IMF October 2012 World Economic Outlook and Global Financial Stability Report

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Global economic growth is being hampered by uncertainty, prospects have deteriorated further, and downside risks have increased and are considerable: Both the IMF's World Economic Outlook (WEO) and Global Financial Stability Report (GFSR) of October 2012 paint a gloomier picture of the global economy than a few months ago.

The WEO subtitled "Coping with High Debt and Sluggish Growth" shows that uncertainty is weighing heavily on global output. Assessing the precise nature and effects of this uncertainty is crucial, but difficult. If uncertainty were to be reduced, the recovery could well turn out to be stronger than currently forecast. A key issue is whether the global economy is just suffering from a slow and bumpy recovery or whether the current slowdown is here to stay.

World output is projected to increase by 3.3% in 2012 and 3.6% in 2013, while euro area growth is forecast to contract by 0.4% in 2012 and to increase by 0.2% in 2013. The analogous projections for Central, Eastern and Southeastern European (CESEE) countries are +2% (2012) and +2.6% (2013). In advanced economies, an accommodative monetary policy helps stimulate growth, offsetting the drag from fiscal consolidation and a still-weak financial system.

Unemployment is expected to stay elevated in many parts of the world. Global imbalances have decreased, but there is still a need for more decisive policy action to tackle them. Within the euro area, current account imbalances and deficits in most periphery economies need to align further.

According to both the WEO and GFSR, which is subtitled "Restoring Confidence and Progressing on Reforms," the euro area crisis is the most obvious threat to the global outlook. As the crisis intensified, new interventions became necessary to prevent further deterioration. The crisis has shown that euro area countries can be hit by strong, country-specific shocks, the adverse effects of which may then be amplified by weak banks. To break the negative feedback loops between sovereigns and banks, the European Financial Stability Facility (EFSF) and its permanent successor, the European Stability Mechanism (ESM), must provide support for countries facing economic challenges and the banks operating in these countries to relieve funding pressures. Sovereigns in need of assistance should apply for resources pooled under the EFSF/ESM to preserve or regain market access. The IMF calls on governments to make the euro area firewall more flexible and the ESM operational as soon as possible. In particular, the ESM should be allowed to intervene in banking systems.

The ECB's commitment to act on secondary markets via the Outright Monetary Transaction (OMT) program is considered to be an important step in the right direction, which has improved financial conditions. However, serious risks remain and anti-crisis measures should be anchored by the vision of a more complete monetary union.

While the crisis has also spurred a host of regulatory reforms, financial systems are still too complex and concentrated, with tight domestic interbank linkages. European policymakers have announced policy measures aimed at reversing the fragmentation of euro area financial markets and strengthening EMU's architecture; now they need to be implemented at the national level.

To ensure market confidence in the viability of EMU, according to the WEO, such a union should rest on four pillars: common supervision, harmonized regulation, a pan-European deposit guarantee scheme, and a pan-European resolution mechanism with common backstops.

While the WEO expects advanced economies to face sluggish growth, output in emerging market and developing economies is forecast to remain relatively solid. In the CESEE economies, improving financial conditions in the crisis-hit economies, stronger demand from the euro area and the end of a boom-bust cycle in Turkey are expected to raise growth back to 4% later in 2013.

But low growth and prevailing uncertainty in advanced economies will also affect emerging market and developing economies, through both trade and financial channels. Financial stress in the euro area periphery has soared. Hence, the environment for emerging market economies (EMEs) has turned more challenging, as the euro area crisis sends renewed shockwaves through a fragile global economy: The GFSR sees the main risk to EMEs in their banking systems struggling with deleveraging pressures, worsening asset quality and slow growth. Among all EMEs, the GFSR considers the CESEE countries to be the most vulnerable given their exposure to the euro area and some similarities with the euro area periphery. EMEs need to beware of potential further fallout from the euro area, while coping with a slowdown in growth that could expose domestic financial stability risks.