GROUP OF TWENTY

GLOBAL PROSPECTS AND POLICY CHALLENGES

G-20 Finance Ministers and Central Bank Governors Meeting
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Prepared by Staff of the

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*Does not necessarily reflect the views of the IMF Executive Board.

EXECUTIVE SUMMARY

While global growth will receive a boost from the decline in oil prices, the outlook has been revised down. The oil price decline, which reflects to an important extent higher supply, mainly a rise in production in the United States and OPEC's decision to maintain current production, will boost global growth by lifting private demand. However, this boost is projected to be more than offset by negative factors, including the drag in investment associated with diminishing medium term growth prospects. Accordingly, global growth in 2015–16 is revised down by a ¼ percentage point to 3.5 and 3.7 percent, respectively.

Market volatility has increased and there have been adjustments in credit and currency markets. Currencies have depreciated and spreads have risen in many emerging markets, notably but not only in commodity exporters. Spreads on high-yield bonds and products exposed to energy prices have widened, but long-term government bond yields have declined in advanced and emerging economies.

Risks are more balanced than in October. Upside risks arise from the demand boost due to lower oil prices, but uncertainty about their future path, which depends on the drivers of the price decline, has also increased. Downside risks linked to financial market sentiment—given prospects for U.S. monetary normalization—are compounded by potential external and balance sheet vulnerabilities in oil exporters. Stagnation and low inflation remain a concern in the euro area and Japan and geopolitical risks continue to be high.

Strong policy action is needed to raise growth and mitigate risks:

- *Advanced economies* should maintain supportive policies. In most advanced economies substantial output gaps and below-target inflation suggest that the boost to demand from lower oil prices is welcome, and that the *monetary* stance should remain accommodative. Where risks of further decline in inflation expectations are present—notably the euro area and Japan—continued monetary accommodation is needed, and the recent ECB announcement of an asset purchase program is welcome. *Fiscal* policy should be growth friendly, including by moderating the pace of consolidation and enhancing *infrastructure investment* in countries with identified needs, large output gaps, and relatively efficient investment processes.

- In many *emerging economies*, policy space to support growth remains limited. In some, lower oil prices will alleviate inflationary pressures, allowing for a more gradual tightening of monetary policy. *Oil exporters* that have accumulated savings and have fiscal space can let fiscal deficits increase and allow a more gradual adjustment of public spending. For others with less policy space, exchange rate flexibility will be a critical buffer to the shock. Some will have to strengthen their policy frameworks to avert persistently higher inflation and adapt to a protracted deterioration in terms of trade. Similar to advanced economies, and with the same caveats, infrastructure investment is needed to ease supply bottlenecks in some emerging economies.

- Lower oil prices offer an opportunity to *reform energy subsidies and taxes* in both oil exporters and importers. The removal of general energy subsidies should be used toward more targeted transfers and to lower budget deficits where relevant.

- There is an urgent need for *structural reforms* to raise potential output across the G-20 members. *Labor market reforms* in advanced economies undergoing population aging should aim at raising labor participation, and actions to increase labor demand and remove impediments to employment are also needed in euro area economies and some emerging markets. Reforms to improve the functioning *of product markets* are also needed in Japan and the euro area, and reforms to improve productivity and raise potential output are key in many emerging economies. A new momentum is needed in the global trade dialogue.

Prepared by a team from the IMF's research Department, led by Emil Stavrev, Esteban Vesperoni, and Sweta Saxena, and including Eric Bang, Ava Yeabin Hong, and Gabi Ionescu.

DEVELOPMENTS, OUTLOOK, AND RISKS

Global growth will receive a boost from lower oil prices, which reflect to an important extent higher supply. However, this boost is projected to be more than offset by negative factors, including the drag in investment associated with diminishing medium term growth prospects. Accordingly, global growth in 2015–16 is revised down by a ¼ percentage point to 3.5 and 3.7 percent, respectively. Risks are more balanced than in October. Upside risks arise from lower oil prices, but the decline has also added uncertainty associated with the future path of oil prices. On the downside, risks linked to financial market sentiment are compounded by potential external and balance sheet vulnerabilities in oil exporters. Stagnation and low inflation in the euro area and Japan remain a concern, and geopolitical risks continue to be high.

1. **While global growth increased broadly as expected in the third quarter of 2014, there were marked growth divergences among major economies**. With the exception of the United States, economic performance in all other major economies fell short of expectations, with lackluster investment—due to a protracted adjustment to diminished expectations about medium-term growth—as the main factor behind this weakness. Specifically:

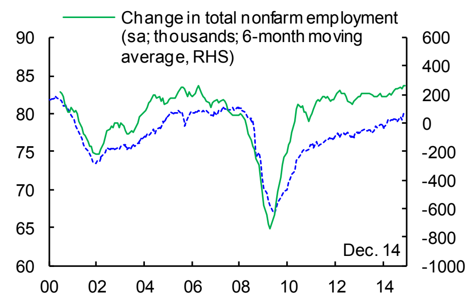
- The recovery in the *United States* was stronger than expected, following the contraction in the first quarter of 2014. It was driven by consumption amid steady recovery in labor markets and consumer confidence, and investment, especially non-residential, on the back of high levels of capacity utilization.

- In *Japan*, the economy fell into technical recession in the third quarter of 2014. The consumption tax increase in the previous quarter had weighted on private domestic demand more than anticipated, despite a cushion from increased infrastructure spending.

- In the *euro area*, growth in the third quarter of 2014 was modestly weaker than expected, largely on account of weak investment. The data releases for December and January show deflation for the area as a whole—the first negative reading since 2009. Inflation expectations declined further, below the ECB's 2 percent medium-term price stability objective—raising risks of a protracted period of low inflation.

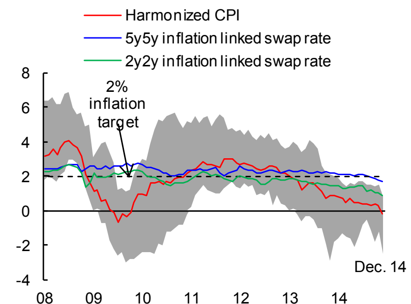
- In *China*, growth slowed to 7.3 percent in the fourth quarter, bringing 2014 growth to 7.4 percent, broadly in line with the government's target.

U.S.: Capacity Utilization and Employment
(percent)



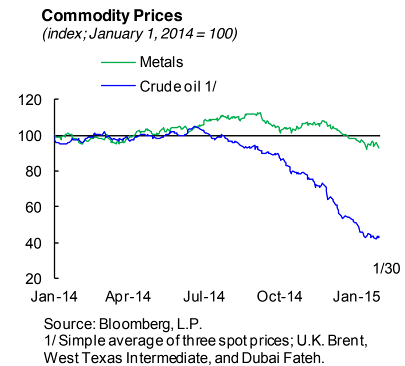
Source: Haver Analytics.

