesia	6.0	4.5	6.0	6.2
Italy	-1.3	-5.0	0.8	1.2
Japan	-1.2	-5.2	1.9	2.0
Korea	2.3	0.2	4.5	5.0
Mexico	1.5	-6.5	4.2	4.5
Russia	5.6	-7.9	4.0	3.3
Saudi Arabia	4.3	0.1	3.7	4.0
South Africa	3.7	-1.8	2.6	3.6
Turkey	0.7	-4.7	5.2	3.4
United Kingdom	0.5	-4.9	1.3	2.5
United States	0.4	-2.4	3.1	2.6
European Union	0.9	-4.1	1.0	1.8

1/ IMF, World Economic Outlook, April 2010 published.
2/ G-20 yearly projections exclude European Union.

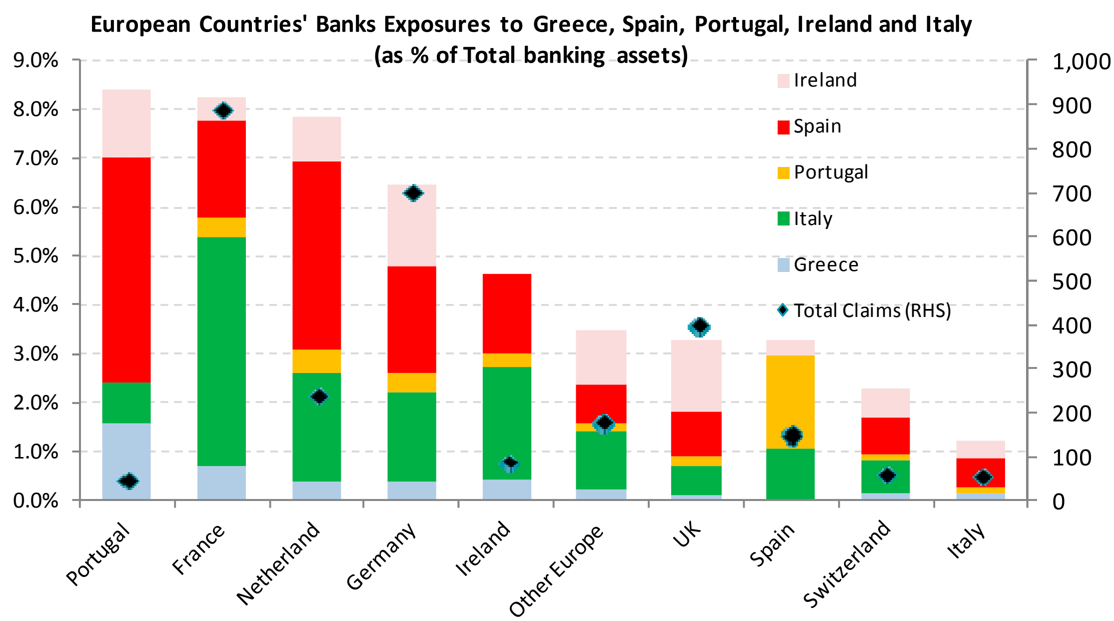
II. RISKS

6. **Immediate risks of a repeat of recent turmoil have fallen, following the extraordinary policy measures announced by the EU/ECB and additional measures adopted by euro area countries, but the situation remains fragile.** Markets will be looking for the implementation of the announced funding package, including approval by national parliaments, and for sustained efforts to improve fiscal balances. If not achieved, then the credibility of the EU/ECB package could be put into question again, potentially triggering renewed turmoil in bond markets and contagion to European banks and other sovereign debt markets. In this downside risk scenario, the main mechanisms for contagion would likely be through the banking system, via:

- *Losses to banks holding euro area public debt.* BIS international banking data show that the most exposed banking systems are France, Portugal, the Netherlands, and Germany.

- *Reductions in interbank credit exposures*. Counterparty credit exposures to Greek banks stand at $34 billion at end 2009. Exposures to Spanish and Portuguese banks are larger still, at $339 billion and $56 billion, respectively. French and German banks are estimated to have the largest exposures, but banks in the Netherlands, U.K. and the U.S. also have large claims.

- *Increases in bank funding costs, owing to higher risk premia*. Funding pressures have increased with recent downgrades in sovereign debt ratings, particularly of Greece.



Sources: BIS, EBF, IMF Staff Calculations

Even with some relief from the EU/ECB package, it bears noting that gross sovereign funding needs for the remainder of 2010 through 2012 are large, and will require increased market confidence. Failed auctions or placement difficulties in bond markets could reignite contagion or have adverse implications for funding costs of other countries.

