

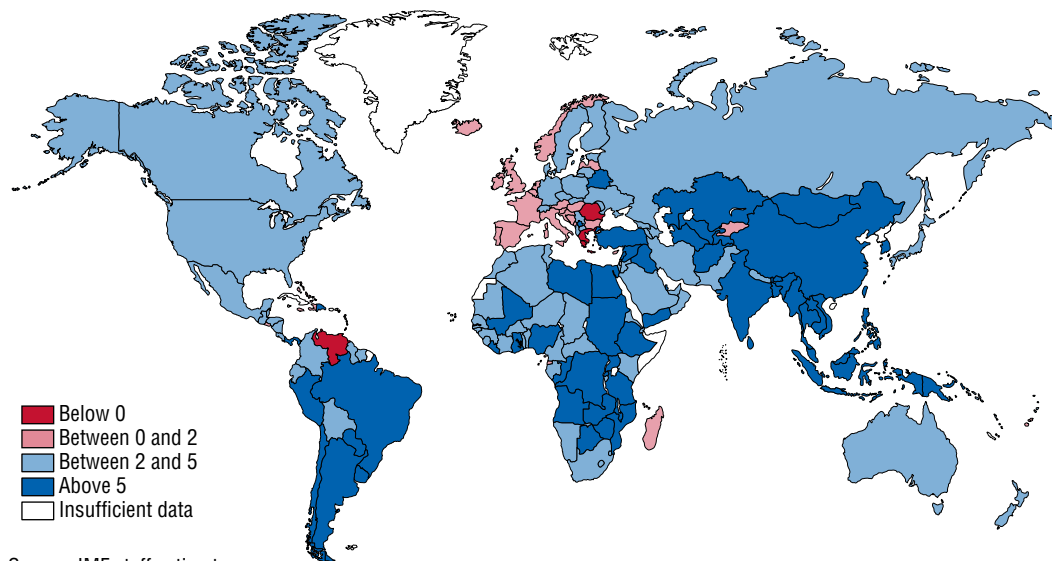
As discussed in Chapter 1, the global recovery is continuing, but its strength is not yet assured. Economic prospects remain uneven across countries and regions (Figure 2.1). In general, the pace of recovery is expected to be faster in economies that had stronger fundamentals before the crisis, smaller output losses during it, and now have more room for policy maneuver and deep links with fast-growing trading partners.<sup>1</sup> China's increasingly wide trading network is driving growth prospects in numerous economies, especially commodity exporters. Strong internal dynamics are supporting near-term growth in other emerging economies, too. However, economic prospects are subdued in major advanced economies, where much-needed policy adjustments have only just begun—in the form of financial sector repair and reform and medium-

term fiscal consolidation. This will weigh on growth in emerging economies, raising the need to boost domestic sources of demand. At the same time, capital will continue to flow toward strong emerging and developing economies, induced by relatively good growth prospects and favorable interest rate differentials.

This chapter begins with Asia, which is leading the global recovery. Then it turns to North America, where there is renewed concern that the recovery may be stalling, with significant implications for the rest of the world. Next, the chapter reviews Europe's economic and policy challenges, which in many ways mirror those at the global level: the need for demand rebalancing within the region, financial sector repair, and medium-term fiscal consolidation. It then outlines the wide range of developments and prospects in Latin America and the Caribbean (LAC), the Commonwealth of Independent States (CIS), the Middle East and North Africa (MENA), and sub-Saharan Africa.

<sup>1</sup>See Chapter 2 of the April 2010 *World Economic Outlook* and IMF (2010a).

**Figure 2.1. Average Projected Real GDP Growth during 2010–11**  
(Percent)



Source: IMF staff estimates.

## Asia Is Advancing with Resilience

Asia entered the global crisis on a strong footing and is continuing to lead the global recovery (Figure 2.2). In most parts of the region, resilience in domestic demand—thanks in part to proactive policy stimulus—has offset the drag from net exports (Figure 2.3). The handoff from public-sector-driven to private-sector-driven growth is well under way in most Asian countries. Industrial production and retail sales have been strong in China and India, among others. Robust activity in these countries in turn is helping power growth in the rest of Asia. In fact, China’s strong and sustained growth over the past several years has served as a linchpin for global trade, benefiting exporters of commodities (for example, Australia, Indonesia, New Zealand) and capital goods (for example, Germany, Japan, some NIEs).<sup>2,3</sup> More-

over, unlike in previous recoveries, a turnaround in private capital inflows has bolstered domestic demand by providing access to external financing. The region is projected to grow by about 7.9 percent in 2010 and 6.7 percent in 2011 (Table 2.1). Activity is projected to moderate from the second half of 2010 and in 2011 in line with the winding down of policy stimulus and policy tightening in economies facing demand pressures, as well as downdrafts from policy adjustments in advanced economies.

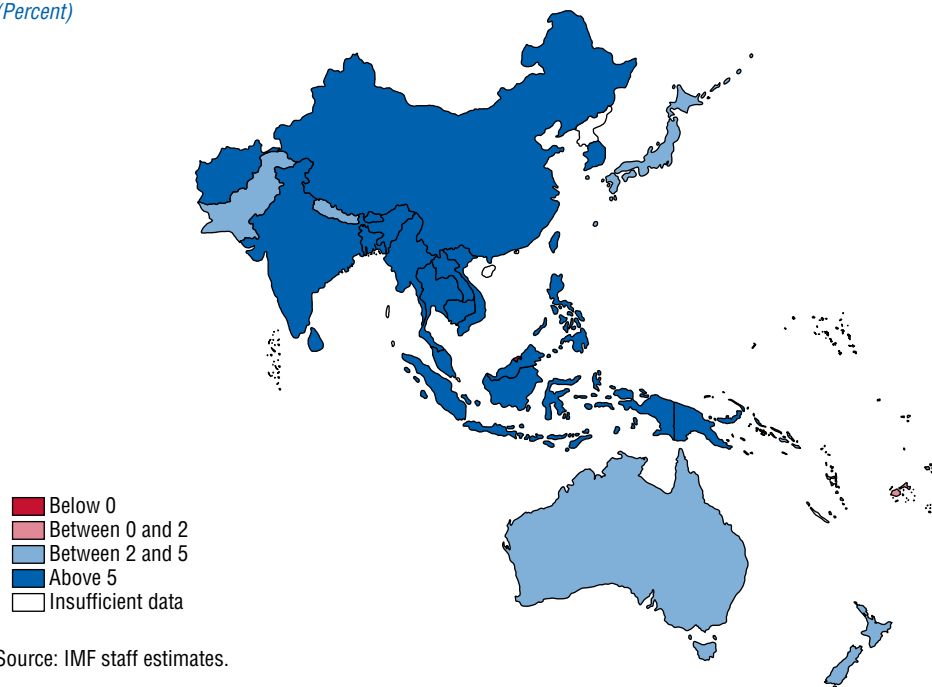
Near-term growth performance will vary across countries because of differences related to the strength of stimulus and private demand along with underlying economic and financial conditions and risks. Thus, a massive fiscal stimulus and credit expansion has boosted domestic demand in China. In India, low reliance on exports, accommodative

<sup>2</sup>Newly industrialized Asian economies comprise Hong Kong SAR, Korea, Singapore, and Taiwan Province of China.

<sup>3</sup>While China continues to be an important conduit in Asia’s global supply chain, the much faster pace of increase in emerging

Asia’s exports to China in recent years—relative to China’s own exports to advanced economies—points to the rising strength of China’s final domestic demand in driving its imports from the rest of Asia (see Figure 2.3 and the April 2010 *Regional Economic Outlook: Asia and Pacific*).

**Figure 2.2. Asia: Average Projected Real GDP Growth during 2010–11**  
(Percent)



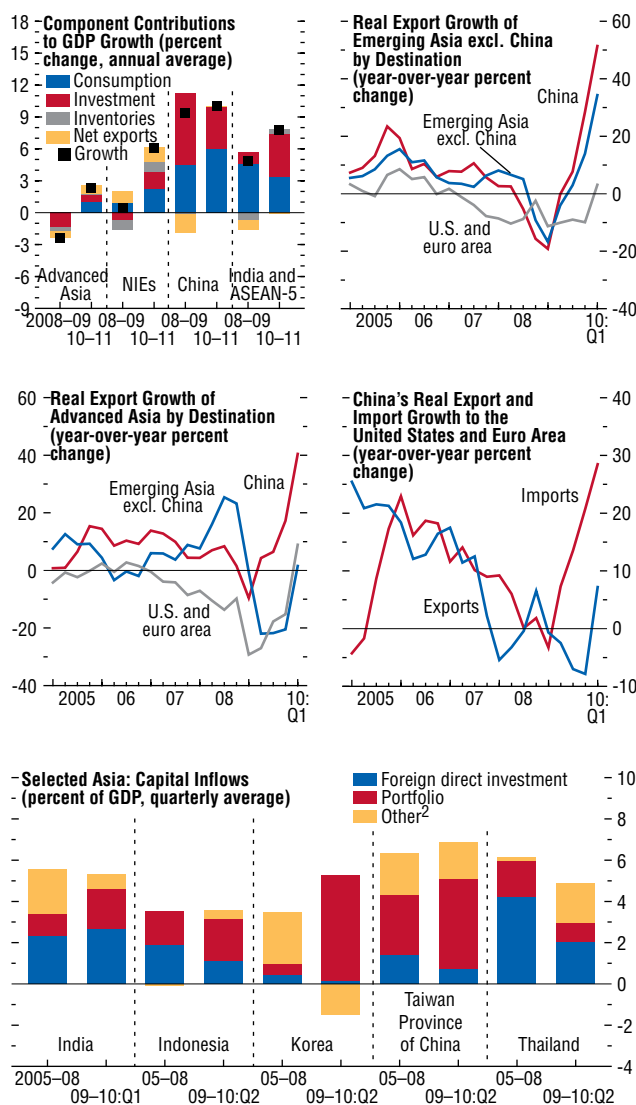
policies, and strong capital inflows have supported domestic activity and growth. In contrast, Japan's economic prospects remain weak, given lackluster domestic demand and a lack of fiscal room to further boost the economy. Prospects are also weak for economies at the lower end of the quality ladder in manufacturing exports and for those where there is macroeconomic and financial uncertainty (Vietnam). The outlook for Pakistan has deteriorated significantly after the recent massive flooding. Country-specific details are discussed further below:

In *China*, real GDP grew at 10.3 percent (year over year) in the second quarter, compared with 11.9 percent in the first quarter. Sustained growth in retail sales and industrial production confirms that private sector activity has advanced beyond the lift from government stimulus. Overall, growth is projected to average 10.5 percent in 2010 and 9.6 percent in 2011, driven by domestic demand. The slight moderation in recent activity is expected to continue through 2011 in light of tighter quantitative limits on credit growth, measures to cool off the property market and limit bank exposure to this, and the planned unwinding of fiscal stimulus in 2011. On average over 2010–11, private domestic demand is poised to contribute two-thirds of near-term growth, and government activity about one-third, whereas the contribution from net exports will be close to zero. Notwithstanding the robustness in domestic demand, the pickup in inflation in 2010 reflected mainly higher food prices rather than core inflation.

*India's* macroeconomic performance has also been vigorous, with industrial production at a two-year high. Leading indicators—the production manufacturing index and measures of business and consumer confidence—continue to point up. Growth is projected at 9.7 percent in 2010 and 8.4 percent in 2011, led increasingly by domestic demand. Robust corporate profits and favorable external financing will encourage investment. Recent activity (10 percent year-over-year growth in real GDP at market prices in the second quarter) was driven largely by investment, and the contribution from net exports is projected to turn negative in 2011, as the strength

Figure 2.3. Asia: Leading the Global Recovery<sup>1</sup>

Economic activity has bounced back because of domestic demand and rebounding exports. Robust import demand from China—particularly in commodities, machinery, and capital goods—has supported activity in both emerging and advanced Asia. The region is attracting capital inflows, which, while providing easy access to financing, has posed some macroeconomic policy challenges (see Box 2.1).



Sources: CEIC Asia database; Haver Analytics; IMF, *Direction of Trade Statistics*; and IMF staff calculations

<sup>1</sup>Advanced Asia: Australia, Japan, and New Zealand; newly industrialized Asian economies (NIEs): Hong Kong SAR, Korea, Singapore, and Taiwan Province of China; ASEAN-5: Indonesia, Malaysia, Philippines, Thailand, and Vietnam; emerging Asia: ASEAN-5, China, India, and NIEs.

<sup>2</sup>Other investment includes financial derivatives.

**Table 2.1. Selected Asian Economies: Real GDP, Consumer Prices, Current Account Balance, and Unemployment**  
(Annual percent change, unless noted otherwise)

	Real GDP			Consumer Prices <sup>1</sup>			Current Account Balance <sup>2</sup>			Unemployment <sup>3</sup>		
	2009	Projections		2009	Projections		2009	Projections		2009	Projections	
		2010	2011		2010	2011		2010	2011		2010	2011
<b>Asia</b>	<b>3.6</b>	<b>7.9</b>	<b>6.7</b>	<b>2.0</b>	<b>4.3</b>	<b>3.3</b>	<b>3.5</b>	<b>3.0</b>	<b>2.8</b>	...	...	...
<b>Advanced Asia</b>	<b>-3.0</b>	<b>4.6</b>	<b>2.8</b>	<b>-0.1</b>	<b>0.7</b>	<b>1.2</b>	<b>3.0</b>	<b>3.1</b>	<b>2.6</b>	<b>4.9</b>	<b>4.7</b>	<b>4.6</b>
Japan	-5.2	2.8	1.5	-1.4	-1.0	-0.3	2.8	3.1	2.3	5.1	5.1	5.0
Australia	1.2	3.0	3.5	1.8	3.0	3.0	-4.4	-2.4	-2.3	5.6	5.2	5.1
New Zealand	-1.6	3.0	3.2	2.1	2.5	5.5	-3.0	-3.2	-4.4	6.2	6.2	5.8
<b>Newly Industrialized Asian Economies</b>	<b>-0.9</b>	<b>7.8</b>	<b>4.5</b>	<b>1.3</b>	<b>2.6</b>	<b>2.7</b>	<b>8.5</b>	<b>7.1</b>	<b>6.9</b>	<b>4.3</b>	<b>3.8</b>	<b>3.7</b>
Korea	0.2	6.1	4.5	2.8	3.1	3.4	5.1	2.6	2.9	3.7	3.3	3.3
Taiwan Province of China	-1.9	9.3	4.4	-0.9	1.5	1.5	11.3	10.0	9.5	5.8	5.3	4.9
Hong Kong SAR	-2.8	6.0	4.7	0.5	2.7	3.0	8.7	8.3	8.3	5.1	4.4	4.1
Singapore	-1.3	15.0	4.5	0.6	2.8	2.4	17.8	20.5	18.4	3.0	2.1	2.2
<b>Developing Asia</b>	<b>6.9</b>	<b>9.4</b>	<b>8.4</b>	<b>3.1</b>	<b>6.1</b>	<b>4.2</b>	<b>4.1</b>	<b>3.0</b>	<b>3.0</b>	...	...	...
China	9.1	10.5	9.6	-0.7	3.5	2.7	6.0	4.7	5.1	4.3	4.1	4.0
India	5.7	9.7	8.4	10.9	13.2	6.7	-2.9	-3.1	-3.1	...	...	...
<b>ASEAN-5</b>	<b>1.7</b>	<b>6.6</b>	<b>5.4</b>	<b>2.9</b>	<b>4.4</b>	<b>4.4</b>	<b>5.1</b>	<b>3.2</b>	<b>2.4</b>	...	...	...
Indonesia	4.5	6.0	6.2	4.8	5.1	5.5	2.0	0.9	0.1	8.0	7.5	7.0
Thailand	-2.2	7.5	4.0	-0.8	3.0	2.8	7.7	3.6	2.5	1.4	1.4	1.4
Philippines	1.1	7.0	4.5	3.2	4.5	4.0	5.3	4.1	3.4	7.5	7.2	7.2
Malaysia	-1.7	6.7	5.3	0.6	2.2	2.1	16.5	14.7	13.8	3.7	3.5	3.2
Vietnam	5.3	6.5	6.8	6.7	8.4	8.0	-8.0	-8.3	-8.1	6.0	5.0	5.0
<b>Other Developing Asia<sup>4</sup></b>	<b>4.4</b>	<b>5.3</b>	<b>4.6</b>	<b>11.2</b>	<b>9.1</b>	<b>9.6</b>	<b>-0.9</b>	<b>-0.3</b>	<b>-1.3</b>	...	...	...
<i>Memorandum</i>												
Emerging Asia <sup>5</sup>	5.8	9.2	7.9	2.8	5.6	4.0	4.8	3.7	3.7	...	...	...