Euro Area: Inflation
(percent change from a year earlier)



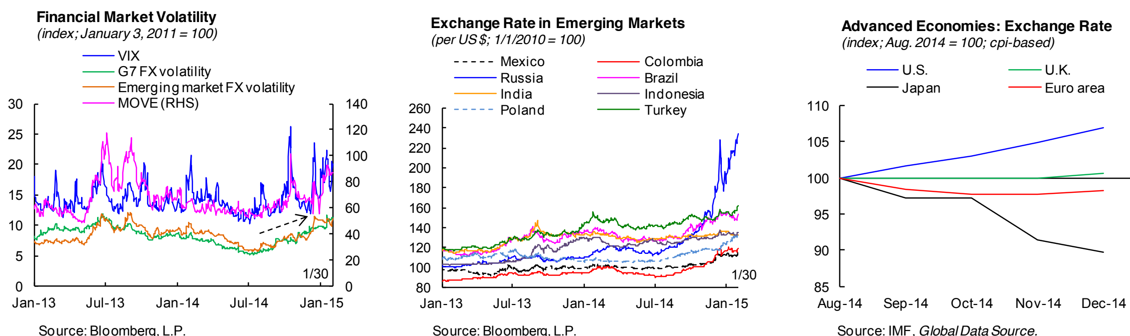
Sources: Bloomberg, L.P.; and Haver Analytics.

2. **In a major development, oil prices have declined by about 55 percent since September**.[1] The decline is partly due to unexpected demand weakness in some major economies, in particular emerging economies—also reflected in declines in metal prices. But the much larger decline in oil prices suggests an important contribution of oil supply factors, including the decision of the Organization of the Petroleum Exporting Countries (OPEC) to maintain current production levels despite the steady rise in production from non-OPEC producers, especially the United States. Oil futures contracts point to a partial recovery in oil prices in coming years, consistent with the expected negative impact of lower prices on investment and future capacity growth in the oil sector.



Source: Bloomberg, L.P.
1/ Simple average of three spot prices; U.K. Brent, West Texas Intermediate, and Dubai Fateh.

3. **Market volatility has increased and there have been adjustments in credit and currency markets**. Risk-off behavior in emerging economies led to currency depreciations not only for oil exporters but also for some importers, and volatility has increased, though from low levels. In the context of a downward shift in inflation expectations and bolder actions in terms of monetary policy—notably, further easing by the euro area's and Japan's central banks—long-term government bond yields have declined, but spreads have increased for high yield issuers—especially in the oil and gas sectors—as well as for some emerging economy sovereigns led by big oil exporters (e.g., Russia, Venezuela and Ecuador). Equity prices in the energy sector have fallen since mid-2014. Amid foreign debt loads built by corporations in emerging economies over the last years, currency depreciations, output price declines, and the increase in spreads may raise concerns over their capacity to meet debt payments (Box 1).



4. **With more marked growth divergence across major economies, the U.S. dollar has appreciated**. In real effective terms, the dollar has appreciated by about 9 percent relative to the October WEO (as of the third week of January). In contrast, the euro and the yen have depreciated by about 6 and 7 percent, respectively, and many emerging market currencies have weakened, particularly those of commodity exporters.

[1] For an analysis about the impact of the sharp decline of oil prices on the global economy, see the Special Topic to the G-20 Surveillance Note, "Impact of Oil Price Decline on the Global Economy."

Box 1. Financial Developments in the Context of the Oil Shock

Financial market volatility has increased—although from low levels compared to historical averages—and there have been adjustments in credit and currency markets. Recent developments in financial markets can be summarized as follows:

Tightening financial conditions in corporate bond markets and emerging economy sovereign bonds. A significant number of U.S. high yield bond issuers are energy companies, which also account for a significant share in the global corporate bond index. Spreads in the U.S. high yield market have risen by 65 basis points since early-December, and the corporate emerging markets bond index (CEMBI) has increased by about 165 basis points over the last six months, pushed by oil and gas companies. This takes place amid weak balance sheets—i.e., interest coverage ratios below 2—in many energy sector companies in emerging economies. Also, over the last six months, the global EMBI spread has widened from 281 to 402 basis points, pushed to a large extent—but not only—by higher spreads in oil exporting countries like Russia, Venezuela, and Ecuador, which likely reflects in part the fact that many large EM oil corporates are state-owned.

Currency depreciation. The currencies of several oil producers in emerging economies have depreciated sharply since end-June and there was an increase in volatility in bond, equity and currency markets. Risk-off behavior in several emerging economies led to currency depreciations even for some oil importers. This may create balance sheet tensions in some emerging economies, especially in the context of substantial foreign debt loads build by corporations over the last years.

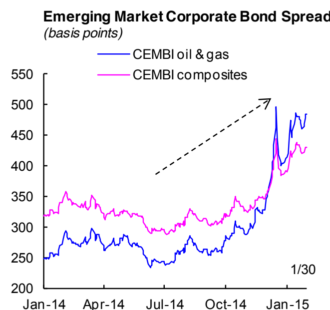
Pressure on corporate earnings. Prospects for lower earnings have already been reflected in equity prices for companies in the oil and gas sectors, which fell by 24 percent over the last six months. Accordingly, a significant decline in corporate earnings in energy sector companies is likely to take place.

The above developments may have further implications:

Banking sector. The exposure of some global banks to oil and gas companies is substantial—between 2 to 8 percent of total assets for some banks—and an increase in non-performing loans would have an impact on the balance sheet of those banks.

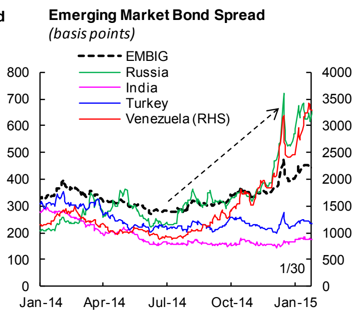
Capital flows. As earnings from oil corporations in emerging market exporters decline, equity inflows are likely to fall. Mutual fund flows to emerging markets have fallen during the last six months.

Emerging Market Corporate Bond Spread
(basis points)



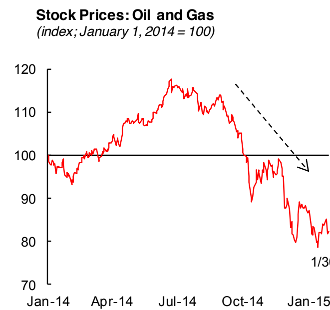
Source: Bloomberg, L.P.