7. **Left unchecked, such financial market disruption could threaten credit supply, cross-border capital flows and the nascent recovery in aggregate demand.** Shocks to European banks would further constrain credit supply and tighten lending conditions, which have only recently shown signs of relaxing. Banks experiencing losses from southern European exposures may attempt to compensate by withdrawing capital from emerging economies, particular those in emerging Europe and Latin America—two Spanish banks represent a significant share of assets in a number of Latin American banking systems, approaching 40 percent in Mexico and Uruguay, and about 25 percent in Chile and Peru,

while Greek and Italian banks are prominent in some Central and Eastern European countries. Conversely, there is a danger that subsidiaries of European banks—such as those of Spanish banks in Latin America—could attempt to "ring fence" assets. It should also be noted that financial sector risks are not confined to European banks—the recent turmoil has demonstrated the susceptibility of banks worldwide to runs on funding. More generally, increases in uncertainty and risk aversion are likely to be damaging for cross border capital flows, especially to emerging economies.

8. **Earlier and large fiscal consolidation than anticipated by the private sector and markets in some European economies could damage confidence.** This risk demonstrates the need for clear communication of medium term fiscal plans and credibility—if longer-term sustainability is viewed with skepticism, despite short-term fiscal consolidation, the immediate effects on demand are likely to be more negative than if the private sector believes that the consolidation will be maintained and able to deliver its long-term benefits.

9. **Adverse developments in the euro area also risk undermining global trade**. A reduction in European output would be significant: the euro area GDP represents approximately 20 percent of world GDP (PPP weighted).

- In terms of trade linkages, the euro area is most important for geographically proximate economies such as the U.K., Norway, Sweden and emerging Europe. Asian economies are highly dependent on external demand—for many Asian economies**,** Europe is at least as important a trading partner as the United States. Moreover, Asian exports are concentrated in cyclical medium- and high-tech goods, so the impact on trade and real GDP growth in Asia of a euro area crisis could potentially be as disruptive as the impact of the U.S. subprime crisis. For Latin America, trade importance is less, but as mentioned above financial links with Europe are relatively stronger; with the exception of Chile, exports to the euro area are less than 5 percent of GDP.

- Commodity incomes of emerging economies could fall in anticipation of lower world growth. In this case, Europe's importance for commodity exporters in Asia and, especially, Latin America is very important. Although depreciation of the euro may help fiscal sustainability in the euro area, a weak Euro could also hurt exports in third markets of those economies that peg to the dollar, especially for exports of high-end consumer and capital goods. There could also be direct effects on world oil prices and, hence, the incomes of oil exporters.

III. Policy Challenges

10. **Attention is now firmly on measures to achieve fiscal sustainability.** The provision of substantial support in the euro area was timely and appropriate, and has mitigated the immediate risk of a liquidity crisis. But these measures should be thought of as having given

a window of opportunity in which to solve underlying problems of sustainability and competitiveness. The new measures adopted by Spain and Portugal, in addition to those by Ireland, are important contributions to this goal. Nonetheless, there is still an urgent need for fiscal reform in the euro area, including deficit rules that have credible enforcement mechanisms.

11. **Heightened awareness of fiscal risks in European economies underlines the need for the immediate communication of credible and coherent fiscal consolidation plans in other countries facing fiscal challenges.**

- Given market pressures, some economies in the euro area will have to tighten fiscal policies more aggressively than expected. That said, the key to assuring markets will be to announce credible medium- and long-term fiscal consolidation, rather than immediately withdrawing stimulus.

- In most advanced G-20 economies, where slack is substantial and the speed of recovery is expected to be moderate, the fiscal stimulus planned for 2010 should be implemented fully. Tightening could begin in 2011, when the recovery is expected to become self sustaining.

- The challenge is to consolidate fiscal positions while also encouraging growth. Reforms to entitlements are essential and could be structured so as to avoid weakening current demand, such as by announcing plans to gradually increase the retirement age and reform health care systems. Revenue policies need to be reformed to maximize efficiency, including by shifting to taxes that encourage saving and investment and greater labor participation.

- Improved public debt management is also desirable, such as lengthening the maturity of public debt, to reduce near-term funding pressures.

12. **Structural reforms are needed to raise the trend level of growth and improve competitiveness in these countries.** Fiscal sustainability in countries such as Greece and Portugal is not only threatened by recent rises in funding costs, but also by low growth prospects and poor competitiveness. Hence, in addition to restoring budget balances to sustainable levels, structural adjustments will be needed, particularly in product and labor markets.

13. **The recent increase in financial stress underscores the urgent need for financial sector reforms and measures to restore the health of banking systems.** Although this has been an outstanding issue since 2008, material changes have been limited. More progress is needed on bank recapitalization; bank consolidation, resolution, and restructuring; and regulatory reform. Larger capital buffers are required to absorb the ongoing and expected

future deterioration in credit quality and to meet expected higher capital standards.[3] Bank funding remains a concern, given upcoming debt rollovers. Credible plans and timetables for implementing regulatory reforms need to be developed and announced, to reduce regulatory uncertainty and to provide for phased implementation as conditions improve. More effective cross-border resolution mechanisms are required, especially in Europe, given the highly-interconnected nature of the banking system there. Such measures would strengthen confidence in the resilience of banking systems to financial shocks.

[3] Measures should also be taken to mitigate risks to the European Central Bank's balance sheet.