<sup>1</sup>Movements in consumer prices are shown as the year-over-year changes in annual averages. December–December changes can be found in Tables A6 and A7 in the Statistical Appendix.

<sup>2</sup>Percent of GDP.

<sup>3</sup>Percent. National definitions of unemployment may vary.

<sup>4</sup>Other Developing Asia comprises the Islamic Republic of Afghanistan, Bangladesh, Bhutan, Brunei Darussalam, Cambodia, Fiji, Kiribati, Lao People's Democratic Republic, Maldives, Myanmar, Nepal, Pakistan, Papua New Guinea, Samoa, Solomon Islands, Sri Lanka, Timor-Leste, Tonga, and Vanuatu.

<sup>5</sup>Emerging Asia comprises all economies in Developing Asia and the Newly Industrialized Asian Economies.

in investment further boosts imports. The rapid pace of domestic activity, evidenced by rapidly rising inflation, led the central bank to increase the repo policy rate, in steps, by a cumulative 125 basis points.

- In *Japan*, an export-led recovery since the second quarter of 2009 strengthened in early 2010, thanks to a stronger-than-anticipated recovery in the Western advanced economies and rising demand for capital goods from China. However, sporadic appreciation of the yen (for example, in May 2010, when financial volatility in Europe triggered safe haven inflows) and the recent cooling of the U.S. economy will continue to affect exports. Although investment activity is projected to pick up—sparked by export-oriented businesses—the unwinding of fiscal stimulus and the sluggish labor market are likely to weigh on near-term growth. Real GDP growth is projected at 2.8 percent in 2010 and 1.5 percent in 2011,

although output will remain below its potential level.

- The rapid recovery in the NIEs has been driven by a rebounding inventory cycle, strong domestic activity, and robust regional demand for these economies' exports (electronics for Singapore, services for Hong Kong SAR, capital goods for Korea). Some NIE property markets have been experiencing sizable price increases (for example, Hong Kong SAR, Singapore), which prompted use of macroprudential policies to prevent the emergence of an asset price bubble. Inflation expectations are nevertheless broadly stable.
- The ASEAN economies<sup>4</sup> have also benefited from the strong regional upswing, particularly those exporting commodities and electronics.

<sup>4</sup>Association of Southeast Asian Nations (ASEAN), which includes Indonesia, Malaysia, Philippines, Thailand, and Vietnam.

The broad-based export rebound is now feeding through an autonomous demand-driven recovery, particularly in private investment (although investment activity is not yet fully under way in Malaysia). In Vietnam, the macroeconomic situation has recently stabilized after the 2009 stimulus measures, which had raised perceived risk and triggered market uncertainty, were partly reversed. Overall, near-term growth for the region is projected to be underpinned both by exports and domestic demand.

- In the advanced economies of commodity producers, Australia and New Zealand, early in the year policy stimulus and exports supported activity. Stronger trade links with China have increased these economies' resilience to cyclical downturns in traditional partners, such as the United States.

Notwithstanding impressive performance so far, risks to near-term growth in emerging Asia are tilted slightly to the downside, mainly because of uncertainty in the external environment. Thus, a slower recovery in the United States and the euro area, a greater-than-anticipated slowdown in China, or negative spillovers from unanticipated financial shocks abroad could interrupt the pace of recovery. These risks are somewhat offset by an upside risk of even faster recovery in private sector activity.

In advanced Asia, downside risks dominate as well, but also reflect domestic vulnerability. These risks include yen appreciation and worsening deflation in Japan; higher risk premiums, given high external debt in New Zealand; and, given assessed mild overvaluation, a potential correction in house prices that could hit household wealth and consumer confidence in Australia and New Zealand.

Looking beyond the crisis, Asia's medium-term prospects depend on how successfully it is able to rebalance the drivers of growth—with greater reliance on domestic sources compared with external demand. Such a rebalancing in China is critical to enhance the role of household consumption in domestic growth. To the extent that a stronger Chinese currency eases this process, other surplus countries in the region could follow suit, which would facilitate the needed shift toward domestic sources of growth. However, in addition to China, the

entire region will need to adopt some combination of the following policies to support durable domestic demand: appropriate appreciation of the currency to enhance domestic income and purchasing power, removal of structural bottlenecks to domestic investment or consumption or both, and boosts to productivity in the nontradables or service sector.<sup>5</sup> In addition, the macroeconomic and structural policy mix to address near-term challenges must—to the extent possible—be conducive to meeting the region's medium-term rebalancing needs.

Against this backdrop, fiscal policy—in particular the unwinding of stimulus—needs to be carefully calibrated to strike a balance between supporting a self-sustained recovery in private activity over the near and medium term and avoiding fiscal risk or overheating pressure. Therefore, fiscal withdrawal would be appropriate under the baseline projections, provided a private demand recovery is robustly established. Some postponement of consolidation may be needed, where there is fiscal room to do so, should external downside risks to growth materialize. In addition, some economies could reorient the composition of fiscal spending within the available fiscal envelope to further support the role of domestic demand in growth (for example, measures to encourage consumption in China and to improve the quality of infrastructure services in Indonesia). In contrast, consolidation should be a priority where fiscal risks are building (India, Malaysia, Philippines). In Japan, decisive fiscal consolidation is unavoidable, given the high level of public debt and anticipated fiscal needs related to the aging population. Consolidation should focus on entitlement spending and comprehensive tax reform. New Zealand's high external debt also calls for greater fiscal prudence.

Monetary policy needs to be responsive to the domestic cycle—that is, prospects for inflation, which are influenced by the degree of economic slack. Most economies in the region have already resumed rate hikes (Australia, India, Korea, Malaysia, New Zealand, Thailand), tightened liquidity management (reimposition of quantitative limits

<sup>5</sup>See also the April 2010 and October 2010 issues of the *Regional Economic Outlook: Asia and Pacific*.

to credit growth in China, higher reserve requirements in India and China), or made use of other tools (steady appreciation of the nominal effective exchange rate target by Singapore). The overall monetary stance, however, is still largely accommodative or neutral. Thus, economies that are beginning to face inflation pressure should further tighten monetary policy. If domestic overheating is influenced by strong capital flows, monetary tightening should be accompanied by currency appreciation to help offset inflation pressure, discourage speculative inflows, and support medium-term rebalancing. Conversely, if private demand is not yet fully established and in the absence of inflation pressure, monetary policy would need to remain accommodative to help jump-start private activity. Finally, if broad-based downside risks to growth begin to materialize, most Asian economies can use the available monetary room to support economic activity.

With the return of normal financial sector conditions, the time is also ripe for unwinding special support measures introduced during the crisis. Some countries have already started (for example, removal of guarantees on banks' wholesale funding in Australia and New Zealand, unwinding of the previously expanded central bank liquidity/rediscount window in Hong Kong SAR and Philippines). Others are tightening regulatory measures further to enhance financial system stability. Policymakers in New Zealand introduced a new liquidity policy, including a core funding ratio to improve bank liquidity and reduce banks' dependence on short-term funding. In China, prudential regulations were introduced to reduce banks' exposure to potentially risky property loans, and other direct measures were deployed to cool the property market (for example, increased minimum down payments, lower loan-to-value ratios, higher mortgage rates for second homes). The banking system thus appears well positioned to absorb moderate potential losses (see the October 2010 issue of the *Global Financial Stability Report*—GFSR). Similarly, policymakers in Hong Kong SAR took measures to address risks of property price inflation. These include maximum loan-to-value ratios on high-end properties

and higher stamp duties on property sales, among others. Hong Kong SAR, Malaysia, and Singapore are employing a coordinated approach to withdraw blanket guarantees on banks' wholesale deposits.

The recent resurgence in capital inflows to emerging Asia, after a temporary stop during the global crisis in 2008, has raised potential policy challenges. On the one hand, capital flows have helped support domestic demand. On the other hand, the size of global inflows relative to the comparatively small financial markets has raised or intensified existing concerns, including the risk of inflation, asset price bubbles, financial sector instability (if inflows are not properly intermediated), excessive appreciation, and risks associated with a sudden stop of capital flows. Given wide variation in capital account openness across economies and across alternative types of investment within the same economy, it is possible that some economies may receive more capital inflows than they can efficiently intermediate. Alternatively, capital controls in one sector (for example, foreign direct investment—FDI) may be inducing excessive inflows into others (for example, portfolio, equity). Economies have been implementing a range of measures to deal with their varied situations (Box 2.1). The measures generally address potential financial stability concerns and do not impose wholesale restraint on capital inflows. At the same time, it is not clear how much these policy responses will deliver. A few issues stand out:<sup>6</sup>

- Macroprudential measures should focus primarily on financial stability and should not be used to postpone needed macroeconomic adjustment. Thus, where large current account imbalances may reflect an undervalued exchange rate, currency appreciation is the best response to capital inflows. Conversely, if the exchange rate is broadly at its medium-term equilibrium level, but reserves are assessed to be insufficient, capital inflows should be used to build up reserves. Many economies in emerging Asia are among the largest reserve holders, and so they do not fall into this category.

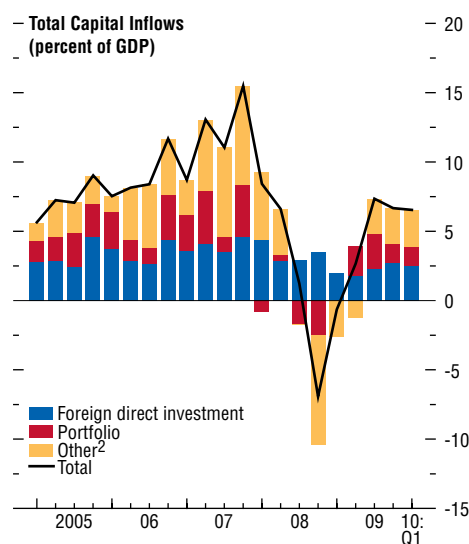
<sup>6</sup>See also the April 2010 GFSR.

### Box 2.1. Emerging Asia: Responding to Capital Inflows

Emerging Asia is experiencing a revival in capital inflows. Total inflows to the region over the past four quarters more than quadrupled relative to 2008 levels (figure), although in many cases, net inflows are negative or dwarfed by large current account surpluses. Many economies are responding to balance of payments surpluses largely through reserve accumulation rather than currency appreciation. In addition, some economies have preemptively adopted a variety of macroprudential measures to address potential financial stability issues and/or discourage speculative inflows:

- Preventing asset price bubbles—setting maximum loan-to-value ratios, increased provisioning vis-à-vis real estate credit, and taking other measures specifically targeting the real estate market (Hong Kong SAR, India, Korea, Singapore).
- Tightening liquidity control and management—taking measures to prevent excessive volatility of capital flows (for example, a one-month holding period for central bank certificates for both resident and nonresident investors in Indonesia); raising required reserves for banks (India).
- Limiting banks' foreign exchange exposure—setting prudential limits on banks' forward open position limits and net open positions (Korea).
- Tightening financial supervision—tightening prudential limits on capital, liquidity, and leverage; enhanced stress testing; enhanced corporate governance (Hong Kong SAR, Singapore).
- Capital controls on inflows—preventing non-residents from opening short-term time deposit

#### Emerging Asia: Recent Experience with Capital Inflows<sup>1</sup>



Sources: CEIC Asia database; Haver Analytics; IMF, *International Financial Statistics*; and IMF staff calculations.

<sup>1</sup>Emerging Asia: China, Hong Kong SAR, India, Indonesia, Korea, Malaysia, Philippines, Singapore, Taiwan Province of China, and Thailand.

<sup>2</sup>Other investment includes financial derivatives.

- accounts (Taiwan Province of China); setting limits on external borrowing operations (India).
- Further liberalizing selected outflows (India, Malaysia, Thailand).

- Greater exchange rate flexibility can reinforce macroprudential measures. For example, two-way exchange rate flexibility can increase the perception of exchange rate risk and discourage speculative capital inflows. This is especially important for economies with excessive external surpluses, where relatively sizable appreciation—apart from narrowing the current account imbalance—would increase the perception of exchange rate risk and therefore deter speculative capital inflows.

- Other macroeconomic policy options include a more aggressive unwinding of fiscal stimulus or even tightening—if inflows are concentrated in government securities—to prevent vulnerability to a sudden turnaround in investor sentiment or a lowering of interest rates when inflation expectations are well grounded. However, given that the adoption of fiscal policies that improve the recipient economy's macro fundamentals could in fact result in stronger inflows to the private sector, such policies on their own would not



necessarily reduce the need for greater exchange rate flexibility.

- If the financial sector is healthy, restrictions on capital outflows can be eased to limit upward pressure on the currency and alleviate concerns about overvaluation or loss of external competitiveness. Furthermore, measures can be taken to free up restrictions in key growth sectors, which could help attract longer-term capital inflows (for example, FDI).

The best response to capital inflows may be a coordinated one, especially when they are driven by global factors or have global implications.<sup>7</sup> Thus, resistance to currency appreciation by one economy could discourage others because of competitiveness concerns. Alternatively, macroprudential measures by one economy could divert flows to others in the region. A potential ratchet effect could lead to reserve accumulation in emerging market economies—larger accumulation of reserves by one could induce further accumulation by others in the region if the level of reserves is perceived as a proxy for the credibility of a country's policy framework (see Cheung and Qian, 2009). International coordination could alleviate challenges of this nature.

Asia should also focus on various structural reforms to accomplish its medium-term rebalancing objectives. Specific policy options include implementing reforms to health care, education, and pension systems to enhance the social safety net (China); promoting investment by small and medium-size enterprises (Japan); improving the business climate (Philippines); increasing the productivity of the nontradables or services sector (China, Japan, Korea); facilitating further product and labor market flexibility and productivity (China, Malaysia, some NIEs, Philippines); lowering corporate saving by realigning relative prices for a range of inputs, including capital, land, water, and energy (China); and further financial sector development and capital market deepening (China, India, Philippines, Thailand).

<sup>7</sup>See also IMF (2010b).

Many economies have already embarked on such reforms. Apart from the recent resumption of a managed floating exchange rate regime in China, the government has launched a number of measures to enhance the social safety net (IMF, 2010c). In Korea, the government recently announced plans to further develop the service industry, including through streamlined regulation and greater competition. Singapore's recent budget contains measures to enhance labor productivity. However, the time needed for these measures to be effective, and the slower pace of adjustment in advanced economies (anticipated in light of the shorter-term economic challenges they face), suggest that the period over which global imbalances may eventually narrow will be protracted.