Emerging Market Bond Spread
(basis points)



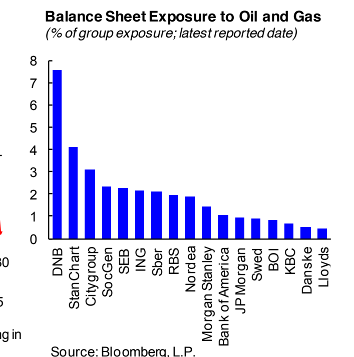
Source: Bloomberg, L.P.

Stock Prices: Oil and Gas
(index; January 1, 2014 = 100)



Source: Bloomberg, L.P.
Note: Average of 40 oil and gas companies quoting in the U.S. stock exchange.

Balance Sheet Exposure to Oil and Gas
(% of group exposure; latest reported date)



Source: Bloomberg, L.P.

5. **While the decline in oil prices will boost global growth, the positive impact will be more than offset by negative factors, notably sluggish investment**. The decline in oil prices—which is expected to reverse only gradually and partially—will support the global recovery by lifting private demand. The impact is expected to be stronger in advanced economy oil importers as the pass-through to end-user prices would be higher than in other importers—where part of the windfall gains from lower prices are expected to accrue to governments in the form of lower energy subsidies. However, the boost from lower oil prices is expected to be more than offset by other factors in most major economies other than the United States—mainly associated with weak investment as expectations about medium term growth are being reassessed. At 3.5 and 3.7 percent, respectively, global growth projections for 2015–16 have been marked down by a quarter percentage point relative to the October 2014 WEO (Table 1).

6. **In *advanced economies*, the strong rebound in the United States points to an increasingly divergent cyclical position vis-à-vis the euro area and Japan**.

- In the *United States*, prospects for demand over the near term are solid, underpinned by strong employment growth. There are no major wage inflation pressures, which should give the Federal Reserve room for maneuver in normalizing rates. Growth is projected to exceed 3 percent in 2015–16, with domestic demand supported by lower oil prices, more moderate fiscal adjustment, and continued support from monetary policy despite the projected gradual rise in interest rates. The recent dollar appreciation, though, is projected to reduce net exports.

- In the *euro area*, the economic outlook has deteriorated, and falling oil prices may put downward pressure on already declining inflation expectations. Activity will be supported by lower oil prices, further monetary policy easing (with the recent expansion of the asset purchase program going beyond what was anticipated in financial markets), a more neutral fiscal policy stance, and the recent euro depreciation. But these factors will be offset by sluggish investment, reflecting the impact of weaker growth in emerging market economies on the export sector, as well as crisis legacies and weaker expected growth. Prospects are also uneven across the euro area. Improving labor markets will support domestic demand in Germany, and the gradual recovery of demand in Spain is expected to continue. The recoveries in Italy and France will be more gradual.

- In *Japan*, policy responses—additional quantitative and qualitative monetary easing and the delay in the second consumption tax rate increase—are expected to support a gradual rebound in activity and, together with the oil price boost and yen depreciation, will strengthen growth to above trend by 2016. Japan is trying to strike a balance between supporting growth and maintaining fiscal sustainability through a commitment to proceed with the delayed 2015 consumption tax increase in April 2017 and achieve a zero primary balance by 2020.

7. **The outlook for *emerging economies* is now weaker than envisaged in October**. Revisions to the October 2014 WEO reflect lower growth in China, a much weaker outlook for Russia, and downward revisions to potential growth in Latin America and commodity exporters.

- In *China*, with investment growth falling—consistent with rebalancing—growth is expected to moderate further as greater weight is placed on reducing vulnerabilities from the recent rapid credit and investment growth. This slowdown will have regional consequences, reflected in downward revisions to growth in much of *emerging Asia*.

- In *India*, the growth forecast is broadly unchanged as weaker external demand is offset by the boost to the terms of trade from lower oil prices and a pickup in industrial and investment activity after policy reforms.

- In *Russia*, growth has been revised downward as a result of the economic impact of sharply lower oil prices and sanctions, both through direct and indirect effects. Russia's sharp slowdown and ruble depreciation have also severely weakened the regional outlook, in particular for other economies in the Commonwealth of Independent States (CIS).

- *Commodity exporters* face challenges ahead. The projected rebound in growth is now weaker as the impact of lower oil and other commodity prices on terms of trade and real incomes would take a heavier toll on medium-term growth. In particular, the growth forecast for Latin America has been reduced. Although some commodity exporters, notably Saudi Arabia, are expected to use fiscal buffers, the room for monetary or fiscal policy support in some other exporters is more limited (e.g., South Africa).

8. **Risks are more balanced compared to the October WEO**. The risks from shifts in sentiment in financial markets are being compounded by uncertainty about the oil price path, which depends on the underlying drivers of the price decline. Stagnation and low inflation in the euro area and Japan remain a concern, and geopolitical risks continue to be high.

- *The main upside risk to the global recovery is associated with lower oil prices.* Amid further declines in oil prices since early January, the boost to global demand from lower oil prices could be greater than it is currently factored into the projections, especially in advanced economies. But oil prices could also have overshot on the downside and could rebound earlier or more than expected if the supply response to lower prices is stronger than expected.

- *Downside risks associated with shifts in sentiment and volatility in global financial markets remain, and lower oil prices may have introduced new risks for emerging market economies.* In global financial markets, risks related to shifts in markets and bouts of volatility are still elevated, especially given the current compression in the term premium. Potential triggers could be surprises in activity in major economies or surprises in the path of monetary policy normalization in the United States in the context of a continued uneven global expansion. Emerging market economies are particularly exposed, as they could face a reversal in capital flows. With the sharp fall in oil prices, these risks have risen in oil exporters, where external and balance sheet vulnerabilities have increased, while oil importers have gained buffers from lower prices. The abandoning of the exchange rate floor by the Swiss National Bank may also increase pressure in markets with loan portfolios in Swiss francs, but global spillovers should be contained.

- *Geopolitical risks are expected to remain high,* although related risks of global oil market disruptions have been downgraded in view of ample net flow supply.

- *Risks to activity from low inflation and prospects of low potential growth over the medium term remain high*. Recent data releases showing deflation and medium term inflation expectations well below the ECB's price stability objective in the *euro area* suggest that, given the zero lower bound, adverse shocks—domestic or external—could still lead to persistently lower inflation or sustained deflation. In some advanced economies, there are still downside risks to prospective potential output, which would feed into weak prospects for near-term demand, hampering the recovery and increasing debt burdens. As for emerging economies, several years of slowing growth prospects continue to point to the risk that potential growth could disappoint further.

