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Professional Risk Opinion

IMF's view on World Economy: Salient features

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(The report is based on 3 IMF publications: World Economic Outlook, Global Financial Stability Report and Fiscal Monitor)

The IMF in its recent World Economic Outlook has highlighted the following views.

- Global economic recovery is continuing, even as the pandemic resurges. However, the fault lines opened by COVID-19 are looking more persistent and near-term divergences are expected to leave lasting imprints on medium-term performance. Vaccine access and early policy support are going to be the principal drivers of the gaps.
- Policy choices have become more difficult as challenges are several like subdued employment growth, rising inflation, food insecurity, setback to human capital accumulation, and climate change giving limited room to manoeuvre.

Growth outlook

The global economy is projected to grow 5.9% in 2021 and 4.9% in 2022 The downward revision for 2021 reflects a downgrade for advanced economies partly due to supply disruptions and worsening pandemic dynamics for low-income developing countries.

This is partially offset by stronger near-term prospects among some commodity-exporting emerging markets. Employment is generally expected to continue lagging the recovery in output. This is something that we in India should keep in mind as even before the pandemic job creation has been a challenge. Overall, the balance of risks for growth is tilted to the downside. The major source of concern is that more aggressive SARS-CoV-2 variants could emerge before widespread vaccination is reached.

Growth projections for 2021 and 2022

Country	2020	2021	2022
World Output	-3.1	5.9	4.9
Advanced Economies	-4.5	5.2	4.5
United States	-3.4	6.0	5.2
Euro Area	-6.3	5.0	4.3
Germany	-4.6	3.1	4.6
France	-8.0	6.3	3.9
Italy	-8.9	5.8	4.2
Spain	-10.8	5.7	6.4
Japan	-4.6	2.4	3.2
United Kingdom	-9.8	6.8	5.0
Canada	-5.3	5.7	4.9
Emerging Market and Developing Economies	-2.1	6.4	5.1
China	2.3	8.0	5.6
India	-7.3	9.5	8.5
ASEAN-5	-3.4	2.9	5.8
Russia	-3.0	4.7	2.9
Brazil	-4.1	5.2	1.5
Mexico	-8.3	6.2	4.0
Saudi Arabia	-4.1	2.8	4.8
Nigeria	-1.8	2.6	2.7
South Africa	-6.4	5.0	2.2

Source: IMF

As can be seen in the table the base effect of negative growth rate in 2020 has resulted in higher growth in 2021 across the spectrum of countries though the impact varies. The 2022 forecasts are probably more real with world growth expected at 4.9% with less of the base effect. However, the base effect would work in the reverse direction and tend to be lower across most nations. Only those which witnessed a moderate recovery in 2021 would have higher growth rates in 2022.

Prospects for advanced economies
Growth prospects for 2021 have been revised down largely reflecting downgrades to the following factors.

- United States due to large inventory drawdowns in the second quarter partly reflecting supply disruptions and softening consumption in the third quarter. The US outlook subsequently incorporates the infrastructure bill recently passed by the Senate and anticipated legislation to strengthen the social safety net, equivalent to about $4 trillion in spending over the next 10 years.
- Germany partly due to shortages of key inputs weighing on manufacturing output.
- Japan reflecting the effect of the fourth State of Emergency from July to September as infections hit a record level in the current wave.

Prospects for developing economies
The forecast for the group is marked up slightly due to upgrades across most regions.

- China's prospects for 2021 are marked down slightly due to stronger-than-anticipated scaling back of public investment.
- Outside of China and India, emerging and developing Asia is downgraded slightly as the pandemic has picked up.

Inflation concerns
Inflation risks are skewed to the upside and could materialize if pandemic-induced supply-demand mismatches continue longer than expected leading to more sustained price pressures and rising inflation expectations that prompt a faster than-anticipated monetary normalization in advanced economies.

Higher inflation would be driven by:
- Pandemic-induced supply-demand mismatches. The sharp contraction in demand in 2020 led many businesses to slash orders of intermediate inputs. As the recovery picked up steam in 2021, some producers found themselves flatfooted and unable to ramp up sufficient supply again quickly. For example, microchip production relative to demand remains hampered. World distribution of shipping containers became highly distorted during the pandemic, leaving many stranded off their usual routes.
- Rising commodity prices. Oil prices are expected to increase in 2021, close to 60% above their low base for 2020. Non-oil commodity prices are expected to rise almost 30% above their 2020 levels, reflecting particularly strong increases in the price of metals and food over recent months. Food price rises have unfortunately tended to concentrate in places where food insecurity is high, putting poorer households under greater stress and raising the possibility of greater social unrest
- Policy-related developments such as the expiration of last year's temporary value-added tax cut in Germany and the increase in the shelter component of US consumer prices as rent and mortgage moratoriums expire in some jurisdictions.
- Exchange rate depreciations have contributed to higher import goods prices in some countries.
- Temporary disruptions such as the closure of the Suez Canal, restrictions in ports in China's Pearl River Delta following COVID-19 outbreaks, and congestion in the ports of Los Angeles and Long Beach exacerbated delays in delivery times.
- Analysis of the Baltic Dry Index—an index of expenditures related to international shipping—suggests that the bulk of its rise over the past few months has been due to supply factors.