### **The U.S. Recovery Is Moderating in the Face of Debt and Continued Uncertainty**

The U.S. economy is recovering, thanks to unprecedented macroeconomic policy stimulus, emergency financial stabilization measures, and a modest cyclical upswing. But the rate of expansion is beginning to moderate. The economy grew at an annualized rate of 1.7 percent in the three months to June, a slower pace than the 3.7 percent growth rate posted in the first quarter. Moreover, high-frequency indicators suggest a weak recovery in coming quarters.

Much of the weakness of this recovery is due to sluggish personal consumption—by far the biggest component of U.S. GDP. There are several reasons for this weakness. First, household net worth has deteriorated sharply (Figure 2.4). House prices have fallen by 25 to 30 percent over the past three years (depending on which index is used), with the brunt of the adjustment falling on households that have the highest marginal propensity to consume. Second, unemployment is high: it is currently 9.6 percent of the workforce; a broader measure of unemployment (which takes into account those seeking full-time jobs but finding only part-time work) is 16.7 percent; and the median duration of unemployment, 20 weeks, is nearly twice the peak level of the previous 40



years. A weak labor market hits incomes and the ability to obtain credit, and it raises job uncertainty for those currently employed. Third, banks are still reluctant to lend to consumers, restricting credit for larger purchases, as they struggle to reduce leverage and restore balance sheets. Overall, given the unusually low savings levels before the crisis and the steep decline in personal net worth since, the desire to save is more likely to stay elevated relative to precrisis levels. The personal saving rate since the beginning of 2009 has averaged 6 percent—a level last seen in 1995—and is projected to remain at about 4 to 6 percent through 2015.

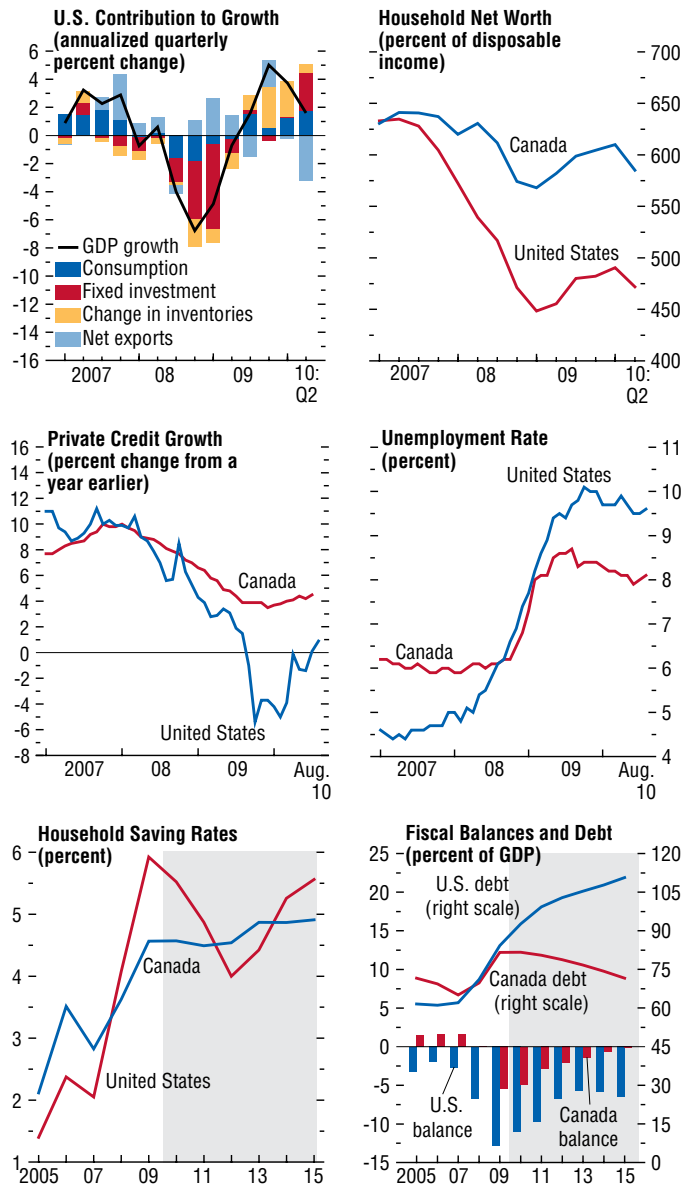
In contrast to private consumption, private investment in software and equipment has rebounded strongly. Firms have also increased productivity, and unit labor costs have declined sharply. In the near term, fixed investment is likely to be the principal driver of domestic demand as inventory accumulation slows. The current account deficit is projected to remain at about 3.3 percent of GDP over the medium term—much lower than during the years leading up to the crisis—because the recovery in investment will be financed by strong private saving and improving fiscal balances.

The most likely prospect for the U.S. economy is for a continued but slow recovery, with growth far weaker than in previous recoveries, considering the depth of the recession. GDP growth is projected to be 2.6 percent in 2010 and 2.3 percent in 2011 (Table 2.2; Figure 2.5). This implies that the gap between actual and potential output will remain wide, even though potential growth has itself suffered temporarily from the crisis. The unemployment rate is therefore expected to remain stubbornly high. Against this backdrop, inflation will remain low—it is projected to be 1.4 percent in 2010 and 1 percent in 2011.

Risks to the outlook remain elevated and are tilted to the downside. Residential and commercial real estate markets are still fragile. Further loan write-downs at small and medium-size banks could inhibit recovery of normal credit conditions. The sharp rise in government debt has increased vulnerability to financial market sentiment, although

**Figure 2.4. United States and Canada: Differing Fortunes**

The pace of recovery in the United States has moderated. Consumers face headwinds of high debt and fallen asset values; weak credit growth, despite extraordinarily loose monetary conditions; and persistently high unemployment. Personal saving rates will remain higher than precrisis levels for a sustained period, and public fiscal balances are projected to deteriorate further. By contrast, the Canadian economy is less hampered by the same factors and is set to recover more strongly.



Sources: Haver Analytics; and IMF staff estimates.

Treasury security yields have fallen significantly recently amid economic weakness, flight to quality, and expectations of additional government bond purchases by the Federal Reserve (Fed). Easing consumer price inflation, together with weak labor markets and relatively low consumption demand, points to a tail risk of deflation. On the upside, it is possible that business fixed investment could rebound faster from still-depressed levels.

Against this backdrop, U.S. authorities will need to find a way to exit from extraordinary policy intervention without undermining the fledgling recovery, while dealing with the long-term legacies of fiscal imbalances, gaps and overlaps in financial regulation, and a weakened banking sector.

- A key macroeconomic challenge is to ensure that the public debt is put on a sustainable path without jeopardizing the recovery. Under current policies, the general government deficit is projected to be about 10 percent of GDP in both 2010 and 2011, and gross general government debt will increase to about 110 percent of GDP by 2015. Given the risks posed by budgetary imbalances, the groundwork for fiscal consolidation must begin in 2011. The proposed fiscal tightening of about 1 percent of GDP in 2011 implied by the administration's mid-session review strikes the right balance between near-term support for the recovery and medium-term credibility. If downside risks to growth materialize, there is some room to reduce up-front adjustment while strengthening medium-term credibility. This could be achieved by further entitlement spending reforms, which would have little immediate impact on demand. However, the existing fiscal plans do not stabilize medium-term debt, which should be put firmly on a downward path to rebuild room for fiscal maneuver and avoid negative effects on lending rates and long-term growth. Hence, a clear commitment to additional consolidation measures under credible economic assumptions (by enshrining targets and/or measures in legislation, for example) would be desirable. In this context, the President's Fiscal Commission is expected to play a key role in fostering political consensus, including in difficult areas such as tax policy and entitlement spending.
- Monetary policy should remain accommodative because of muted inflation, subpar growth, and lingering financial strain. The Fed has maintained the policy rate at a record low while signaling that conditions are likely to warrant keeping the rate at exceptionally low levels for an extended period. In light of larger downside risks, the Fed's recent decision to resume its purchases of government securities (using resources from maturing government-sponsored-enterprise debt

**Table 2.2. Selected Advanced Economies: Real GDP, Consumer Prices, Current Account Balance, and Unemployment**

(Annual percent change, unless noted otherwise)

	Real GDP			Consumer Prices <sup>1</sup>			Current Account Balance <sup>2</sup>			Unemployment <sup>3</sup>		
	2009	Projections		2009	Projections		2009	Projections		2009	Projections	
	2009	2010	2011	2009	2010	2011	2009	2010	2011	2009	2010	2011
<b>Advanced Economies</b>	<b>-3.2</b>	<b>2.7</b>	<b>2.2</b>	<b>0.1</b>	<b>1.4</b>	<b>1.3</b>	<b>-0.3</b>	<b>-0.3</b>	<b>-0.1</b>	<b>8.0</b>	<b>8.3</b>	<b>8.2</b>
United States	-2.6	2.6	2.3	-0.3	1.4	1.0	-2.7	-3.2	-2.6	9.3	9.7	9.6
Euro Area <sup>4,5</sup>	-4.1	1.7	1.5	0.3	1.6	1.5	-0.6	0.2	0.5	9.4	10.1	10.0
Japan	-5.2	2.8	1.5	-1.4	-1.0	-0.3	2.8	3.1	2.3	5.1	5.1	5.0
United Kingdom <sup>4</sup>	-4.9	1.7	2.0	2.1	3.1	2.5	-1.1	-2.2	-2.0	7.5	7.9	7.4
Canada	-2.5	3.1	2.7	0.3	1.8	2.0	-2.8	-2.8	-2.7	8.3	8.0	7.5
Other Advanced Economies	-1.2	5.4	3.7	1.5	2.4	2.5	4.8	5.0	4.9	5.0	4.8	4.7
<i>Memorandum</i>												
Newly Industrialized Asian Economies	-0.9	7.8	4.5	1.3	2.6	2.7	8.5	7.1	6.9	4.3	3.8	3.7

<sup>1</sup>Movements in consumer prices are shown as annual averages. December–December changes can be found in Table A6 in the Statistical Appendix.

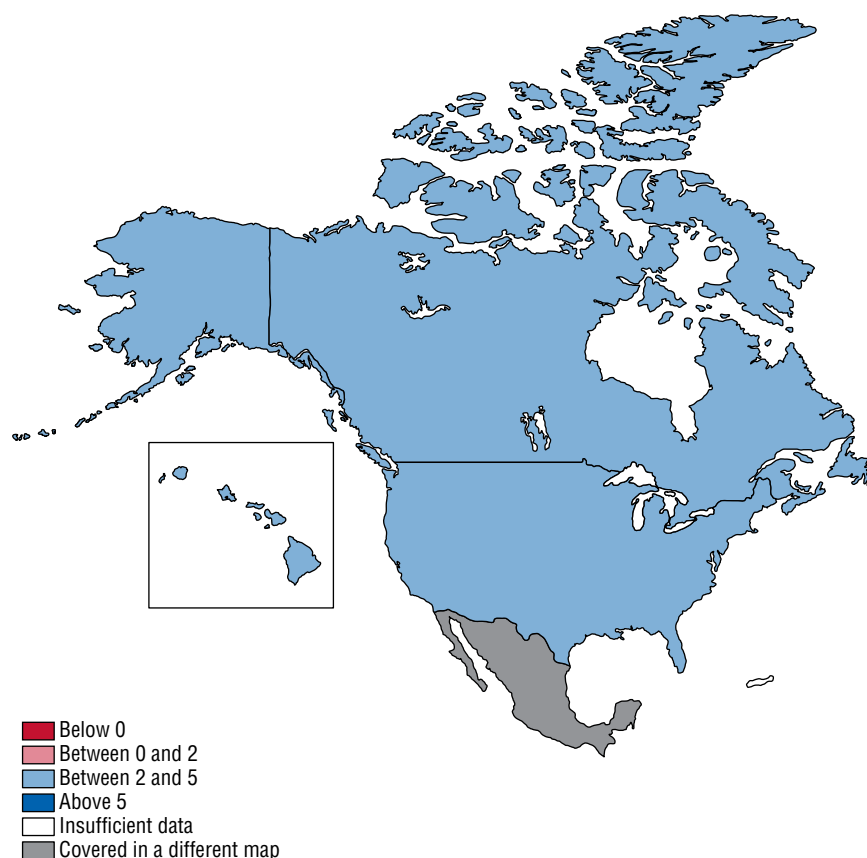
<sup>2</sup>Percent of GDP.

<sup>3</sup>Percent. National definitions of unemployment may vary.

<sup>4</sup>Based on Eurostat's harmonized index of consumer prices.

<sup>5</sup>Current account position corrected for reporting discrepancies in intra-area transactions.

**Figure 2.5. United States and Canada:  
Average Projected Real GDP Growth during 2010–11  
(Percent)**



Source: IMF staff estimates.

and mortgage-backed securities in its portfolio) is appropriate. In the event that such risks materialize, policy responses could include a strengthened commitment to maintaining the ultra-low policy rate for an extended period, expanding asset purchases, and relaunching facilities to aid stressed markets. Meanwhile, the Fed has been developing a well-diversified toolkit for managing monetary conditions, which will help facilitate monetary exit when needed.

- Notwithstanding considerable efforts to improve financial stability, the banking system remains vulnerable. Capital will probably need to be raised to meet higher regulatory requirements. The newly enacted Dodd-Frank Wall Street Reform and Consumer Protection Act expands

oversight of systemically important financial firms. It establishes a special resolution authority, with the aim of facilitating orderly intervention procedures for systemically important nonbank financial institutions. It increases regulation of over-the-counter derivatives markets and establishes the Bureau of Consumer Financial Protection. The legislation also authorizes the Financial Stability Oversight Council (FSOC), which encompasses all the major financial supervisory bodies at the federal level and is chaired by the Treasury secretary. The FSOC is authorized to (1) recommend higher prudential requirements; (2) designate financial firms, activities, or market utilities as systemically important; and (3) approve the breakup of large and complex

companies if financial stability is threatened.

However, the specifics will need to be worked out before it will be clear how the legislation will be implemented in practice, especially concerning the setting of new prudential norms, the cross-border implementation of resolution procedures, and the functioning of the FSOC.

Policy choices in the United States matter greatly for the rest of the world. The huge prospective funding requirements of the government may have implications for other economies. To the extent that 10-year Treasury bonds set a benchmark for other assets, market nervousness about the fiscal position of the United States could cause an international increase in interest rates. In addition, because of the U.S. dollar's role as a reserve currency and the importance of the United States as a financial center, policy inaction by the U.S. authorities would have far greater effects on other economies than that implied by trade linkages alone. Shocks to confidence in the United States could cause an international increase in bond and equity risk premiums.

The Canadian economy has been relatively buoyant. Household balance sheets are healthier than in the United States, and banks have very solid books. Monetary and fiscal stimulus and strong international demand for commodities helped boost the growth rate in the first quarter of this year to 5.8 percent, double that of the United States, with consumer spending especially robust. House prices held up relatively well during the crisis. The unemployment rate, at 8.1 percent, is well below that in the United States and has been declining steadily since early 2009. However, recent data indicate a moderation in growth, which nonetheless seems to remain above potential. Risks to the Canadian economy are mainly external. The economy is vulnerable to a dip in commodity prices, particularly for minerals and energy, and a slowdown in the U.S. economy, which buys about three-quarters of its exports.

Improving conditions have allowed policymakers in Canada to start unwinding policy stimulus. The Bank of Canada has already raised the overnight rate from 0.25 percent, where it had been since the crisis, to 1 percent as of September. The fiscal stimulus package has been implemented as sched-

uled. Should conditions worsen unexpectedly, fiscal policy would be able to respond—the Canadian fiscal deficit is projected to be 2.9 percent of GDP in 2011, with net public debt hovering around 33.5 percent of GDP.