POLICIES: STRONG ACTION IS NEEDED TO RAISE ACTUAL AND POTENTIAL GROWTH AND MITIGATE RISKS

Advanced economies should maintain supportive policies, given still substantial output gaps and below-target inflation. Fiscal policy should be growth friendly, including by increasing infrastructure investment. In many emerging market economies, macroeconomic policy space to support growth remains limited, but lower oil prices will alleviate inflationary pressures, allowing for a more gradual tightening of monetary policy. For oil exporters, the need to adjust fiscal stance would depend on the scope of savings from past higher prices of oil and exchange rate regimes. For countries with less policy space, exchange rate flexibility will be a critical buffer to the shock. Lower oil prices offer an opportunity to reform energy subsidies and taxes in both oil exporters and importers. There is an urgent need for structural reforms to raise potential output in both advanced and emerging economies.

DESPITE LOWER OIL PRICES, ADVANCED ECONOMIES NEED TO KEEP SUPPORTIVE POLICIES

9. **While lower oil prices should boost domestic demand, accommodative monetary conditions remain essential in most advanced economies, given still sizable output gaps**. In most advanced economies, output gaps are still substantial, inflation is below target, and monetary policy remains constrained by the zero lower bound. The boost to demand from lower oil prices is thus welcome. Central banks should be mindful that further declines in inflation, even if temporary, may lead to additional downdraft in inflation expectations and rising real interest rates. This suggests that central banks should be particularly vigilant to signs of pass-through from oil prices to core inflation, which may require early action in economies with already low inflation. The unbalanced recovery across economies suggests that low inflation would pose challenges to central banks, although to a different degree.

- In the *United States*, lower oil prices contribute positively to the recovery and there is a strong case to abstract from the effects of temporary oil supply shocks unless they translate into second round effects in wage and price settings (e.g. a persistent decline in longer term inflation expectations). The Fed's employment and inflation objectives should guide policy

decisions and the beginning of normalization of the monetary policy stance, which is currently expected around mid-2015.

- In the *euro area*, given rising risks of a protracted period of low inflation amid further declines in inflation and inflation expectations, *the ECB's recent announcement of an asset purchase program (APP) is welcome*. The APP (monthly purchases of €60 billion for 19 months) will include private and public securities. Also, the interest rate on future TLTRO facilities was lowered.
- In *Japan,* the implementation of the Bank of Japan's (BoJ) October announcement of expanded Quantitative and Qualitative Monetary Easing (QQE) framework by accelerating purchases of JGBs (and extending their maturity) and tripling the purchases of private assets remains critical to support domestic demand. These monetary measures need to be supplemented by progress on 'third arrow' structural reforms.

10. **Fiscal policy should be growth friendly**. The pace and composition of fiscal consolidation should be designed to support both the recovery and long-term growth, including by enhancing infrastructure investment in economies with identified needs, output gaps, and relatively efficient investment processes (e.g., Germany, the United States). Where there is space, supportive fiscal stance can bring forward the growth benefits of structural reform by helping offset short-term adverse effects. In the euro area, flexibility within the fiscal governance framework should be used to support key structural reforms and public investment. Finally, credible medium-term consolidation plans remain needed in Japan and the United States.

11. **Macro-prudential tools should be the first line of defense against financial stability risks**. Following a long period of low rates, excessive risk-taking may have built in some sectors—credit booms in a number of smaller advanced economies and the underpricing of risks in certain segments of U.S. financial markets. Deploying macro-prudential tools to limit financial risks—which in some cases may require changes to regulatory and legal structures—can reduce the need for monetary policy response to financial stability concerns. It will also make systemic institutions more resilient, help contain pro-cyclical asset price and credit dynamics, and cushion the consequences of liquidity squeezes if volatility spikes. International cooperation is needed to achieve more orderly resolution across borders and consistent regulatory frameworks and supervision.

POLICY NEEDS ACROSS EMERGING ECONOMIES DIFFER

12. **In many emerging economies macroeconomic policy space to support growth remains limited**. Policy response will vary depending on whether countries are net oil importers or exporters—and for the latter, on buffers accumulated during periods of high commodity prices.

- *In some emerging economies, lower oil prices may alleviate inflationary pressures and reduce vulnerabilities*. This would allow for *monetary policy* to be tightened more gradually or by less than otherwise required. The scope to do so will require credible macroeconomic policies and frameworks, which has proven essential in coping with volatile financial conditions in the past.

Nonetheless, some economies (e.g., Turkey) that rely heavily on private external financing will need to proactively further adjust policies. Some economies (Brazil, India, South Africa, Turkey) need to maintain the course of *fiscal* consolidation, given large fiscal deficits and high inflation in some cases, and high external borrowing that has increased exposure to external funding risks in others.

- *For oil exporters, the optimal policy response to the sharp decline in prices will depend on the buffers accumulated during the years of high oil revenue and exchange rate regimes*. Many exporters for which oil receipts typically contribute to a sizable share of fiscal revenues are experiencing large shocks in proportion to their economies. In some economies that have accumulated substantial savings from past higher prices and have fiscal space can let fiscal deficits increase temporarily and draw on these funds to allow for a more gradual adjustment of public spending (e.g., Saudi Arabia). In economies where adjustment is unavoidable, allowing exchange rate depreciation will be a critical buffer to cushion the impact of the shock (e.g., Russia), which highlights the challenges faced by oil exporters with fixed exchange rate regimes (e.g., Venezuela, Ecuador). Some will have to strengthen their monetary frameworks to avert the possibility that depreciation will lead to persistently higher inflation and further depreciation, and to adapt to the prospects of a protracted deterioration in terms of trade. Efforts to increase revenue mobilization and improve expenditure prioritization should continue.
- Similar to advanced economies, and with the same caveats, *infrastructure investment* is needed to ease supply bottlenecks in some emerging economies (e.g., Brazil, India, South Africa).

13. **Lower oil prices offer an opportunity to reform energy subsidies and taxes in both oil exporters and importers**. In some countries—either exporters or importers—lower oil prices offer an opportunity to reform energy subsidies and taxes. Through the deregulation of diesel prices and the raising of energy excises duties, India and Indonesia have taken initial steps for the elimination of these subsidies. The removal of general energy subsidies should be used toward more targeted transfers and to lower budget deficits where relevant.

