

KEY POINTS

- **The IMF's appraisal of the growth prospects for the global economy is largely unchanged from the latest update in January 2014, although low inflation in the euro zone adds to the risks.**
- **The program for Ukraine, which should entail approximately US\$16 billion, is likely to be formally approved by the IMF executive board by the end of April, following consultations with major shareholders this week.**
- **After the two unsuccessful attempts in recent weeks to have US Congress ratify the 2010 IMF governance package, further reform plans are on hold indefinitely. This has implications that go well beyond the IMF.**



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A PREVIEW OF THE 2014 IMF SPRING MEETINGS

Finance ministers and central bank governors from around the world are set to gather in Washington, DC for the IMF ministerial meetings later this week, where they will discuss three main items. This commentary outlines what topics will be deliberated and previews the main thrust of the discussions that are likely to unfold.

Assessment of the Global Economy

The prospects for the global economy remain broadly unchanged from the latest IMF assessment published in January 2014. Global growth is projected at slightly less than four percent this year, a respectable increase from three percent last year.

The assessment of the risks for the global economy has not significantly changed from the latest World Economic Outlook update. In emerging economies, exchange rate flexibility remains key to facilitate adjustment, and credible macroeconomic policies will be needed to cope with any re-emerging turbulence. In advanced economies, avoiding the premature exit from accommodative monetary policies remains important, alongside the need to promote better cooperation among central banks regarding their exit plans.

The euro zone continues to add to the risk map that policy makers will be assessing this week. If inflation expectations decline further, they would expose the euro zone's already troubled economy to deflation risks, should adverse shocks materialize. In all three major world economies — the United States, Japan and the euro zone — inflation consistently performs below their respective central bank targets. In both the United States and Japan, inflation rates appear to be heading in the right direction. In the euro zone, however, it is, by and large, less clear.

As a result, the combination of low growth, very low inflation and high public debt, makes the prospects for debt sustainability in some national economies worse. For instance, based on the IMF's forecasts of GDP growth, and assuming zero inflation, Italy's debt-to-GDP ratio will remain at approximately the current level over the next four years — that is, above 130 percent of GDP.

Moreover, the impact of low inflation in the euro zone goes beyond debt sustainability as it makes intra-euro rebalancing more challenging. In fact, it becomes even more difficult for southern Europe to sustain its efforts to fill competitiveness gaps with the northern economies if it has to sustain substantial real, as opposed to nominal, wage cuts over time.

The Ukraine Crisis and Heightened Geopolitical Risks

Ukraine will attract considerable attention in the official, but also informal, conversations at the margin of the ministerial meetings. Following an IMF staff-level agreement for a program of between US\$14 billion and US\$18 billion for Ukraine, the IMF executive board is likely to formally approve the program in the second half of this month, after informal consultations that IMF Managing Director Christine Lagarde will hold with major shareholders this week.

In the IMF's assessment, Ukraine suffers from a greater geopolitical risk than an economic or financial risk. Indeed, its reserve assets plunged in the unfeasible attempt by Ukraine authorities to defend the currency peg, but are still worth



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about US\$15 billion. Its budget deficit is on the high side, but the IMF has stepped in when countries had deficits that were considerably higher. Finally, Ukraine's public debt is just over 40 percent of GDP and its external debt still stands at about one-third of GDP — hardly worrisome numbers. In IMF jargon, they do not pose a sustainability problem.

On the whole, the financial program that the IMF management will recommend to the executive board in coming weeks is likely to exhibit a number of non-reversible policy actions to be implemented through upfront actions (prior actions). Such prior actions are likely to enhance the flexibility of Ukraine's exchange rate regime and catalyze well-defined commitments to reign in its fiscal and quasi-fiscal deficit.

On the latter, a gradual but steady reform in the subsidy to the energy prices for households is unavoidable. Current prices are based on a cost-recovery mechanism currently set at approximately 20 percent. As a result, even if prices were to increase by 50 percent, cost recovery would only increase to 30 percent. As high as that may seem, it would still place Ukraine's cost-recovery level considerably below that of Moldova, the closest comparable neighbour.

Taking this into consideration, the IMF is likely to demand a substantial increase in energy prices, but it will also provide for a system of targeted support aimed, for instance, at the poorest third of households. This safety net, combined with a widespread domestic awareness that Ukraine must reduce its dependence from Russia and circumscribe its threats, is likely to reduce domestic opposition to this long-needed reform. To manage any possible opposition to this measure, both the Ukraine authorities and the IMF will emphasize that the bulk of energy measures will kick in next winter, as the cold season is about to end.

Unfulfilled Governance Reform — What's Next?

After two unsuccessful attempts by the Obama administration within a few weeks to have Congress ratify the Seoul 2010 package of IMF governance reform, any further reform in the coming years is on hold.

This will have two effects. First, it will reduce the ability of the IMF to credibly act as a stabilizing anchor by not boosting an adequate lending firepower. Emerging economies will have less incentive to commit large resources, even on a contingent basis, if they cannot credibly be assured that governance arrangements will be amended accordingly. As a result, they may be tempted to drift away from the IMF and support regional or plurilateral financial arrangements whose development, if left without a legitimate central anchor, may contribute to the fragmentation of the international financial architecture.

Second, and most importantly, failure to approve the Seoul IMF reform package undermines the implicit contract that advanced and emerging economies made at the height of the financial crisis: the former committed to provide a greater voice for the emerging economies in global governance, while the latter would take more responsibility toward a strong, stable and sustainable global economy. Consequently, failure to ratify the Seoul package goes well beyond the IMF and jeopardizes the credibility of the Group of Twenty, where this implicit contract was first stipulated and agreed.