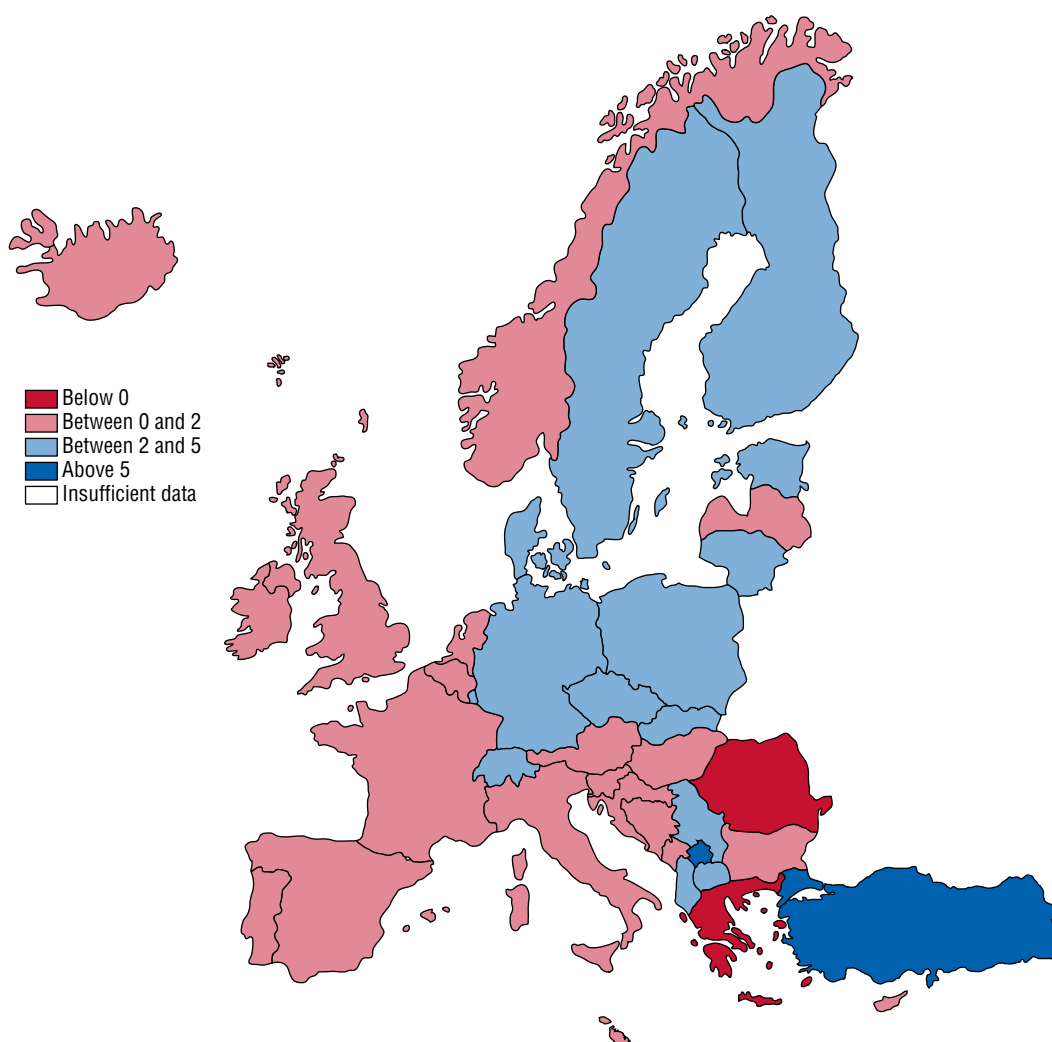
## Europe Is Facing a Gradual and Uneven Recovery

In Europe, the road to recovery has been bumpy. Largely caused by unsustainable policies in some member countries, the sovereign debt crisis in the spring erupted before the euro area's recovery could gain traction. The crisis spread internationally, threatening the financial system as well as regional and global recovery. A strong and far-reaching policy response contained the situation. Unprecedented liquidity and credit support, new European financing instruments, and substantial fiscal action in affected countries arrested the financial turmoil, moderating its adverse impact on Europe's economic activity.

The recovery has finally gained some vigor, but it is still likely to be moderate and uneven (Figures 2.6 and 2.7). Advanced Europe's GDP is projected to grow at 1.7 percent in 2010 and 1.6 percent in 2011 (Table 2.3). Emerging Europe's growth is expected to be 3.7 percent in 2010 and 3.1 percent in 2011. There are pronounced differences in economic prospects across the region, depending on the condition of public and private sector balance sheets and the extent to which macroeconomic policies can support the recovery.

- Despite robust manufacturing exports in recent months, moderate recovery is expected in Germany because weak growth is expected among its trading partners. In France, growth is projected to be modest, as private consumption is weakened by high unemployment and the withdrawal of stimulus measures. In Italy, the recovery is expected to be even more subdued, as a persistent competitiveness problem limits the scope for export growth, and planned fiscal consolidation weakens private demand. Constrained by fiscal and competitiveness imbalances, growth in Greece, Ireland, Portugal, and Spain is projected to be much lower. Outside the euro area, the

**Figure 2.6. Europe: Average Projected Real GDP Growth during 2010–11**  
(Percent)



Source: IMF staff estimates.

prospects for recovery are similarly diverse. In the United Kingdom, domestic demand is expected to remain relatively subdued, particularly following the recent measures to cut the budget deficit.

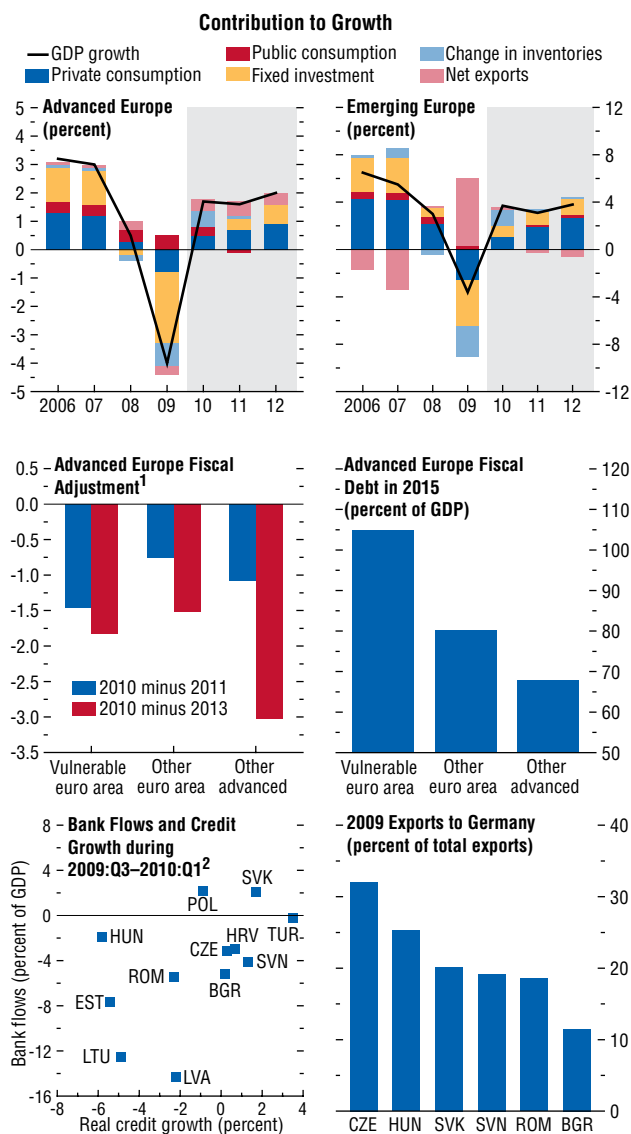
- In emerging Europe, growth in economies that experienced the mildest downturns (Poland), and others that faced the crisis with relatively strong household and bank balance sheets (Turkey), is projected to continue gaining strength, helped by the normalization of global trade and capital flows. However, those that had experienced unsustainable domestic booms (Bulgaria, Latvia)

or have vulnerable private or public sector balance sheets (Hungary, Romania) are expected to recover more slowly. These problems have tightly constrained the room for policy maneuver.

Risks to the outlook have become more balanced. Although downside risks continue to threaten Europe's recovery, some upside risks have recently emerged. The main upside risk comes from higher-than-expected real activity in Germany, which could lift growth in Europe more generally, given the country's substantial trade and production linkages. Nevertheless, downside risks still loom large. In the

**Figure 2.7. Europe: A Gradual and Uneven Recovery**

The recovery is gradually taking hold, but domestic demand is expected to remain sluggish, especially in advanced Europe. Fiscal consolidation plans across Europe are rightfully differentiated: economies facing market pressure or external financing constraints have larger and more front-loaded adjustments than those with more manageable debt dynamics. Economic prospects are closely connected via cross-border bank flows and trade linkages, especially with Germany.



Sources: Bank for International Settlements; Haver Analytics; IMF, *Direction of Trade Statistics*; and IMF staff estimates.  
<sup>1</sup>Change in structural balance in percent of potential GDP. Vulnerable euro area comprises Greece, Ireland, Italy, Portugal, and Spain. Other euro area comprises euro area economies excluding vulnerable euro area. Other advanced comprises advanced Europe excluding the euro area.  
<sup>2</sup>BGR: Bulgaria; CZE: Czech Republic; EST: Estonia; HRV: Croatia; HUN: Hungary; LTU: Lithuania; LVA: Latvia; POL: Poland; ROM: Romania; SVK: Slovak Republic; SVN: Slovenia; TUR: Turkey.

near term, as discussed in Chapter 1 of the GFSR, the potential for financial spillovers across sovereigns remains elevated in the euro area, particularly among peripheral economies. European banking systems are still heavily reliant on government support and are highly vulnerable to deterioration in the real economy, sovereign shocks, and funding strains. Hence, if unaddressed, renewed financial sector stress could spread—including to emerging Europe via trade and cross-border bank flows—and could have significant adverse effects on real activity. In the medium term, the main risk is that fiscal and competitiveness imbalances in peripheral economies and insufficient action to tackle weak banks could lead to a protracted period of subpar growth and occasional crises.

Against this backdrop, the overarching policy challenge is to use the window of opportunity afforded by the unprecedented policy support to address underlying problems through national and EU-level action.

Establishing public debt sustainability remains a top priority for many European economies. Across Europe, current fiscal consolidation plans are going in the right direction. They are rightfully differentiated—economies facing market pressure or severe external financing constraints (for example, Greece, Iceland, Ireland, Portugal, Spain) have larger and more front-loaded adjustments than others. Nevertheless, given the considerable near-term easing in Germany, the overall fiscal stance in the euro area will remain broadly neutral in 2010—as is appropriate, given the still-fragile recovery. Plans for medium-term fiscal adjustment, however, need to be strengthened considerably to deliver permanent savings in the face of looming age-related spending. Ambitious entitlement spending reforms would deliver large credibility gains at a lesser cost in terms of short-term growth; they would also forestall a need for more painful reforms in the future. Some economies have taken steps in that direction (for example, France, Italy), but more could be done. Key items will be raising the retirement age to reflect increased life expectancy, more efficient health care spending, and reform of social security funding that reduces distortions to the labor supply.

**Table 2.3. Selected European Economies: Real GDP, Consumer Prices, Current Account Balance, and Unemployment***(Annual percent change, unless noted otherwise)*

	Real GDP			Consumer Prices <sup>1</sup>			Current Account Balance <sup>2</sup>			Unemployment <sup>3</sup>		
	2009	Projections		2009	Projections		2009	Projections		2009	Projections	
		2010	2011		2010	2011		2010	2011		2010	2011
<b>Europe</b>	<b>-4.0</b>	<b>2.0</b>	<b>1.8</b>	<b>1.3</b>	<b>2.3</b>	<b>2.0</b>	<b>0.1</b>	<b>0.3</b>	<b>0.5</b>	...	...	...
<b>Advanced Europe</b>	<b>-4.1</b>	<b>1.7</b>	<b>1.6</b>	<b>0.7</b>	<b>1.8</b>	<b>1.6</b>	<b>0.3</b>	<b>0.8</b>	<b>1.0</b>	<b>8.8</b>	<b>9.4</b>	<b>9.3</b>
Euro Area <sup>4,5</sup>	-4.1	1.7	1.5	0.3	1.6	1.5	-0.6	0.2	0.5	9.4	10.1	10.0
Germany	-4.7	3.3	2.0	0.2	1.3	1.4	4.9	6.1	5.8	7.5	7.1	7.1
France	-2.5	1.6	1.6	0.1	1.6	1.6	-1.9	-1.8	-1.8	9.4	9.8	9.8
Italy	-5.0	1.0	1.0	0.8	1.6	1.7	-3.2	-2.9	-2.7	7.8	8.7	8.6
Spain	-3.7	-0.3	0.7	-0.2	1.5	1.1	-5.5	-5.2	-4.8	18.0	19.9	19.3
Netherlands	-3.9	1.8	1.7	1.0	1.3	1.1	5.4	5.7	6.8	3.5	4.2	4.4
Belgium	-2.7	1.6	1.7	0.0	2.0	1.9	0.3	0.5	1.8	7.7	8.7	8.5
Greece	-2.0	-4.0	-2.6	1.4	4.6	2.2	-11.2	-10.8	-7.7	9.4	11.8	14.6
Austria	-3.9	1.6	1.6	0.4	1.5	1.7	2.3	2.3	2.4	4.8	4.1	4.2
Portugal	-2.6	1.1	0.0	-0.9	0.9	1.2	-10.0	-10.0	-9.2	9.6	10.7	10.9
Finland	-8.0	2.4	2.0	1.6	1.4	1.8	1.3	1.4	1.6	8.3	8.8	8.7
Ireland	-7.6	-0.3	2.3	-1.7	-1.6	-0.5	-3.0	-2.7	-1.1	11.8	13.5	13.0
Slovak Republic	-4.7	4.1	4.3	0.9	0.7	1.9	-3.2	-1.4	-2.6	12.1	14.1	12.7
Slovenia	-7.8	0.8	2.4	0.9	1.5	2.3	-1.5	-0.7	-0.7	6.0	7.8	8.1
Luxembourg	-4.1	3.0	3.1	0.4	2.3	1.9	5.7	6.9	7.2	6.0	5.8	5.6
Cyprus	-1.7	0.4	1.8	0.2	2.2	2.3	-8.3	-7.9	-7.4	5.3	7.1	6.9
Malta	-2.1	1.7	1.7	1.8	1.9	2.1	-6.1	-5.4	-5.3	7.0	6.9	6.9
United Kingdom <sup>5</sup>	-4.9	1.7	2.0	2.1	3.1	2.5	-1.1	-2.2	-2.0	7.5	7.9	7.4
Sweden	-5.1	4.4	2.6	2.0	1.8	1.9	7.2	5.9	5.7	8.3	8.2	8.2
Switzerland	-1.9	2.9	1.7	-0.5	0.7	0.5	8.5	9.6	10.3	3.6	3.6	3.4
Czech Republic	-4.1	2.0	2.2	1.0	1.6	2.0	-1.1	-1.2	-0.6	6.7	8.3	8.0
Norway	-1.4	0.6	1.8	2.2	2.5	1.4	13.1	16.6	16.4	3.2	3.5	3.6
Denmark	-4.7	2.0	2.3	1.3	2.0	2.0	4.2	3.4	3.0	3.6	4.2	4.7
Iceland	-6.8	-3.0	3.0	12.0	5.9	3.5	-6.5	-0.9	2.1	8.0	8.6	8.4
<b>Emerging Europe<sup>6</sup></b>	<b>-3.6</b>	<b>3.7</b>	<b>3.1</b>	<b>4.7</b>	<b>5.2</b>	<b>4.1</b>	<b>-2.5</b>	<b>-3.7</b>	<b>-4.0</b>	...	...	...
Turkey	-4.7	7.8	3.6	6.3	8.7	5.7	-2.3	-5.2	-5.4	14.0	11.0	10.7
Poland	1.7	3.4	3.7	3.5	2.4	2.7	-1.7	-2.4	-2.6	8.2	9.8	9.2
Romania	-7.1	-1.9	1.5	5.6	5.9	5.2	-4.5	-5.1	-5.4	6.3	7.2	7.1
Hungary	-6.3	0.6	2.0	4.2	4.7	3.3	0.2	0.5	0.7	10.1	10.8	10.3
Bulgaria	-5.0	0.0	2.0	2.5	2.2	2.9	-9.5	-3.0	-3.1	6.8	8.3	7.6
Croatia	-5.8	-1.5	1.6	2.4	1.9	2.8	-5.3	-3.8	-4.7	9.2	9.5	9.0
Lithuania	-14.8	1.3	3.1	4.2	1.0	1.3	4.2	1.9	0.2	13.7	18.0	16.0
Latvia	-18.0	-1.0	3.3	3.3	-1.4	0.9	8.6	5.5	2.9	17.3	19.8	17.5
Estonia	-13.9	1.8	3.5	-0.1	2.5	2.0	4.5	4.2	3.4	13.8	17.5	16.4

<sup>1</sup>Movements in consumer prices are shown as annual averages. December–December changes can be found in Tables A6 and A7 in the Statistical Appendix.<sup>2</sup>Percent of GDP.<sup>3</sup>Percent. National definitions of unemployment may vary.<sup>4</sup>Current account position corrected for reporting discrepancies in intra-area transactions.<sup>5</sup>Based on Eurostat's harmonized index of consumer prices.<sup>6</sup>Includes Albania, Bosnia and Herzegovina, Kosovo, former Yugoslav Republic of Macedonia, and Serbia.