POLICIES FOR STRONGER AND MORE BALANCED GROWTH CONTINUE TO BE CRITICAL

14. **There is an urgent need for structural reforms to achieve the G-20 objective of raising collective output by 2 percent above the October 2013 WEO baseline**. Weaker projected global growth for 2015–16 further underscores that increasing actual and potential output should be a policy priority in most economies, as discussed in previous surveillance notes; fresh momentum needs to be injected in global trade dialogue (Annex 1). Specifically:

- Structural reforms to improve the functioning *of product markets* are needed in Japan, euro area countries, and emerging economies. Reforms to enhance productivity, remove infrastructure bottlenecks in the energy sector (India, South Africa), improve education, enhance labor and product markets (Brazil, China, India, South Africa), and ease limits on trade and investment and improve business conditions (Brazil, Indonesia, Russia) could boost productivity and support growth prospects.

- *Labor market reforms* in advanced economies undergoing population aging (e.g., Japan, Korea, and the United States), to raise labor force participation, including of women and/or older workers. Actions to increase labor demand and remove impediments to employment, including reducing duality in labor markets where relevant, are key where a large fraction of the population remains unemployed (euro area economies, South Africa).

- *Given the deterioration in the inflation and economic outlook and risks of stagnation, the need for a comprehensive strategy to boost growth is particularly relevant in the euro area and Japan*. The recent additional monetary easing is welcome, and further progress is needed in addressing structural weaknesses and improving the quality of fiscal adjustment. Sustaining the recovery will require structural reforms to raise potential growth along with demand support.

15. **Global current account imbalances have narrowed in 2013–14, but they remain somewhat larger than desirable and policy action is needed to reduce them**. Systemic risk associated with global imbalances has decreased. Nonetheless, in many countries external and internal rebalancing are essential to sustainable growth. Policy actions vary across the G-20 economies, but include medium-term fiscal consolidation, limiting financial excesses, and structural reforms to facilitate adjustment in deficit economies. In some surplus economies, policies that support stronger domestic demand would help, including moving toward more market-based exchange rates, and reducing capital account restrictions. Overall, joint policy actions on both sides of excess imbalances would benefit growth and reduce financial risks.

Table 1. Real GDP Growth

(Percent change)

	Year over Year							
			Est.	Projections (from Jan. 2015)		Deviations (from Oct. 2014)		
	2012	2013	2014	2015	2016	2014	2015	2016
World 1/	**3.4**	**3.3**	**3.3**	**3.5**	**3.7**	**0.0**	**-0.3**	**-0.3**
Advanced economies	1.2	1.3	1.8	2.4	2.4	0.0	0.1	0.0
Euro area	-0.7	-0.5	0.8	1.2	1.4	0.0	-0.2	-0.3
Emerging market and developing countries 2/	5.1	4.7	4.4	4.3	4.7	0.0	-0.6	-0.5
Advanced G-20	1.6	1.6	1.8	2.5	2.5	0.0	0.1	0.0
Emerging G-20	5.4	5.3	5.0	4.6	4.8	0.0	-0.6	-0.6
G-20 3/	3.5	3.5	3.4	3.6	3.7	0.0	-0.3	-0.3
Argentina 4/	0.8	2.9	-0.4	-1.3	0.0	1.3	0.2	0.0
Australia	3.6	2.1	2.7	2.7	2.9	-0.2	-0.2	-0.2
Brazil	1.0	2.5	0.1	0.3	1.5	-0.2	-1.1	-0.7
Canada	1.9	2.0	2.4	2.3	2.1	0.2	-0.1	-0.3
China	7.8	7.8	7.4	6.8	6.3	0.0	-0.3	-0.5
France	0.3	0.3	0.4	0.9	1.3	0.0	-0.1	-0.2
Germany	0.6	0.2	1.5	1.3	1.5	0.1	-0.2	-0.3
India 5/	4.7	5.0	5.8	6.3	6.5	0.1	-0.1	0.0
Indonesia	6.3	5.8	5.1	5.2	5.5	-0.1	-0.3	-0.3
Italy	-2.3	-1.9	-0.4	0.4	0.8	-0.3	-0.5	-0.5
Japan	1.8	1.6	0.1	0.6	0.8	-0.8	-0.2	-0.1
Korea	2.3	3.0	3.5	3.7	3.9	-0.3	-0.3	-0.1
Mexico	4.0	1.4	2.1	3.2	3.5	-0.3	-0.3	-0.3
Russia	3.4	1.3	0.6	-3.0	-1.0	0.3	-3.5	-2.5
Saudi Arabia 6/	5.4	2.7	3.6	2.8	2.7	-1.0	-1.6	-1.7
South Africa	2.2	2.2	1.4	2.1	2.5	0.0	-0.2	-0.3
Spain 7/	-2.1	-1.2	1.4	2.0	1.8	0.1	0.3	0.0
Turkey	2.1	4.1	3.0	3.4	3.4	0.0	0.4	-0.3
United Kingdom	0.7	1.7	2.6	2.7	2.4	-0.6	0.0	-0.1
United States	2.3	2.2	2.4	3.6	3.3	0.3	0.5	0.3
European Union	-0.3	0.1	1.3	1.6	1.8	-0.1	-0.2	-0.2

Source: IMF, *World Economic Outlook* January 2015.

1/ The quarterly estimates and projections account for 90 percent of the world purchasing-power-parity weights.

2/ The quarterly estimates and projections account for approximately 80 percent of the emerging market and developing countries.

3/ G-20 aggregations exclude European Union.

4/ The data for Argentina are officially reported data as revised in May 2014. On February 1, 2013, the IMF issued a declaration of censure, and in December 2013 called on Argentina to implement specified actions to address the quality of its official GDP data according to a specified timetable. On December 15, 2014, the Executive Board recognized the implementation of the specified actions it had called for by end-September 2014 and the steps taken by the Argentine authorities to remedy the inaccurate provision of data. The Executive Board will review this issue again as per the calendar specified in December 2013 and in line with the procedures set forth in the Fund's legal framework.

5/ For India, data and forecasts are presented on a fiscal year basis and output growth is based on GDP at market prices. Corresponding growth rates for GDP at factor cost are 4.7, 5.6, 6.3, and 6.5 percent for 2013/14, 2014/15, 2015/16, and 2016/17, respectively.

6/ For Saudi Arabia, the revisions to the growth forecasts for 2015-16 partly reflect a rebasing of the national accounts to 2010, which resulted in a higher share of the oil sector in the economy and a downward revision of estimated actual growth in 2013 and 2014.

7/ Permanent invitee.

