

World Economic Outlook and Financial Stability Report: IMF

The IMF in its recently released World Economic Outlook states on a cautious note the global prospects have improved again, but that recovery in advanced countries would remain bumpy. Economic activity in advanced countries is seen to have stabilised and emerging and developing economies have picked-up, with continued support from policy measures renewing confidence.

World economic growth is now pegged at 3.25% in 2013, moving up to 4.0% in 2014. In particular -

- **Advanced economies by 1.2% and 2.2% in 2013 and 2014**
- **Emerging Market and Developing economies by 5.3% and 5.7% for the same periods**

While two major impending threats (disintegration of Euro-zone and sharp fiscal contraction in the US) have been averted with timely policy intervention, new threats to smooth global recovery continue to emerge; these would include –

- Short-term risks - uncertainty from fallout of Cyprus and political developments in Italy
- Medium-term risks - adjustment fatigue, insufficient institutional reform and prolonged stagnation in the euro area as well as debt and deficits concerns in the US and Japan.

Main Observations

- Manufacturing and Trade cycles have begun to re-accelerate (particularly, for emerging market economies). Euro-zone countries lag behind the global upturn. Caution comes from the fact that investments had stalled in the contractionary phase and this rebound may be driven by inventory-reduction.
- Strong positive political decisions in advanced countries have driven equity markets up. Resumption of capital inflows has helped diminish risk spreads for emerging market economies.
- Despite uptick in credit-growth and easing of lending conditions in the US, monetary policy rates are expected to remain low for the next three years. Financial market conditions are expected to improve as global growth gains traction.
- Fiscal withdrawal in advanced economies is pegged at around 1% of GDP for different advanced countries (Japan at 1.5%, US at 1.75% and Euro zone at 0.75%).
- Global inflationary pressures have moderated and would be under control at around 3.25% in 2014, despite increased economic activity, on account of stabilizing commodity prices
- Current account balances have been adversely impacted by slowdown in trade. Spill-overs from the trade channel will diminish and imbalances would continue to narrow. Currencies have responded appropriately to changing macro-economic policies and falling risk aversion.
- Gross and net capital flows have declined relative to pre-crisis levels, suggesting that vulnerabilities to net external positions have not eased substantially.

Solutions to mitigate risks

- The US and Japan need to devise and implement stronger and more credible medium-term fiscal consolidation plans.
- The Euro area needs to strengthen the Economic and Monetary Union (EMU).
- Emerging market and developing economies need to tighten policies, starting with monetary policy and prudential measures to tackle excesses in financial sector, followed by a return to fiscal balance.

Old Risks, New Challenges

The Global Financial Stability Report was released by the IMF simultaneously - it too vouched for improved financial stability with reduced tail risks in the monetary and financial space. This has caused risk appetite to increase and asset prices to rally. ***The report sounds of a warning signal by stating that if medium-term challenges are not addressed the rally in financial markets could turn unsustainable with resurgence in risks morphing into a chronic financial crisis phase.***

- While renewed monetary stimulus and continued liquidity support have enthused confidence, further improvement in financial sector requires both balance sheet repair and smooth unwinding in public and private debt overhangs. Also prolonged accommodative monetary stance could push portfolio rebalancing and risk appetite to adverse mode
- The process of de-risking and deleveraging in the banking sector remains incomplete. The pace and uniformity in banking sector reforms agenda across countries is crucial. Particularly, banks in emerging market economies face the challenge of supporting growth whilst safeguarding against rising domestic vulnerabilities.

Take on India

Growth in India, by the IMF has been pegged at 5.75% in 2013 (and 6.2% in 2014); this would be backed by implementation of pro-growth measures and improvement in external demand conditions. Significant structural changes however, are likely to lower potential growth lower in the medium-term with price pressures at comparatively higher levels when compared with the rest of the region.

In the financial space, India like other emerging market economies has registered an upturn in delinquency rates for certain loans. ***Going forward, rapid credit growth in a slower economy is expected to put pressure on credit quality. Accordingly, the risk of under-estimating true asset quality problems is pertinent risk in India*** (as also in China).

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