Monetary policy should remain very supportive for the foreseeable future in most European economies. In advanced Europe, inflation remains low because output gaps are large, and inflation expectations are well anchored. Core inflation is projected to remain at about 1½ percent in the euro area. Thus, in the euro area, it is appropriate to keep interest rates exceptionally low, and, given

continued financial strain, to very gradually unwind nonstandard support measures and collateral-requirement changes. This will help support the recovery by dampening the adverse short-term effects of fiscal consolidation on domestic demand. If downside risks to growth materialize, central banks in advanced Europe may need to again rely more strongly on their balance sheets to further ease



monetary conditions. In emerging Europe, inflation prospects are a bit mixed—reflecting different exchange rate regimes and varying degrees of economic slack—but are generally contained. In some economies, value-added tax hikes are likely to temporarily drive up inflation (for example, Poland, Romania).

The resilience of Europe's financial sector must be improved and its stability secured. Resolving banking sector issues is essential to spur lending, which is very important to firms' external funding. As discussed in the October 2010 GFSR, however, European banks continue to face challenges. These include heavy reliance on European Central Bank financing facilities—or on government support—and large exposure to risky sovereign debt. The stress tests conducted by the Committee of European Banking Supervisors have been helpful in improving disclosure regarding banks' condition. These tests also provide a useful guide to the need to recapitalize, restructure, or resolve vulnerable banks. In this respect, some economies (for example, Ireland, Spain) have made more progress than others (for example, Germany) in tackling weak banks. Nonetheless, as discussed in the GFSR, an adverse funding scenario could have a significant impact on the European banking system. To cope with the looming wall of maturing bank debt, some blanket financial support measures may need to be extended, but not at the cost of postponing much-needed restructuring. Meanwhile, it will be important to resolve uncertainty about regulatory reforms, which would help increase banks' willingness to supply credit and support the recovery. Invigorating credit is also a challenge in emerging Europe, particularly given the deterioration in bank credit portfolios during the crisis.

Another crucial task ahead is the reform of EU policy frameworks. The cross-border dimension of many issues argues for a stronger role at the EU level. The crisis exposed long-standing problems in existing fiscal, structural, and financial stability policies. Such weaknesses need to be addressed in order to ensure Europe's future stability and growth.

A key challenge is the future of fiscal surveillance and sovereign crisis management. An arrangement along the lines of the European Stabilization Mech-

anism (ESM) is likely to prove useful, but sharing fiscal burdens implies a need for shared responsibility for fiscal policy. This principle was recognized with the adoption of the Stability and Growth Pact. However, economies failed to live up to its letter and spirit by not adjusting sufficiently during good times. Thus, the Pact needs to be strengthened to feature better incentives for preventing and resolving fiscal imbalances. It needs to encourage the building up of sufficient buffers in good times, establish credible procedures for the enforcement of the common fiscal rules, and beef up centralized crisis management capabilities—a gap now temporarily filled by the ESM and the larger European Financial Stability Facility, the latter designed specifically for euro area members.

In addition, the crisis has shown how financial sector problems in specific countries can very quickly have pan-European consequences. Differences in prudential policies and practices across countries encourage complex business structures, regulatory arbitrage, and rent seeking, with deleterious consequences for Europe's financial stability. Supervisory or regulatory gaps have major spillovers. Hence, joint accountability and responsibility for Europe's common good of "financial stability"—in the form of an integrated European financial stability framework—are urgently needed. Such a framework needs to be built on two pillars: (1) integrated crisis management and resolution—for example, through a European resolution authority—and (2) integrated supervision, to make burden sharing acceptable. Both are necessary to achieve a fully integrated, efficient, and stable market for financial services. Steps in this direction are being taken—for instance, the establishment of the European Systemic Risk Board and discussions about a more integrated resolution framework. Nevertheless, considering the devastating consequences of the crisis and the magnitude of the challenge, progress is still very slow, hampered by narrow national interests.

Last, a better structural policy framework is also necessary to help improve competitiveness, address macroeconomic imbalances, and boost growth.

The current policy agenda (Europe 2020) could be improved in several ways. Specifically, surveil-

lance over structural bottlenecks, competitiveness, and imbalances needs to become more binding. It should also consider the fiscal and financial policy challenges facing countries. To speed the process of reform, priority should be given to a narrow range of strategic objectives that have major cross-border implications. For instance, most Mediterranean economies need to address labor market segmentation, inadequate wage flexibility, and skill mismatches; upgrade education systems; and foster capital deepening and innovation. In addition, reform to bankruptcy proceedings in these economies will help facilitate firm turnover and entrepreneurship. For all EU economies, further liberalization of product and service markets under the Single Market program will strengthen the employment effects of labor market reform.

### Latin America Is Sustaining Its Growth Momentum

The LAC region is exiting the global crisis at a faster pace than anticipated (Figures 2.8 and 2.9). This reflects solid macroeconomic policy fundamentals, sizable policy support, favorable external financing conditions, and strong commodity revenues. Robust commodity export revenues have boosted domestic income, which along with easy financing conditions has supported domestic demand. For many of these economies, the potential negative effect from subdued demand for imports by the advanced economies will be manageable, given lower reliance on external trade<sup>8</sup> and greater dependence on commodity exports, for which external demand is projected to remain robust (see Chapter 1, Appendix 1.1). However, Mexico, with its deep real and financial links to the U.S. economy, and the commodity-importing Central American and Caribbean regions, with their dependence on tourism and remittance flows from the United States, will be more vulnerable than others to weak U.S. economic conditions.

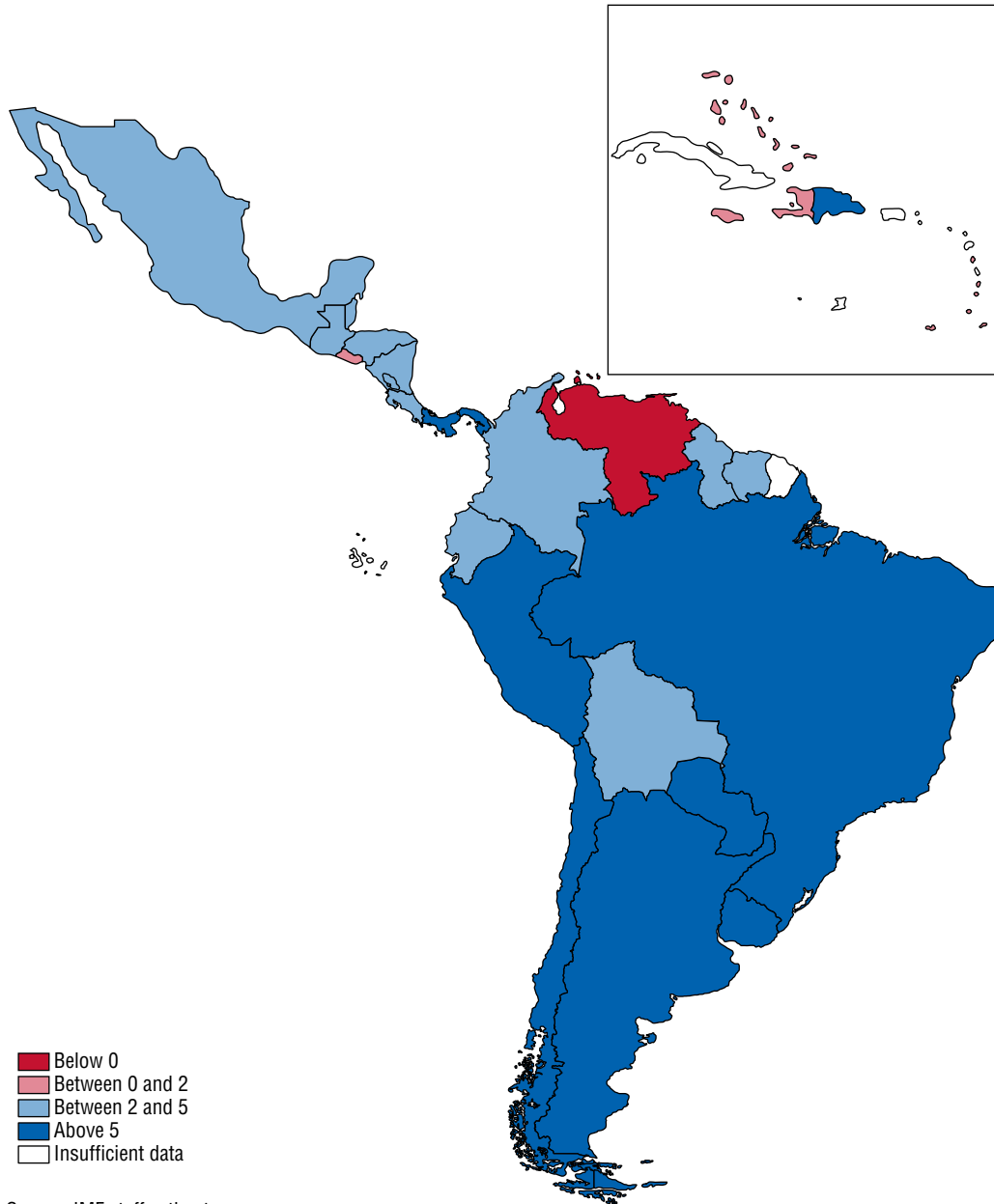
<sup>8</sup>For instance, the share of exports plus imports in total GDP—a very rough measure of openness—averaged less than 50 percent in the LA-5 (Brazil, Chile, Colombia, Mexico, Peru) in the past five years (compared with more than 125 percent for the ASEAN economies).

Growth in the region is projected to average 5.7 percent in 2010 and 4 percent in 2011 (Table 2.4). Risks to the outlook emerge from both external and domestic factors. External risks are tilted to the downside, reflecting mainly a worse-than-anticipated recovery in advanced economies, with its negative spillovers on commodity prices. An additional contagion channel arises from the large presence of foreign banks in Latin America, although the fact that these banks have relied primarily on subsidiaries funded by local deposits rather than cross-border flows mitigates the risk. On the other side, there are also risks of overheating, particularly if unwinding of earlier stimulus takes longer than currently anticipated (see below).

Prospects within the LAC region are quite diverse given the varying strength of macroeconomic policy frameworks, the role of domestic demand, and different degrees of exposure to spillovers from global trade and financial markets:

- Impressive improvements in macroeconomic policy frameworks over the past two decades, combined with accommodative policies, easy external financing conditions, and strong commodity prices, are driving a robust recovery in the LA-4 (Brazil, Chile, Colombia, Peru). Despite the expected dynamism in domestic demand, current account balances are projected to deteriorate only marginally in 2010 and 2011. High commodity prices and continued vitality in Asia are expected to sustain exports. Similarly, Uruguay, which has made substantial progress in macroeconomic policy management and faces a favorable external environment, is expected to experience strong growth dynamics in 2010–11.
- Mexico is also staging a steady recovery, despite the 2009 hard landing and the drag from the U.S. economy. As in the LA-4, recovery has been underpinned by strong policy frameworks in the run-up to the crisis. However, Mexico's outlook arguably faces larger downside risks than that of the LA-4. A weaker-than-projected recovery in the U.S. economy would have important implications for Mexico. Furthermore, with more than 80 percent of domestic financial system assets owned by systemic global banks, substantially higher capital charges arising from global

**Figure 2.8. Latin America and the Caribbean:  
Average Projected Real GDP Growth during 2010–11  
(Percent)**



Source: IMF staff estimates.

financial sector regulatory reform could affect the availability of credit for the private sector in Mexico.

- The outlook for the rest of the LAC region is somewhat mixed. Overall, the commodity

exporters will continue to benefit from the strength in their terms of trade, growing links with China, and strong intraregional linkages. Thus, Argentina and Paraguay are set to experience high growth, supported in large part

by strong trade ties vis-à-vis Brazil and a sharp rebound in agricultural production following last year's severe drought. Conversely, despite high oil prices, Ecuador's recovery will be muted given supply-side constraints. Venezuela's recession will continue in 2010, reflecting severe supply bottlenecks, challenges from capital flight, and generally weak policy frameworks. Growth in most of the Caribbean countries will be subdued amid weak prospects for tourism and remittances and limited room for policy support in light of chronic public debt burdens.<sup>9</sup>

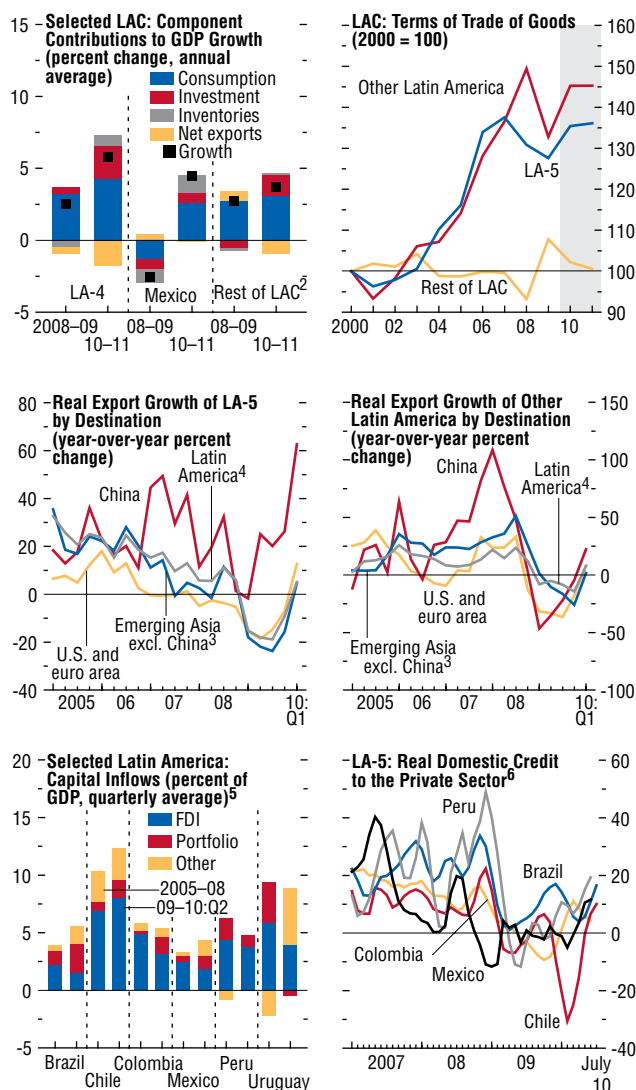
LAC economies need to establish policies to achieve strong and sustainable growth like Asia. However, unlike Asia, medium-term policy priorities are not driven by rebalancing more toward domestic demand (given relatively low reliance on external trade, although the tourism-dependent Caribbean countries are notable exceptions) but rather by a need to ensure that strong growth does not give rise to balance sheet vulnerabilities in the private or public sector. Macroeconomic and prudential policies will need to be designed to ensure that the recovery becomes well entrenched and at the same time to contain the risks of overheating and the buildup of fiscal and financial sector risks.