For 2021 inflation forecasts vary across zones. For India it has been placed at 5.6% and 1.1% for China. ASEAN-5 is to have inflation of 2%. Advanced Europe is to be modest at 2.1% with Euro and UK being 2.2%. Emerging Europe would be higher at 8.4%. USA is to be at 4.3% and Canada 3.2%. Latin America would have the highest inflation at 11.5%. Middle east and central Asia would be at 11.7%. Sub-Saha Africa would have inflation of 10.7%. Hence most of the low-income countries would be afflicted with high inflation.

Fiscal policy
The imperatives will depend on the stage of the pandemic. Health care-related spending remains the priority. As the pandemic persists and fiscal space is limited in some countries, lifelines and transfers will need to become increasingly targeted to the worst affected and provide retraining and support for reallocation.

In most advanced countries fiscal policy continues to be accommodative and is shifting towards strengthening economies through a green transition, digital transformation, and other longer-term investments. The large fiscal packages announced or approved by the European Union and the United States could add a cumulative $4.6 trillion to global GDP between 2021 and 2026. Additional measures (including in Europe) are expected with the forthcoming national budgets for 2022.

By contrast, in emerging markets and low-income developing countries, growth is held back by the low availability of vaccines, and governments are shifting expenditures toward addressing pandemic-related priorities. Higher interest rates and lower government revenues have strained the capacity of low-income developing countries to provide fiscal

support and service their debt. As fiscal stance is less supportive than in advanced economies, output and tax revenues are not projected to regain their precrisis trajectory and the reduction in deficits will occur largely through lower spending.

Overall fiscal policy remains supportive, with 2021 deficits falling by about 2% of GDP in 2021 on an average. However, deficits are still well above pre-pandemic levels, especially in advanced economies. Deficits are projected to decrease further by almost 3 % in 2022 and return to their pre-pandemic levels by 2026.

Monetary policy and financial markets

Although central banks can generally look through transitory inflation pressures and avoid tightening until there is more clarity on underlying price dynamics, they should be prepared to act quickly if the recovery strengthens faster than expected or risks of rising inflation expectations become tangible. In settings where inflation is rising amid still-subdued employment rates and risks of expectations de-anchoring are becoming concrete, monetary policy may need to be tightened to get ahead of price pressures, even if that delays the employment recovery. The alternative of waiting for stronger employment outcomes runs the risk that inflation increases in a self-fulfilling way, undermining the credibility of the policy framework and creating more uncertainty.

Financial conditions have eased further in advanced economies, buoyed by expectations of continued accommodative monetary policy and rising risk asset valuations. By contrast, financial conditions have changed little, on balance, in emerging markets, as monetary policy tightening in response to inflation pressure in some countries has offset gains in risk asset prices.

While financial conditions have eased further in advanced economies the sense of optimism that had propelled markets in the first half of the year faded somewhat over the summer. Investors have become increasingly concerned about the economic outlook amid rising virus infections and greater uncertainty about the strength of the recovery, particularly in emerging markets. In late September, concerns that inflationary pressures may be more persistent than initially anticipated have pushed nominal yields higher.

Corporate balance sheets have strengthened overall. A feared substantial pickup in bankruptcies has not materialized mainly due to targeted fiscal support and unprecedented monetary policy support. Revenues have risen, with profitability surpassing pre-pandemic levels in several economies. Credit quality in speculative-grade bond markets has continued to strengthen, with default rates expected to remain low.

While investors still expect recent price pressures to moderate and then gradually subside, concerns about inflation risks have intensified recently in financial markets. In addition to the recent rise in energy and commodity prices, investors have highlighted the possibility that supply chain disruptions and shortages of labor and materials may be more persistent than currently anticipated feeding into wage dynamics and inflation expectations. Asset valuations appear to be stretched in some market segments. Despite recent market turbulence, equity prices have risen further boosted by accommodative monetary policy and strong earnings. *However, equity price misalignments (relative to fundamentals-based values) have remained elevated in most markets. Credit spreads have narrowed to below pre-pandemic levels. House prices have risen rapidly in many countries, reflecting, among other factors, the improved outlook, policy support, and shifting household preferences.*

Emerging markets continue to face large financing needs. Local currency government bond yields have increased in many countries on the back of domestic factors (higher inflation and fiscal concerns). The late-September increase in the US Treasury yields may exert additional pressure going forward, leading to higher funding costs for many countries.

Inflation pressure has led many central banks to adopt a tighter monetary policy stance. *The outlook for capital flows has improved, boosted by the ongoing recovery and robust global risk appetite. Monetary conditions are still broadly accommodative, with deeply negative real rates. But there is a risk that real rates may rise significantly in coming years. A sudden change in the monetary policy stance of advanced economies may result in a sharp tightening of financial conditions, adversely affecting capital flows and exacerbating pressures in countries facing debt sustainability concerns*.

Contact:

Economics Department	-		
Mradul Mishra	Media Relations	mradul.mishra@careratings.com	+91-22-6837 4424

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CARE Ratings Limited
Corporate Office: 4th Floor, Godrej Coliseum, Somaiya Hospital Road, Off Eastern Express Highway, Sion (East), Mumbai - 400 022
Tel. : +91-22-6754 3456 I CIN: L67190MH1993PLC071691

Connect :