ANNEX 1. TRADE AS KEY PILLAR OF A GLOBAL NEW MOMENTUM

Given the slowdown in global trade growth in recent years, trade is an essential component of the global policy agenda. There are potentially important gains for both advanced and developing countries from further trade integration in traditional and new areas (services, regulations, investment) and further expansion of global supply chains. Coherence among preferential and multilateral efforts is needed to avoid fragmenting the global trading system, even as efforts are made to prop and retool its governance.

Growth in global trade has slowed as the benefits of past reforms and integration trends have matured and new reforms have languished. Trade grew more rapidly than global growth in the last few decades, contributing to higher growth and productivity by allowing countries to integrate and specialize. But over the last few years global trade has slowed, as trade liberalization momentum has faded and global value chains (GVCs) in several regions have matured. Trade volumes grew about 3 percent in 2012–14, substantially lower than the pre-crisis average of 7.1 percent (1987 to 2007). Earlier, WTO membership allowed countries, most notably China, to rapidly integrate into the global trading system even as supply chains were built in Asia, Europe and North America.

Trade is an essential component of the global policy agenda to bolster growth, requiring a commitment to focus on trade policy. A new momentum is needed in policies amid heightened risks to global growth and concerns over a "new mediocre." At a country and global level, trade reforms can complement and augment the benefits of other structural reforms, including by increasing external competition, forming a key element of infrastructure investment, and supporting the strengthening of policy and institutional frameworks. Reinvigorating global trade requires the adoption of more granular commitments on trade policy beyond the oft-repeated standstill on protectionism.

There are potentially important gains to be made from further trade integration and expansion of global supply chains. These gains come from traditional liberalization in many countries (in particular low-income countries and many emerging market economies) and sectors (e.g., agriculture) including via unilateral efforts; from lowering barriers in new trade policy frontiers (services, regulations, investment); and from additional expansion of GVCs, particularly to regions and countries that have missed out on these opportunities in the past (e.g., Africa, South America and South Asia).

- For most *advanced countries* a key issue will be the implications of their efforts to pioneer and advance the new trade policy frontiers, opening services markets and making their regulatory systems more coherent, with large potential gains to themselves and to others if these initiatives minimize fragmentation and are eventually multilateralized.
- Many *emerging market economies*, for example in South Asia and Latin America, can still benefit greatly from integrating via traditional liberalization, including on a unilateral basis,

and by anchoring their economies to GVCs, moving away from import-substitution policies that have failed in the past and avoiding protectionism through the use of non-tariff barriers.

- *Low-income countries* need trade and integration to GVCs as a central plank of their development and growth strategy, for which trade facilitation is critical. Access to advanced economies' markets through preferential agreements such as the Economic Partnership Agreements (EPA) of the EU will provide new export opportunities and reduce trade costs that would support intra-regional trade, most notably in Africa. In addition, LICs can benefit by removing forms of protectionism that hinder job creation and export growth. For these economies, addressing traditional trade barriers, such as upgrading poor trade infrastructures, and improving economic institutions are still crucial.

Reigniting global trade integration would require an open architecture that allows different speeds and depths, but also coherence among preferential and multilateral efforts. The finalization of the Bali agreement is welcome, but earlier impasses as well as the longstanding difficulties to advance the Doha Round have emphasized the need to buttress the governance of the multilateral trading system. With the fulcrum of trade policy moving to regional and plurilateral deals, new trade liberalization initiatives should seek to avoid fragmenting trade, even as renewed efforts are made to prop and retool the governance of the multilateral system, with the WTO at its center. The challenges and priorities ahead include:

- *New liberalization arrangements should ultimately avoid fragmenting the global trading system*. Trade liberalization efforts are currently taking place mainly via preferential (e.g., Trans-Pacific Partnership (TPP) and Transatlantic Trade and Investment Partnership (TTIP)) and plurilateral negotiations (e.g., Trade in Services Agreement (TISA) and Information Technology Agreement (ITA)), which can help advance liberalization in new trade areas. To avoid fragmenting the trading system these efforts need to be pursued openly and transparently and foster eventual multilateralization. Over time, arrangements based on these principles can maximize the benefits of deals and ignite reciprocal opening efforts from non-members.
- *Advancing integration in new trade areas (services, regulations, investment) may take new paths but also require retooling the global governance of trade*. These initiatives have large potential benefits but also intersect with legitimate national policies and regulatory concerns, making the process very different and much more complex than past trade negotiations that mainly focused on lowering tariffs. Moreover, the eventual multilateralization of these agreements would have major implications for the global governance of the trading system.
- *Traditional trade liberalization such as tariff liberalization and trade facilitation is still needed*. It is important for many low-income countries as well as a swathe of emerging market economies, as tariffs remain higher than in advanced economies. Reducing trade costs for low-income countries also requires a sustained effort to improve trade facilitating infrastructures and economic institutions.
- *Heightened and coordinated vigilance will be needed to avoid both old and new forms of protectionism*. The WTO has been effective in evidencing and limiting traditional protectionism through higher tariffs and other border measures but there is a risk that protectionism will increase through diverse non-tariff measures such as undue regulatory barriers, for which large data gaps exist.

This is a crucial juncture of the trade and trade policy landscape. With the traditional multilateral processes at an impasse until recently, it is essential to step back and think broadly on how to reignite the momentum for global trade integration, and how preferential and multilateral efforts should fit now and in the future.

GROUP OF TWENTY

IMPACT OF OIL PRICE DECLINE ON THE GLOBAL ECONOMY

Special Topic to the G-20 Surveillance Note

G-20 Finance Ministers and Central Bank Governors Meeting
February 9–10, 2015
Istanbul, Turkey

Prepared by Staff of the

INTERNATIONAL MONETARY FUND*

*Does not necessarily reflect the views of the IMF Executive Board.

SUMMARY[1]

Oil prices have plunged recently, affecting everyone: producers, exporters, governments, and consumers. Overall, the supply related decline in oil prices together with improved efficiency is a shot in the arm for the global economy. This note focuses on the impact of the supply related decline of oil prices on the global economy. Based on simulations, and bearing in mind that they do not represent a forecast of the state of the global economy, the analysis suggests a gain for world GDP between 0.3 and 0.7 percent in 2015, compared to a scenario without the drop in oil prices. There is, however, much more to this complex and evolving story. This note provides a short summary of the oil market now and in the future, the implications for various groups of countries as well as for financial stability, and how policymakers should address the impact on their economies. The key findings are:

- *The decline of oil prices over the past several months has been driven by both demand and supply factors*. There is, however, substantial uncertainty about the evolution of supply and demand factors ahead and the relative contribution of demand and supply factors to the observed price decline.