Thus, the priority for the region is now to use the window provided by the cyclical upswing to start unwinding stimulus, regain room for policy maneuver, and sustain its relatively recent track record of strong macroeconomic policy management. In many economies the policy mix should favor early withdrawal of the fiscal stimulus, while allowing the withdrawal of monetary stimulus to proceed at a slower pace. Fiscal tightening will help address risks of inflation pressure (Peru, Uruguay) and exchange rate overvaluation (Brazil), reduce the generally high public debt and associated vulnerability, and provide a cushion for future contingencies. Moreover, given policy challenges arising from strong and persistent capital inflows

<sup>9</sup>See the October 2010 *Regional Economic Outlook: Western Hemisphere* for a more detailed discussion of the challenges and prospects in the rest of the LAC region.

## Figure 2.9. Latin America and the Caribbean (LAC): Advancing with Strength<sup>1</sup>

A proactive crisis response and favorable terms of trade have driven Latin America's speedy recovery. Commodity exporters are also benefiting from increasing demand from emerging Asia, particularly China. Capital inflows have picked up sharply in some economies. Although inflows have boosted the equities market, the recovery in private credit has remained sluggish.



Sources: CEIC EMED database; Haver Analytics; IMF, *Balance of Payments Statistics*; IMF, *Direction of Trade Statistics*; and IMF staff estimates.

<sup>1</sup>LA-4: Brazil, Chile, Colombia, and Peru; LA-5: LA-4 and Mexico; Other Latin America: Argentina, Bolivia, Ecuador, Paraguay, Uruguay, and Venezuela.

<sup>2</sup>Rest of LAC in this panel excludes Antigua and Barbuda, Dominica, Grenada, Guyana, Jamaica, St. Kitts and Nevis, St. Lucia, and St. Vincent and the Grenadines due to lack of data on GDP components.

<sup>3</sup>Emerging Asia: ASEAN-5, China, India, and NIEs. See Figure 2.3 for list of NIEs and ASEAN-5.

<sup>4</sup>Latin America: LA-5 and Other Latin America (see footnote 1).

<sup>5</sup>Data for Peru only up to 2009:Q4. Data for Colombia and Uruguay only up to 2010:Q1. FDI = foreign direct investment. Other investment includes financial derivatives.

<sup>6</sup>Annualized percent change of three-month moving average over previous three-month moving average.

**Table 2.4. Selected Western Hemisphere Economies: Real GDP, Consumer Prices, Current Account Balance, and Unemployment***(Annual percent change, unless noted otherwise)*

	Real GDP			Consumer Prices <sup>1</sup>			Current Account Balance <sup>2</sup>			Unemployment <sup>3</sup>		
	2009	Projections		2009	Projections		2009	Projections		2009	Projections	
		2010	2011		2010	2011		2010	2011		2010	2011
<b>North America</b>	<b>-3.0</b>	<b>2.9</b>	<b>2.5</b>	<b>0.2</b>	<b>1.7</b>	<b>1.2</b>	<b>-2.6</b>	<b>-3.0</b>	<b>-2.6</b>	...	...	...
United States	-2.6	2.6	2.3	-0.3	1.4	1.0	-2.7	-3.2	-2.6	9.3	9.7	9.6
Canada	-2.5	3.1	2.7	0.3	1.8	2.0	-2.8	-2.8	-2.7	8.3	8.0	7.5
Mexico	-6.5	5.0	3.9	5.3	4.2	3.2	-0.6	-1.2	-1.4	5.5	5.0	4.5
<b>South America</b>	<b>-0.2</b>	<b>6.3</b>	<b>4.1</b>	<b>6.4</b>	<b>6.8</b>	<b>6.9</b>	<b>-0.3</b>	<b>-1.0</b>	<b>-1.4</b>	...	...	...
Brazil	-0.2	7.5	4.1	4.9	5.0	4.6	-1.5	-2.6	-3.0	8.1	7.2	7.5
Argentina <sup>4</sup>	0.9	7.5	4.0	6.3	10.6	10.6	2.0	1.7	1.2	8.4	8.0	8.6
Colombia	0.8	4.7	4.6	4.2	2.4	2.6	-2.2	-2.7	-2.8	12.0	12.0	11.5
Venezuela	-3.3	-1.3	0.5	27.1	29.2	32.2	2.6	7.8	8.2	7.9	8.6	8.1
Peru	0.9	8.3	6.0	2.9	1.7	2.5	0.2	-1.3	-2.2	8.6	8.0	7.5
Chile	-1.5	5.0	6.0	1.7	1.7	3.0	2.6	-0.7	-2.0	9.6	9.0	8.7
Ecuador	0.4	2.9	2.3	5.2	4.0	3.5	-0.7	-0.8	-1.6	8.5	8.6	8.5
Bolivia	3.4	4.0	4.5	3.3	1.7	4.1	4.6	6.5	5.2	...	...	...
Uruguay	2.9	8.5	5.0	7.1	6.5	6.4	0.7	-0.1	-0.7	7.3	7.0	6.9
Paraguay	-3.8	9.0	5.0	2.6	4.6	5.2	-1.0	-1.2	-1.6	5.6	5.3	5.2
<b>Central America<sup>5</sup></b>	<b>-0.5</b>	<b>3.1</b>	<b>3.7</b>	<b>3.8</b>	<b>3.9</b>	<b>4.1</b>	<b>-1.8</b>	<b>-5.1</b>	<b>-5.5</b>	...	...	...
<b>The Caribbean<sup>6</sup></b>	<b>0.4</b>	<b>2.4</b>	<b>4.3</b>	<b>3.5</b>	<b>7.2</b>	<b>5.5</b>	<b>-4.2</b>	<b>-3.0</b>	<b>-2.9</b>	...	...	...
<i>Memorandum</i>												
Latin America and the Caribbean <sup>7</sup>	-1.7	5.7	4.0	6.0	6.1	5.8	-0.6	-1.2	-1.6	...	...	...

<sup>1</sup>Movements in consumer prices are shown as annual averages. December–December changes can be found in Tables A6 and A7 in the Statistical Appendix.<sup>2</sup>Percent of GDP.<sup>3</sup>Percent. National definitions of unemployment may vary.<sup>4</sup>Private analysts estimate that consumer price index inflation has been considerably higher. The authorities have created a board of academic advisors to assess these issues. Private analysts are also of the view that real GDP growth has been significantly lower than the official reports since the last quarter of 2008.<sup>5</sup>Central America comprises Costa Rica, El Salvador, Guatemala, Honduras, Nicaragua, and Panama.<sup>6</sup>The Caribbean comprises Antigua and Barbuda, The Bahamas, Barbados, Belize, Dominica, Dominican Republic, Grenada, Guyana, Haiti, Jamaica, St. Kitts and Nevis, St. Lucia, St. Vincent and the Grenadines, Suriname, and Trinidad and Tobago.<sup>7</sup>Comprises Mexico and economies from the Caribbean, Central America, and South America.

in some economies, fiscal tools are likely better options to deal with overheating pressures than monetary tools. However, in Chile, fiscal stimulus can be withdrawn only gradually in the context of earthquake-related reconstruction spending, and so tighter monetary conditions may be needed to rein in inflation. For the rest of Latin America as well, it is also critical to use the cyclical upswing to rebuild fiscal room and avoid procyclical policies. However, the pace of stimulus withdrawal could be slowed if downside risks to growth were to materialize, especially for countries with available policy room.

With respect to the approach to capital inflows, the focus among the LA-5 (LA-4 plus Mexico) has appropriately been to deepen capital markets and improve the supervisory and regulatory framework to enable absorption of capital inflows without endangering financial stability. Other priorities for

the region include structural reforms to improve the investment climate, which would attract stable FDI inflows and improve external competitiveness (for example, streamlining business regulations, upgrading infrastructure, labor and product market reforms). However, these reforms will take time to implement. In the meantime, economies have begun to use a combination of macroeconomic and macroprudential measures to address the challenges posed by capital inflows (Box 2.2). Regarding the use of capital controls, preliminary indications are that they may have helped somewhat in changing the composition of inflows but not the volume (see the April and October 2010 issues of the GFSR). In this context, the possible use of capital controls should be supported by other measures—for example, continued two-way exchange rate flexibility to discourage speculative inflows, fiscal consolidation (where public debt is high and private sector

## Box 2.2. Latin America-5: Riding Another Wave of Capital Inflows

After a brief hiatus during the height of the global crisis in 2008, the LA-5 economies are experiencing a resurgence in capital inflows (figure). Strong capital inflows have been a mixed blessing. On the one hand, they have provided cheap and readily available financing to boost domestic demand. On the other hand, these flows have increased concern about domestic overheating, external competitiveness (given considerable currency appreciation in the context of exchange rates that are mostly at or above their medium-term values), increased sterilization costs (with sizable interest rate differentials vis-à-vis external rates), and heightened risks of a potential boom-bust cycle—problems this region has confronted in the past. The situation today raises fewer financial stability concerns because domestic credit is staging a relatively slow recovery. However, capital inflows have induced booms in many equity markets, and concerns about asset price bubbles have been growing.

Against this backdrop, country authorities have responded by adopting a number of measures to safeguard financial sector stability, eliminate asset price bubbles, and discourage inflows:

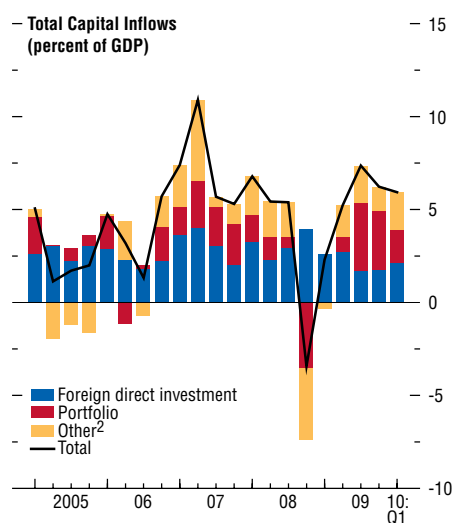
- Financial sector supervision—all the LA-5 countries are at various stages of further enhancing financial sector regulatory standards for capital adequacy, liquidity, and asset quality.
- Tighter liquidity control and management—required reserves for banks have been raised (Brazil).
- Capital controls on inflows—These include a direct tax on fixed income and equity inflows (reintroduced in October 2009 by Brazil after a brief break) and minimum-stay rules for FDI

recovery entrenched), and enhanced financial sector monitoring and supervision.

### The CIS Region Is Experiencing a Modest Recovery

The recovery in the CIS region has been supported by high commodity prices, normalizing trade and capital flows, accommodative policies, and positive regional spillovers (Figures 2.10 and 2.11). The

### LA-5: Handling the Capital Inflows Bonanza<sup>1</sup>



Sources: CEIC EMED database; Haver Analytics; IMF, *Balance of Payments Statistics*; and IMF staff calculations.

<sup>1</sup>LA-5: Brazil, Chile, Colombia, Mexico, and Peru. Data for Peru only up to 2009:Q4.

<sup>2</sup>Other investment includes financial derivatives.

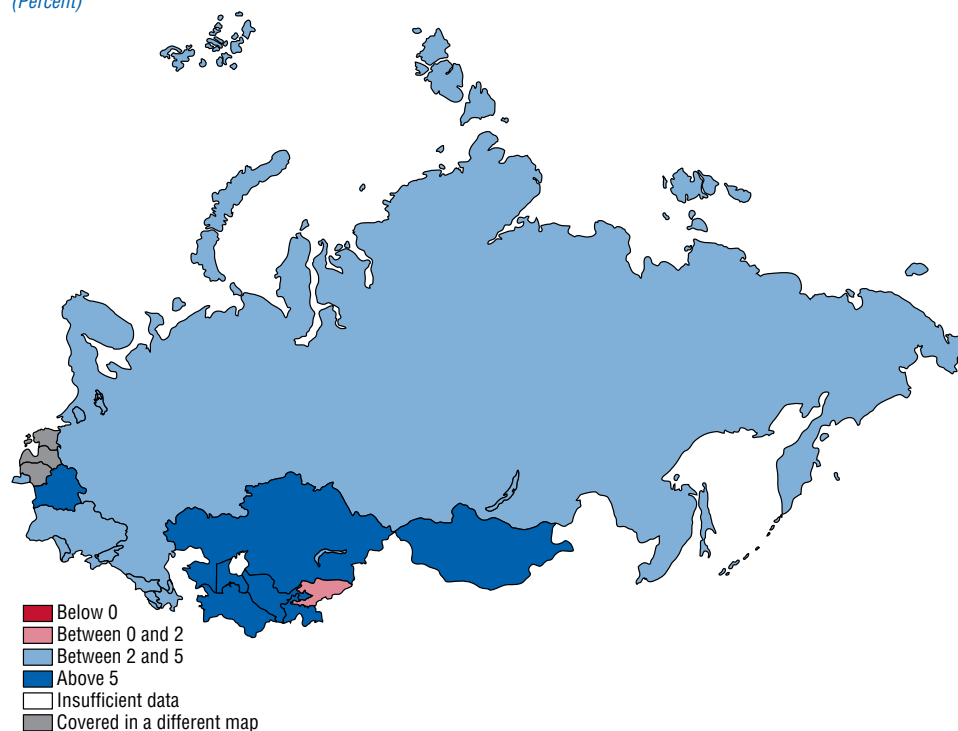
(implemented by Colombia before the crisis but removed in October 2008).

- Prudential capital controls—these include unremunerated reserve requirements on foreign borrowing (maintained by Colombia from before the crisis but currently zero rated) and higher reserve requirements on short-term (less than two years) external loans (Peru).
- Further liberalization of selected outflows—Chile, Colombia, Peru.

region is benefiting from Russia's gradual recuperation. Some economies in the region have already experienced an increase in remittances from Russia.<sup>10</sup>

<sup>10</sup>Alturki, Espinosa-Bowen, and Ilahi (2009) find that Russia appears to influence regional growth mainly through the remittance channel. In particular, a 10 percentage point increase in growth of remittances from Russia is associated with a 0.3 percentage point GDP increase in growth in the CIS countries, with a 0.4 percentage point increase in oil-importing CIS countries' growth.

**Figure 2.10. Commonwealth of Independent States:  
Average Projected Real GDP Growth during 2010–11<sup>1</sup>**  
(Percent)



Source: IMF staff estimates.

<sup>1</sup>Includes Georgia and Mongolia.

