Legacies, Clouds and Uncertainties Weigh on IMF's Projections

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By Olivier Blanchard

The recovery continues, but it is weak and uneven.

You have now seen the basic numbers from our latest projections in the October 2014 *World Economic Outlook* (http://www.imf.org/external/pubs/ft/weo/2014/02/index.htm) released today. We forecast world growth to be 3.3% in 2014, down 0.1% from our July forecast, and 3.8% in 2015, down 0.2% from our July forecast.

This number hides however very different evolutions. Some countries have recovered or nearly recovered. But others are still struggling.

Looking around the world, economies are subject to two main forces. One from the past: Countries have to deal with the legacies of the financial crisis, ranging from debt overhangs to high unemployment. One from the future, or more accurately, the anticipated future: Potential growth rates are being revised down, and these worse prospects are in turn affecting confidence, demand, and growth today.

Because these two forces play in different countries to different degrees, economic evolutions are becoming more differentiated. With this in mind, let me take you on the usual quick tour of the world:

Growth prospects vary in advanced economies

Among advanced countries, the United States (http://www.imf.org/external/pubs/ft/survey/so/2014/new072314a.htm) and the United Kingdom (http://www.imf.org/external/pubs/ft/survey/so/2014/car072814a.htm) in particular are leaving the financial crisis behind and achieving decent growth. Even for them however, potential growth is lower than it was in the early 2000s.

Japan (http://www.imf.org/external/pubs/ft/survey/so/2014/car073114a.htm) is growing, but high public debt inherited from the past, together with very low potential growth going forward, raise major macroeconomic and fiscal challenges.

Growth in the euro area (http://www.imf.org/external/pubs/ft/survey/so/2014/car071414a.htm) nearly stalled earlier this year, even in the core. While this reflects in part temporary factors, both legacies, primarily in the south, and low potential growth, nearly everywhere, are playing a role in slowing down the recovery.

Emerging markets are adjusting to slower growth

In emerging market (http://www.imf.org/external/pubs/ft/survey/so/2014/pol061214a.htm) economies, lower potential growth is the dominating factor. For emerging market economies as a whole, potential growth is now forecast to be 1.5% lower than it was in 2011. But, there again, differentiation is the rule:

China (http://www.imf.org/external/pubs/ft/survey/so/2014/CAR073014A.htm) is maintaining high growth, despite the end of a housing and a credit boom. Looking forward, rebalancing is likely to imply slightly lower growth, but this must be seen as a healthy development.

India (http://www.imf.org/external/pubs/ft/survey/so/2014/car022014a.htm) has recovered from its relative slump, and, thanks in part to policy and a renewal of confidence, growth is expected to exceed 5% again.

By contrast, uncertain investment prospects in Russia had already led to low growth before the Ukraine crisis, and the crisis has made it worse. Uncertain prospects and low investment, are also weighing on Brazil.

Finally, low income developing countries continue to do remarkably well, and this despite a slowdown in commodity prices. We forecast their growth rate to b 6.1% in 2014, 6.5 in 2015.

Downside risks are clearly present (https://imfdirect.files.wordpress.com/2014/10/weo_tbl_102014_500.jpg)

The long period of low interest rates has led to some search for yield, and financial markets may be too complacent about the future. One should not overplay these risks, but, clearly, policy makers should be on the lookout. Macro prudential tools are the right instruments, but one has to worry that they may not be up to the task.

Geopolitical risks have become more relevant. So far, there is little evidence that Ukraine crisis has had measurable effects beyond the affected countries and their immediate neighbors. Nor has turmoil in the Middle East affected either the level or the volatility of energy prices very much. But, clearly, the risk that they do so in the future is there, and could affect the world economy in a major way.

The third risk is a stalling of the recovery in the euro area, the risk that demand weakens further, and that low inflation turns into deflation. This is not our baseline, as we believe fundamentals are slowly improving, but, were it to happen, it would clearly be the major issue confronting the world economy.