- *While the impact of the drop varies across countries, there are some common traits*: *oil importers* stand to benefit from higher household income, lower input costs, improved external positions, and improved fiscal positions from lower fuel subsidies and higher fuel taxes. *Oil exporters* will take in less revenue, and their budgets and external balances will be under pressure.

- *Risks to financial stability have increased, but remain limited*. Currencies in emerging economies have depreciated not only oil exporting countries but also in some oil importers. If sustained, the decline in oil prices could have a material impact on banks with high dollar and energy sector exposures, particularly in emerging economies where depreciations have already been substantial. Given global financial linkages, these developments demand increased vigilance all around.

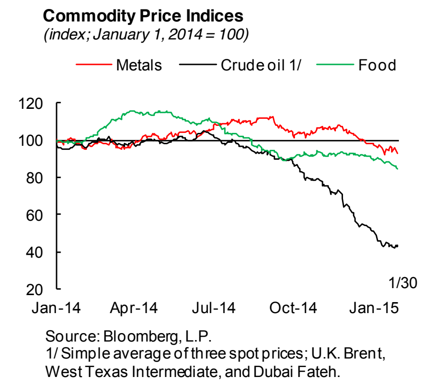
- *Oil exporters that have accumulated substantial funds should smooth out the adjustment by not curtailing fiscal spending abruptly*. For those without savings funds and strong fiscal rules, budgetary and exchange rate pressures may, however, be significant. Without the right monetary policies, this could lead to higher inflation and further depreciation.

- *The fall in oil prices provides an opportunity for many countries to decrease energy subsidies*. The savings should be used toward more targeted transfers, and for some to increase energy taxes and lower other taxes.

[1] This note draws extensively on the IMF Blog “Seven Questions about the Recent Oil Price Slump” by Arezki and Blanchard.

RECENT DEVELOPMENTS AND PROSPECTS

1. **Oil prices have fallen about 55 percent since September 2014, driven by both demand and supply factors**. While other commodity prices have fallen as well, the decline has been much smaller, pointing to factors beyond weaker demand. Indeed, on the *demand* side, revisions of International Energy Agency forecasts of oil demand between June and December, combined with estimates of the short run elasticity of oil supply, suggest that unexpectedly weaker demand during this period can only partly explain the sharp oil price decline. On the *supply side*, the evidence points to a number of factors, including surprise increases in oil production. This is in part due to faster than expected recovery of oil production in some OPEC members, but a major factor is the announced intention of Saudi Arabia—the biggest OPEC oil producer—not to counter the steadily increasing supply of oil from both other OPEC and non-OPEC producers, and the subsequent November 2014 decision by OPEC to maintain their collective production ceiling of 30 million barrels a day in spite of a perceived glut.



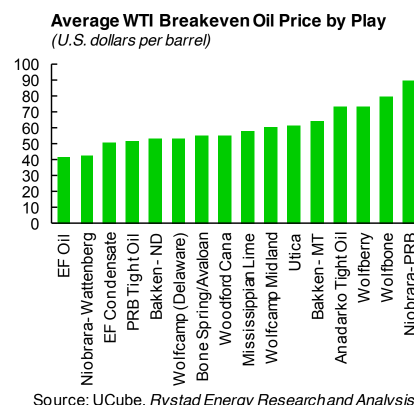
Source: Bloomberg, L.P.
1/ Simple average of three spot prices; U.K. Brent, West Texas Intermediate, and Dubai Fateh.

2. **Available information suggests that speculation has had little impact on the sharp fall of oil prices over the past several months**. Beyond traditional demand and supply factors, "financialization"—oil and other commodities considered by financial investors as a distinct asset class—and "speculation" do not appear to have affected the recent rapid oil price decline. According to the latest report from the International Energy Agency, oil inventories have reached their highest level in two years, suggesting expectations of price increases, not price declines.

3. **The impact of the oil price decline on global growth depends on the persistence of the shock**. The more persistent the decline of oil prices, the more will consumers and firms adjust consumption and production, hence bigger the boost to global growth. The persistence of this supply shift depends on two factors:

- *The willingness of OPEC, and in particular Saudi Arabia, to cut production in the future*. This in turn depends in part on the motives behind such strategy, e.g., the relative importance of geopolitical and economic factors. One hypothesis is that Saudi Arabia has found it too costly, in the face of steady increases in non-OPEC supply, to be the swing producer and maintain a high price. If so, and unless the pain of lower revenues leads other OPEC producers and Russia to agree to share cuts more widely in the future, the shift in strategy is unlikely to change soon. Another hypothesis is that it may be an attempt by OPEC to reduce profits, investment, and eventually supply by non-OPEC suppliers, some of whom face much higher costs of extraction than the main OPEC producers.

- *The response of investment and in turn oil production to low oil prices*. There is some evidence that capital expenditure on oil production has started to fall. According to Rystad Energy, overall capital expenditure of major oil companies is 7 percent lower for the third quarter of 2014 compared to 2013. Available projections from the same source indicate that capital expenditures will fall markedly throughout 2017. For unconventional oil, such as shale, (which now accounts for 4 million out of a world supply of 93 million barrels a day), the break-even price—the oil price at which it becomes worthwhile to extract—of the main United States shale fields (Bakken, Eagle Ford and Permian) is typically below $60 per barrel. With oil price below $50 per barrel, rates of return will be significantly lower, and some highly leveraged firms that did not hedge against lower prices are already under financial stress and have been cutting their capital expenditure and laying off significantly.

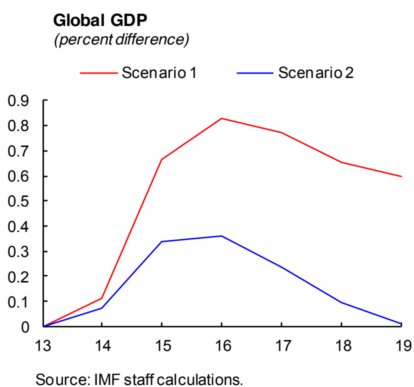


Source: UCube, *Rystad Energy Researchand Analysis*.

IMPLICATIONS FOR THE GLOBAL ECONOMY

Real Sector

4. **The decline in oil prices due to supply factors will boost global growth**. Given the considerable uncertainty about the impact of lower prices on future oil supply, two scenarios with different assumptions about the supply-related change in the oil price going forward are considered, with an average oil price decline of about 30 percent relative to the October 2014 WEO baseline over the medium-term.[2] In the first scenario, 60 percent of the decline in the oil price path throughout 2019 relative to the October 2014 WEO baseline is attributed to supply shifts. In the second scenario, the supply shift accounts for 60 percent of the price decline initially but its contribution gradually declines to zero by 2019 due to the assumed higher contribution of demand to the long-run decline of oil prices. Under the first scenario, the supply shift lifts global GDP by 0.7 and 0.8 percent, respectively, in 2015–16. In the second scenario, the same initial supply shift implies an increase in global GDP of 0.3 percent in 2015 and 0.4 percent in 2016 relative to what was expected with the oil price path used in the October WEO.