Real activity for the CIS region is expected to grow at 4.3 percent in 2010 and 4.6 percent in 2011 (Table 2.5). As in other regions, prospects vary considerably. Exposure to commodity prices, the degree of integration with global financial markets, the extent of policy support, and links to Russia are factors that differ importantly across economies.

- In Russia, despite relatively high oil prices, the near-term outlook is for a modest recovery. Output growth is projected to reach 4 percent in 2010 and 4.3 percent in 2011. Although the current heat wave and related wildfires could detract from near-term growth, and the ongoing rebound still depends on policy support, a self-sustained consumption-led recovery should gradually take hold. The adjustment of bank balance sheets appears to have run its course, and banks seem poised to cautiously expand lending.

Gradually rising real wages and lower unemployment should support consumption.

- High commodity prices also benefit other energy exporters in the region. Large-scale investment and higher volumes of gas exports are projected to boost growth in Turkmenistan to 9.4 percent in 2010 and 11.5 percent in 2011. In Uzbekistan, real activity is expected to expand by 8 percent in 2010 and 7 percent in 2011. Kazakhstan is set for a slower recovery, due to lingering problems in its financial system.
- For energy importers as a group, growth is projected to pick up to 4.6 percent in 2010 and 5 percent in 2011, reflecting the global recovery and financial stability (for example, Ukraine). Some of these economies (for example, Armenia, Moldova, Tajikistan) will benefit from the rebound in remittances from Russia.



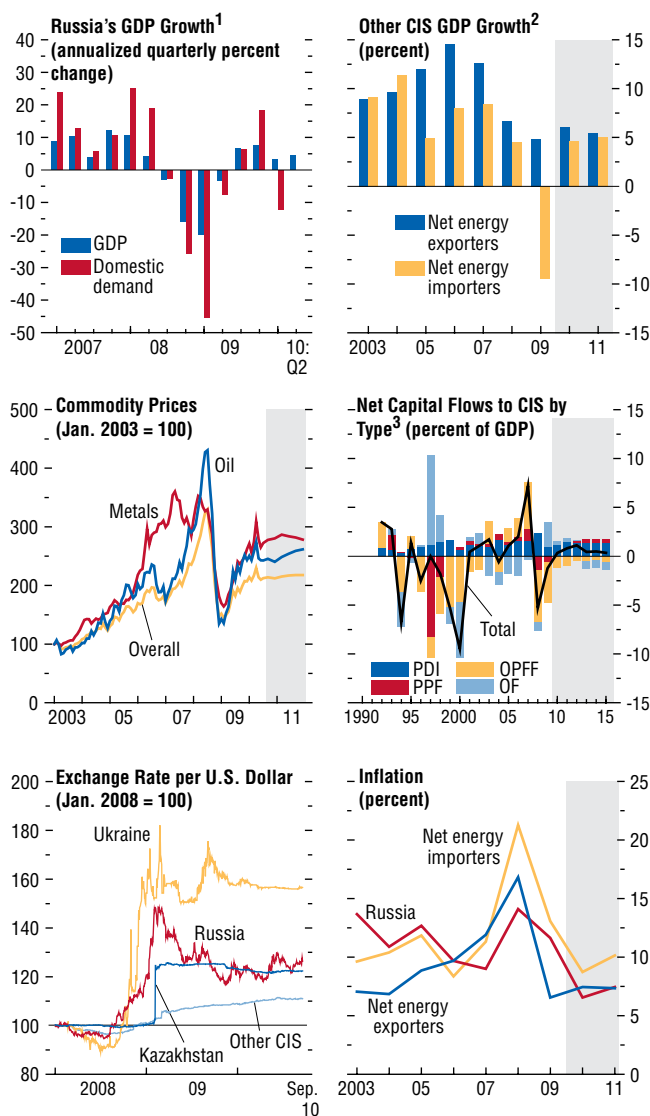
Overall, near-term risks to growth in the region are broadly balanced. On the upside, more favorable external developments—particularly higher commodity prices and a renewal of capital inflows—or a more rapid recovery in credit could push growth higher. The recently launched customs union among Belarus, Kazakhstan, and Russia could enhance trade and provide an additional boost to growth within the union. On the downside, external shocks—adverse changes in commodity prices or a shock to investor confidence—present the key downside risks. With some exceptions (for example, Kazakhstan), foreign banks have a minor role in CIS economies. At the same time, the region—and Russia in particular—continues to be very vulnerable to volatility in capital flows and global risk appetite. For instance, the euro area crisis in May led to a fresh bout of volatility in Russian stock markets and renewed downward pressure on the ruble. A worse-than-expected growth outcome in Russia would have second-round effects throughout the region, mainly through remittances and trade.

The fiscal challenges vary across the region. In Russia, the task is to ensure that the large fiscal stimulus (about 9 percent of GDP) is unwound as the global economy gathers strength—in this regard, a key concern is that some three-quarters of the fiscal package entailed permanent measures (for example, higher pension outlays). Given the composition of government spending, reversing the fiscal stimulus will be difficult without undertaking significant public sector reforms that allow savings in socially sensitive areas such as health care, social protection, and pensions. Energy importers in the region have limited fiscal room and are mostly aiming for a neutral fiscal stance or modest fiscal adjustment in 2010.

Most economies in the region operate under pegged or heavily managed exchange rate regimes, which deprive them of one means of adjusting to shocks. In this respect, the recent greater exchange rate flexibility in Russia is welcome. So far, the more flexible exchange rate regime, alongside cuts in policy interest rates, has helped deter speculative capital inflows. But the focus now should be on inflation control, and the monetary easing cycle has been appropriately paused. In Kazakhstan, the economy

## Figure 2.11. Commonwealth of Independent States (CIS): A Modest Recovery

The recovery in the CIS region is gaining traction, supported by high commodity prices, normalizing trade and capital flows, accommodative policies, and positive spillovers from Russia. Amid a more favorable external environment, capital flows are expected to pick up, but to lower levels than before the crisis. In Russia, the more flexible exchange rate regime, alongside cuts in policy interest rates, has helped deter speculative capital inflows. But the focus now should be on inflation control.



Sources: Haver Analytics; IHS Global Insight; IMF Primary Commodity Price System; and IMF staff estimates.

<sup>1</sup>Domestic demand data available only through 2010:Q1.

<sup>2</sup>Net energy exporters include Azerbaijan, Kazakhstan, Turkmenistan, and Uzbekistan. Net energy importers include Armenia, Belarus, Georgia, Kyrgyz Republic, Moldova, Mongolia, Tajikistan, and Ukraine.

<sup>3</sup>OF: official flows; OPFF: other private financial flows; PDI: private direct investment; PPF: private portfolio investment.

**Table 2.5. Commonwealth of Independent States: Real GDP, Consumer Prices, Current Account Balance, and Unemployment***(Annual percent change, unless noted otherwise)*

	Real GDP			Consumer Prices <sup>1</sup>			Current Account Balance <sup>2</sup>			Unemployment <sup>3</sup>		
	2009	Projections		2009	Projections		2009	Projections		2009	Projections	
	2009	2010	2011	2009	2010	2011	2009	2010	2011	2009	2010	2011
<b>Commonwealth of Independent States (CIS)<sup>4</sup></b>	<b>-6.5</b>	<b>4.3</b>	<b>4.6</b>	<b>11.2</b>	<b>7.0</b>	<b>7.9</b>	<b>2.6</b>	<b>3.8</b>	<b>3.0</b>	...	...	...
Russia	-7.9	4.0	4.3	11.7	6.6	7.4	4.0	4.7	3.7	8.4	7.5	7.3
Ukraine	-15.1	3.7	4.5	15.9	9.8	10.8	-1.5	-0.4	-1.3	8.8	8.8	7.7
Kazakhstan	1.2	5.4	5.1	7.3	7.6	6.6	-3.2	3.2	2.0	8.0	7.8	7.6
Belarus	0.2	7.2	6.2	13.0	7.3	10.8	-13.1	-14.0	-13.9	0.9	0.9	0.9
Azerbaijan	9.3	4.3	1.8	1.5	5.5	6.0	23.6	24.1	22.2	6.0	6.0	6.0
Turkmenistan	6.1	9.4	11.5	-2.7	3.9	4.8	-16.1	-4.7	3.4	...	...	...
Mongolia	-1.6	8.5	7.0	6.3	10.5	8.9	-9.8	-13.9	-22.9	11.6	3.0	3.0
<b>Low-Income CIS</b>	<b>4.8</b>	<b>5.3</b>	<b>4.5</b>	<b>6.2</b>	<b>7.6</b>	<b>8.1</b>	<b>7.1</b>	<b>8.2</b>	<b>8.4</b>	...	...	...
Uzbekistan	8.1	8.0	7.0	14.1	10.6	11.4	2.7	3.8	6.3	0.2	0.2	0.2
Georgia	-3.9	5.5	4.0	1.7	6.4	7.4	-11.7	-12.0	-12.5	16.9	16.8	16.7
Armenia	-14.2	4.0	4.6	3.5	7.8	5.5	-16.0	-14.6	-12.6	6.8	7.0	7.0
Tajikistan	3.4	5.5	5.0	6.5	7.0	8.0	-4.9	-3.6	-5.7	...	...	...
Kyrgyz Republic	2.3	-3.5	7.1	6.8	4.8	5.7	2.1	-5.4	-9.4	5.8	5.6	5.4
Moldova	-6.5	3.2	3.5	0.0	7.4	6.0	-8.1	-11.2	-11.4	6.4	7.5	6.5
<i>Memorandum</i>												
Net Energy Exporters <sup>5</sup>	-6.0	4.3	4.5	10.8	6.7	7.4	3.8	5.1	4.2	...	...	...
Net Energy Importers <sup>6</sup>	-9.5	4.6	5.0	13.1	8.7	10.2	-5.8	-5.4	-6.1	...	...	...

<sup>1</sup>Movements in consumer prices are shown as annual averages. December–December changes can be found in Table A7 in the Statistical Appendix.<sup>2</sup>Percent of GDP.<sup>3</sup>Percent. National definitions of unemployment may vary.<sup>4</sup>Georgia and Mongolia, which are not members of the Commonwealth of Independent States, are included in this group for reasons of geography and similarities in economic structure.<sup>5</sup>Net Energy Exporters comprise Azerbaijan, Kazakhstan, Russia, Turkmenistan, and Uzbekistan.<sup>6</sup>Net Energy Importers comprise Armenia, Belarus, Georgia, Kyrgyz Republic, Moldova, Mongolia, Tajikistan, and Ukraine.

would benefit from greater exchange rate flexibility, once the problems in the banking system have been resolved. This would facilitate monetary management, help the economy adjust to external shocks, and promote local-currency financial market development.

Banking sector balance sheets remain impaired in several CIS economies and call for continued policy attention. In Russia, restoring normal credit expansion will require decisive actions to improve provisioning standards and to enhance the powers of the supervisory authority, including over connected lending. In Kazakhstan, a transparent and comprehensive strategy to resolve bad debts—which involves an independent assessment of systemic banks to evaluate recapitalization needs—is critical for restoring financial sector health. In Ukraine, financial sector reforms are also essential to revitalizing the banking system, by ensuring an adequate level of capitalization. More independence for the central bank to pursue monetary and financial stability would also be desirable.

Over the medium term, the overarching challenges in the region are to improve the investment climate and diversify the pattern of growth. In Russia, for instance, there is a need for public administration reform, civil service reform, and judicial reform to ensure a level playing field for all investors. Such reforms will be critical to modernizing the economy. It will also be important to use capital flows wisely, in order to help move the economy from its dependence on oil revenues. In other energy exporters in the region, the priority is to facilitate private sector development and, in some economies, diversify away from the hydrocarbon sector. Such policies will help achieve sustained welfare gains.

### The Middle East and North Africa Region Is Recovering Strongly

The strength of the recent economic recovery in the MENA region is largely underpinned by the rebound in oil prices from their trough in 2009,

which has boosted receipts for oil exporters in the region. In addition, a sizable and rapid fiscal policy response, especially in oil-exporting economies, has played a substantial role in supporting the non-oil sector in these economies. These expansionary policies have had spillover effects on the region's oil importers—where fiscal expansion was of a more moderate size—due to close trade links between these two groups of economies (Figures 2.12 and 2.13).

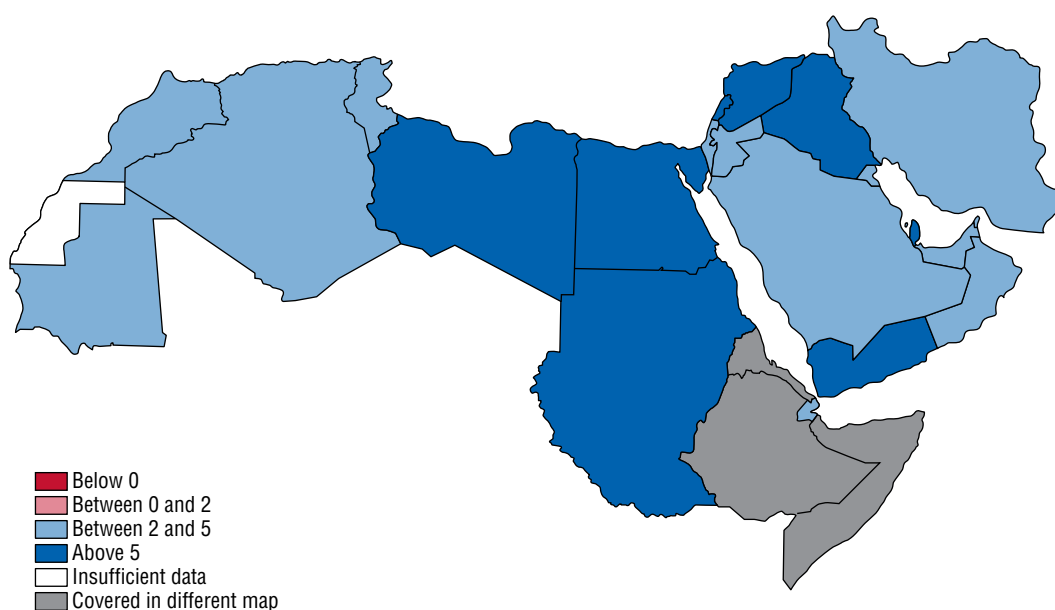
These positive factors contribute to an expected growth rate for the region as a whole of 4.1 percent in 2010 and 5.1 percent in 2011 (Table 2.6).

- Average growth rates among oil exporters are projected to be higher over the next two years, compared with 2009. Supported by sizable government infrastructure investment, real activity in Saudi Arabia is expected to grow at 3.4 percent in 2010 and 4.5 percent in 2011.
- Growth in oil-importing economies is expected to remain robust in 2010 and 2011. Members of this group managed to weather the global recession relatively well, partly due to relatively limited global financial links. Some economies that

experienced a boom-bust cycle in capital flows, such as Egypt, responded by drawing down reserves to limit the impact on the exchange rate and the real economy. In fact, net capital inflows have already turned positive in Egypt since the second half of 2009. Within the group, Lebanon continued to register strong growth through the recession, supported by signs of political stability and strong capital inflows.