Latest IMF projections

The global recovery remains fragile and uneven.
(percent change)

			Projections		Difference from July 2014 WEO update	
	2012	2013	2014	2015	2014	2015
World Ouput	3.4	3.3	3.3	3.8	-0.1	-0.2
Advanced Economies	1.2	1.4	1.8	2.3	0.0	-0.1
United States	2.3	2.2	2.2	3.1	0.5	0.0
Euro Area	-0.7	-0.4	0.8	1.3	-0.3	-0.2
Germany	0.9	0.5	1.4	1.5	-0.5	-0.2
France	0.3	0.3	0.4	1.0	-0.4	-0.5
Italy	-2.4	-1.9	-0.2	0.8	-0.5	-0.3
Spain	-1.6	-1.2	1.3	1.7	0.1	0.1
Japan	1.5	1.5	0.9	0.8	-0.7	-0.2
United Kingdom	0.3	1.7	3.2	2.7	0.0	0.0
Canada	1.7	2.0	2.3	2.4	0.1	0.1
Other Advanced Economies[1]	2.0	2.3	2.9	3.1	0.0	-0.1
Emerging Market and Developing Economies	5.1	4.7	4.4	5.0	-0.1	-0.2
Commonwealth of Independent States	3.4	2.2	0.8	1.6	-0.1	-0.5
Russia	3.4	1.3	0.2	0.5	0.0	-0.5
Excluding Russia	3.6	4.2	2.0	4.0	-0.4	-0.4
Emerging and Developing Asia	6.7	6.6	6.5	6.6	0.1	0.0
China	7.7	7.7	7.4	7.1	0.0	0.0
India[2]	4.7	5.0	5.6	6.4	0.2	0.0
ASEAN-5[3]	6.2	5.2	4.7	5.4	0.1	-0.2
Emerging and Developing Europe	1.4	2.8	2.7	2.9	0.0	0.0
Latin America and the Caribbean	2.9	2.7	1.3	2.2	-0.7	-0.4
Brazil	1.0	2.5	0.3	1.4	-1.0	-0.6
Mexico	4.0	1.1	2.4	3.5	0.0	0.1
Middle East, North Africa, Afghanistan, and Pakistan	4.8	2.5	2.7	3.9	-0.4	-0.9
Sub-Saharan Africa	4.4	5.1	5.1	5.8	-0.4	0.0
South Africa	2.5	1.9	1.4	2.3	-0.3	-0.4

Source: IMF, *World Economic Outlook*, October 2014.
[1]Excludes the G7 (Canada, France, Germany, Italy, Japan, United Kingdom, United States) and euro area countries.
[2]For India, data and forecasts are presented on a fiscal year basis and output growth is based on GDP at market prices.
[3]Indonesia, Malaysia, Philippines, Thailand, and Vietnam.

(https://imfdirect.files.wordpress.com/2014/10/weo_tbl_102014_500.jpg)

And this takes me to policy implications

In advanced economies, policies must both deal with the legacies of the crisis and address low potential growth. With respect to legacies, while a major focus has been on improving bank balance sheets, debt overhang of firms and households remains an issue in a number of countries. So long as demand remains weak, monetary accommodation and low interest rates remain of the essence.

The weak recovery in the euro area has triggered a new debate about the stance of fiscal policy. The low spreads on sovereign bonds suggest that the fiscal consolidation of the past few years has led financial investors to believe that current fiscal paths are sustainable. This credibility, which was acquired at a high price, should not be threatened. This does not mean however that there is no scope for fiscal policy to sustain the recovery. As we argue in one of the analytical chapters, infrastructure investment (http://www.imf.org/external/pubs/ft/survey/so/2014/RES093014A.htm), even if debt financed, may well be justified and can help demand in the short run and supply in the medium run. And, were the risk of stalling to materialize, being ready to do more is also important.

Finally, one obviously wishes that potential growth were higher. This would not only be good for itself, but it would also make fiscal and financial challenges much less daunting. Increasing potential output, let alone potential growth, is however a tall order, and expectations should remain realistic. Yet, in most countries, specific structural reforms can help. The challenge, for both advanced and emerging market countries, is to go beyond the general mantra of "structural reforms," to identify which reforms are most needed, which reforms are politically feasible.

Perhaps more generally, the challenge for policy makers is to reestablish confidence, through a clear plan to deal with both the legacies of the crisis and the challenge of low potential growth.

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