Source: IMF staff calculations.

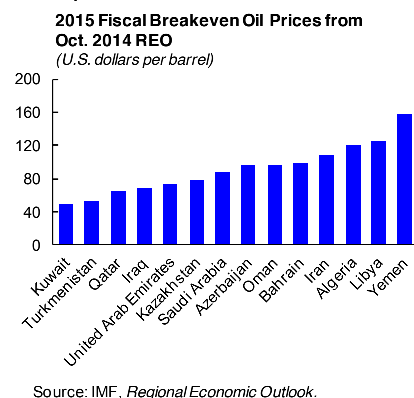
[2] These simulations assume a 100 percent pass-through of international oil price declines into domestic oil prices, implying no fiscal savings. Given low pass-through during oil price declines, these fiscal savings can amount to 1 percent of GDP for emerging and developing countries (see http://www.voxeu.org/article/energy-subsidies-developing-countries).

5. **The net positive global effects of lower oil prices mask asymmetric effects across countries**. Specifically:

- *Oil importers will benefit from higher real incomes of consumers and lower costs in the production of final goods*. Among importers, the simulations suggest GDP increases between 0.3–0.7 percent in 2015 across countries, in line with varying oil intensity in consumption and production across countries. For many importers, the boost from lower oil prices—while sizable—is somewhat muted by the recent currency depreciation against the U.S. dollar, which implies a smaller oil price decline in domestic currency and by the lower pass-through to retail prices in some countries. Lastly, oil importers that are heavily dependent on what happens to oil exporters may experience negative spillovers.

- *Oil exporters will suffer from generally declining real incomes and profits, but much will depend on whether governments, which typically accrue most of the oil revenue, will adjust spending*. Unlike oil importers, oil exporters depend much more on oil. For example, energy accounts for 25 percent of Russia's GDP, 70 percent of its exports, and 50 percent of federal revenues. Among MENA oil producers, the share of oil in government revenue is 63 percent. One way to illustrate the vulnerabilities of oil-exporting countries is to compute the so-called fiscal break-even prices—that is, the oil prices at which the governments of oil-exporting countries balance their budgets. The breakeven prices vary considerably across countries, ranging from $49 per barrel (Kuwait) to $157 (Yemen). In addition, the existence and size of accumulated fiscal buffers will also be critical parameters determining whether the fiscal shock can be smoothed over time.

2015 Fiscal Breakeven Oil Prices from Oct. 2014 REO
(U.S. dollars per barrel)



Source: IMF, *Regional Economic Outlook*.

Financial Sector

6. **Declines in oil prices have financial implications, directly through the effects of oil prices themselves, and indirectly through the induced adjustment of exchange rates**.

- *Lower oil prices weaken the financial position of firms in the energy sector, especially those that have borrowed in dollars*. As a result, the position of banks and other institutions with substantial claims on the energy sector weakens. The proportion of energy firms with an interest coverage ratio (the ratio of cash flows to interest payments) below 2 stands at 31 percent in emerging market economies, indicating that some of these companies may indeed be at risk. CEMBI spreads, which reflect spreads on high yield emerging market corporates, have increased by 100 basis points since June.

- *Lower oil prices may lead to an appreciation of oil importers' currencies, and to a depreciation of those oil exporters' currencies with flexible exchange rates, with balance sheet implications*. The drop in oil price has contributed to an abrupt depreciation of currencies in a number of oil exporting countries, including Russia and Nigeria but also in some oil importers. While the decrease in the price of oil is only one of the reasons behind the fall of the ruble, the Russian currency depreciated by 50 percent since the beginning of last year. While controlled depreciations can help oil exporters adjust, they also exacerbate financial problems for those

firms and governments whose debt is denominated in dollars. And, in countries where expectations are not well anchored, uncontrolled depreciations can quickly lead to very high inflation.

7. **If sustained, the oil price slump will thus have a concentrated and material impact on those bondholders and banks with high dollar and energy sector exposures**. The exposure of the global banking system is likely not to be large enough to cause appreciable increase in provisioning requirements and should be partially offset by improving credit quality in oil importing countries and sectors. However, the exposure of some global banks to the oil and gas sectors significant in some cases, posing risks to balance sheets.

POLICIES

8. **Lower oil prices provide monetary space in most oil importers**. In most *advanced economies*, output gaps are still substantial, inflation is below target, and monetary policy remains constrained by the zero lower bound. The boost to demand from lower oil prices is thus welcome. But if the further declines in inflation, even if temporary, lead to additional downdraft in inflation expectations in major economies, monetary policy must stay accommodative through other means to prevent real interest rates from rising. In this regard, use of forward guidance to anchor medium run inflation expectations and avoid sustained deflation is crucial. In some *emerging market economies*, lower oil prices will alleviate inflation pressure and external vulnerabilities, thereby allowing central banks not to raise policy interest rates or to raise them more gradually.

9. **Oil exporters, for which oil receipts typically contribute to a sizable share of fiscal revenues, are experiencing larger shocks in proportion to their economies**. Those that have accumulated substantial funds from past higher prices and have fiscal space can let fiscal deficits increase temporarily and draw on these funds to allow for a more gradual adjustment of public spending to the lower prices. For others, allowing fiscal adjustment and substantial exchange rate depreciation will be the main means available to others to cushion the impact of the shock on their economies. Some will have to strengthen their monetary frameworks to avert the possibility that depreciation will lead to persistently higher inflation and further depreciation. In general, all oil exporters should do more lasting fiscal reforms, including creating and broadening non-oil fiscal base and improving natural resource management.

10. **Lower oil prices also offer an opportunity to reform energy subsidies and taxes in both oil exporters and importers at low political cost**. For example, many countries have been able to successfully decrease subsidies recently.[3] The saving from the removal of general energy subsidies should be used toward more targeted transfers, to lower budget deficits where relevant, and to increase public infrastructure if conditions are right. In a number of *advanced economies* and emerging market economies (such as South Africa), this might also be an opportunity to increase energy taxes, using the savings to reduce other taxes, such as labor taxes.

[3] These include Angola, Bahrain, Cameroon, Cote d'Ivoire, Egypt, Haiti, India, Indonesia, Jordan, Kuwait, Malaysia, Mauritania, Morocco, Sudan, Thailand, Tunisia, U.A.E., and Yemen.