The economic outlook in the region is closely linked to global developments, primarily through the impact of global economic activity on oil prices. The impact is not confined to the MENA exporters. Oil-importing economies in the region also benefit (roughly one-fourth of their exports go to oil exporters). Although oil prices have rebounded from the lows in 2009, future increases are projected to be modest. Expansion in demand by rapidly growing emerging markets is expected to be offset by stagnant demand from advanced economies. Oil and gas production capacity is set to increase, particularly in Saudi Arabia and Qatar, underpinned by continued expansion of productive capacity. The balance of

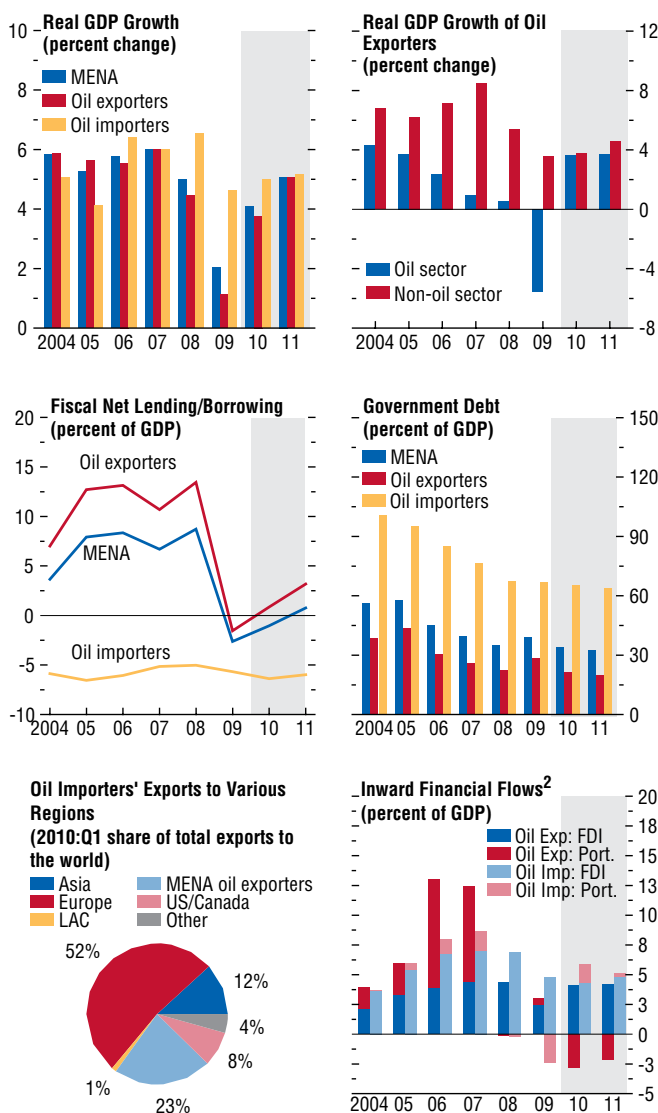
**Figure 2.12. Middle East and North Africa:  
Average Projected Real GDP Growth during 2010–11  
(Percent)**



Source: IMF staff estimates.

**Figure 2.13. Middle East and North Africa (MENA): Recovering Strongly**

Recovery in the region is supported largely by the rebound in oil prices from their trough in 2009. In addition, government spending programs, especially in the oil-exporting economies, have played a significant role in supporting the non-oil sector in these economies. This fiscal stimulus has had positive spillovers to the oil-importing economies, which have close trade and financial links with the oil exporters.<sup>1</sup>



Sources: Haver Analytics; IMF, *Direction of Trade Statistics*; IMF, *International Financial Statistics*; and IMF staff estimates.

<sup>1</sup>Oil exporters include Algeria, Bahrain, Islamic Republic of Iran, Iraq, Kuwait, Libya, Oman, Qatar, Saudi Arabia, Sudan, United Arab Emirates, and Republic of Yemen. Oil importers include Djibouti, Egypt, Jordan, Lebanon, Mauritania, Morocco, Syrian Arab Republic, and Tunisia. LAC is Latin America and the Caribbean. Other includes Africa and the Commonwealth of Independent States.

<sup>2</sup>"Exp" refers to exporters and "Imp" to importers. "FDI" refers to "direct investment in the reporting economy," and "Port." refers to "portfolio investment, liabilities."

risks to oil prices, as evidenced in options prices, is currently to the upside, which augurs well for the region. Nevertheless, the tail risk of a collapse in oil prices has significant implications for the region, especially for lower-income oil-exporting economies. The prospective increase in world shale gas production is also likely to weigh on receipts of MENA gas exporters (see Appendix 1.1 in Chapter 1 for further discussion of commodity developments).

The possibility of heightened economic turbulence in Europe poses a significant downside risk for oil importers in the MENA region. Europe is their largest trading partner, accounting for about half of their total exports. In addition, the Maghreb economies (for example, Tunisia, Morocco) are heavily reliant on Europe as a source of tourism, remittances, and FDI flows. The volatile global environment poses significant policy challenges for the region. Fiscal policy strategies have varied, largely due to the respective strengths of public sector balance sheets. Most oil exporters are continuing to implement stimulus measures in 2010. Although particular country circumstances vary, plans to consolidate should be in place once recovery is more entrenched or if signs of incipient overheating emerge. Some oil importers, on the other hand, have already begun the process of consolidation. Debt levels in these economies are, on average, higher than in oil-exporting economies.

Monetary policy in the region largely mirrors that of the United States because of the large number of economies that have fixed exchange rates vis-à-vis the U.S. dollar. Economies that have independent monetary policies, mostly the oil importers, have appropriately halted their easing in the face of growing inflation pressure.

An immediate challenge for policymakers in this region is to revive the financial intermediation process. In many economies, credit growth has been sluggish in the aftermath of the crisis due to weak balance sheets both for the banking sector and the nonfinancial corporate sector. Prominent corporate defaults in Dubai, Kuwait, and Saudi Arabia have contributed to increased uncertainty regarding the health of the corporate sector generally. The spillover from these episodes to broader lending conditions in other MENA economies, however, has thus far been

**Table 2.6. Selected Middle East and North African Economies: Real GDP, Consumer Prices, Current Account Balance, and Unemployment***(Annual percent change, unless noted otherwise)*

	Real GDP			Consumer Prices <sup>1</sup>			Current Account Balance <sup>2</sup>			Unemployment <sup>3</sup>		
	2009	Projections		2009	Projections		2009	Projections		2009	Projections	
		2010	2011		2010	2011		2010	2011		2010	2011
<b>Middle East and North Africa</b>	<b>2.0</b>	<b>4.1</b>	<b>5.1</b>	<b>6.7</b>	<b>6.8</b>	<b>6.2</b>	<b>2.6</b>	<b>4.4</b>	<b>5.2</b>	...	...	...
<b>Oil Exporters<sup>4</sup></b>	<b>1.1</b>	<b>3.8</b>	<b>5.0</b>	<b>5.9</b>	<b>6.4</b>	<b>5.9</b>	<b>4.6</b>	<b>6.7</b>	<b>7.8</b>	...	...	...
Islamic Republic of Iran	1.1	1.6	3.0	10.8	9.5	8.5	3.6	4.2	4.5	...	...	...
Saudi Arabia	0.6	3.4	4.5	5.1	5.5	5.3	6.1	6.7	6.2	10.5	10.5	10.8
Algeria	2.4	3.8	4.0	5.7	5.5	5.2	0.3	3.4	3.6	10.2	10.0	9.8
United Arab Emirates	-2.5	2.4	3.2	1.2	2.0	2.5	4.0	5.4	5.6	...	...	...
Kuwait	-4.8	2.3	4.4	4.0	4.1	3.6	29.1	30.1	30.3	1.6	1.6	1.6
Iraq	4.2	2.6	11.5	-2.8	5.1	5.0	-25.7	-14.4	-8.6	...	...	...
Qatar	8.6	16.0	18.6	-4.9	1.0	3.0	14.3	15.6	23.0	...	...	...
Sudan	4.5	5.5	6.2	11.3	10.0	9.0	-12.9	-8.9	-7.1	14.9	13.7	12.6
<b>Oil Importers<sup>5</sup></b>	<b>4.6</b>	<b>5.0</b>	<b>5.2</b>	<b>9.1</b>	<b>7.9</b>	<b>6.9</b>	<b>-4.0</b>	<b>-4.2</b>	<b>-3.9</b>	...	...	...
Egypt	4.7	5.3	5.5	16.2	11.7	10.0	-2.4	-2.0	-1.6	9.0	9.2	9.0
Morocco	4.9	4.0	4.3	1.0	1.5	2.2	-5.0	-5.3	-4.9	9.1	9.6	9.1
Syrian Arab Republic	4.0	5.0	5.5	2.8	5.0	5.0	-4.5	-3.9	-3.4	...	...	...
Tunisia	3.1	3.8	4.8	3.5	4.5	3.5	-2.8	-4.4	-4.1	13.3	13.2	13.1
Lebanon	9.0	8.0	5.0	1.2	5.0	3.5	-9.5	-11.1	-11.2	...	...	...
Jordan	2.3	3.4	4.2	-0.7	5.5	5.0	-5.0	-7.2	-8.5	13.0	13.0	12.5
<i>Memorandum</i>												
Israel	0.8	4.2	3.8	3.3	2.3	2.8	3.8	6.2	5.7	7.7	7.4	7.2
Maghreb <sup>6</sup>	2.4	5.0	4.6	3.7	4.2	3.9	1.1	3.7	4.1	...	...	...
Mashreq <sup>7</sup>	4.8	5.4	5.4	11.9	9.8	8.4	-3.8	-3.8	-3.5	...	...	...

<sup>1</sup>Movements in consumer prices are shown as annual averages. December–December changes can be found in Tables A6 and A7 in the Statistical Appendix.<sup>2</sup>Percent of GDP.<sup>3</sup>Percent. National definitions of unemployment may vary.<sup>4</sup>Includes Bahrain, Libya, Oman, and Republic of Yemen.<sup>5</sup>Includes Djibouti and Mauritania.<sup>6</sup>The Maghreb comprises Algeria, Libya, Mauritania, Morocco, and Tunisia.<sup>7</sup>The Mashreq comprises Egypt, Jordan, Lebanon, and Syrian Arab Republic.

limited—possibly due to relatively rapid and orderly restructuring. The decline in external sources of funds, along with slow deposit growth, has nevertheless curtailed the ability of banks to extend loans.

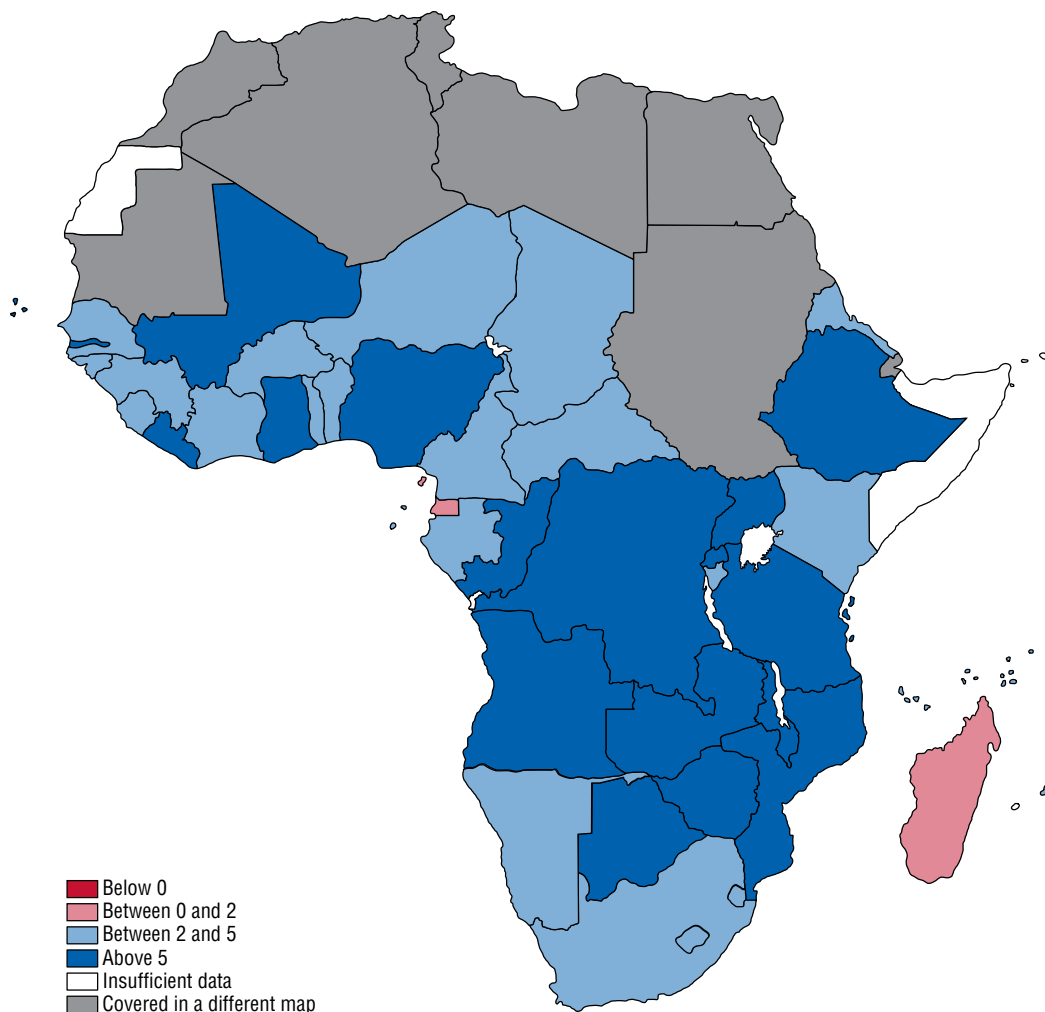
The region has largely been bypassed by the recent surge in capital flows to emerging markets, with the notable exception of Egypt and Lebanon. Portfolio flows turned negative in 2009 and are expected to remain so over the next two years. Bank flows to the region are also unlikely to rebound quickly because of the ongoing restructuring and regulatory changes in advanced economies.

In line with the improvement in oil prices, the overall external balance in the region is expected to recover, although not to precrisis levels. For oil exporters, the current account balance, which fell from a surplus of close to 20 percent of GDP in 2008 to 4.6 percent in 2009, is projected to increase to 6.7 percent of GDP in 2010 and 7.8 percent of GDP in 2011. Surpluses of roughly this magnitude

are expected to continue through 2015. The counterpart is a large buildup in net foreign assets, which historically have flowed into government securities and private equity investments in the United States and advanced economies in Europe.

As discussed in the October 2010 *Regional Economic Outlook: Middle East and Central Asia*, a key medium-term objective is to raise potential growth and create jobs for the region's rapidly growing population. The region needs to redirect trade toward today's growth engines, attract FDI from these economies, and exploit the potential for intra-regional trade and FDI. This underlines the need for structural measures to enhance competitiveness. Improving the business environment, including through the establishment of strong legal and regulatory frameworks, is essential. Building human capital through greater emphasis on education and training will be particularly important. And, as in all emerging market regions, increased financial

**Figure 2.14. Sub-Saharan Africa:  
Average Projected Real GDP Growth during 2010–11  
(Percent)**



Source: IMF staff estimates.

sector depth and stability and a track record of macroeconomic stability and policy would increase the prospects for robust, self-sustaining growth.

### **Africa's Growth Is Accelerating**

As sub-Saharan Africa rebounds from the slowdown in 2009, strong macroeconomic fundamentals through much of the region leave it well

positioned to benefit from the global recovery now under way (Figure 2.14). The slowdown to 2.6 percent in 2009 was brief, limited also by the rapid implementation of countercyclical policies made possible by the policy room that many economies had built prior to the downturn. Output growth in the region is projected to accelerate to 5 percent in 2010 and 5.5 percent in 2011, supported not only by the recovery in exports and commodity prices,



but also by robust domestic demand in a number of economies (Table 2.7). Foreign inflows to the region, including official flows, FDI, and remittances, were less affected by the global downturn than had been feared, although the outlook remains uncertain (Figure 2.15).

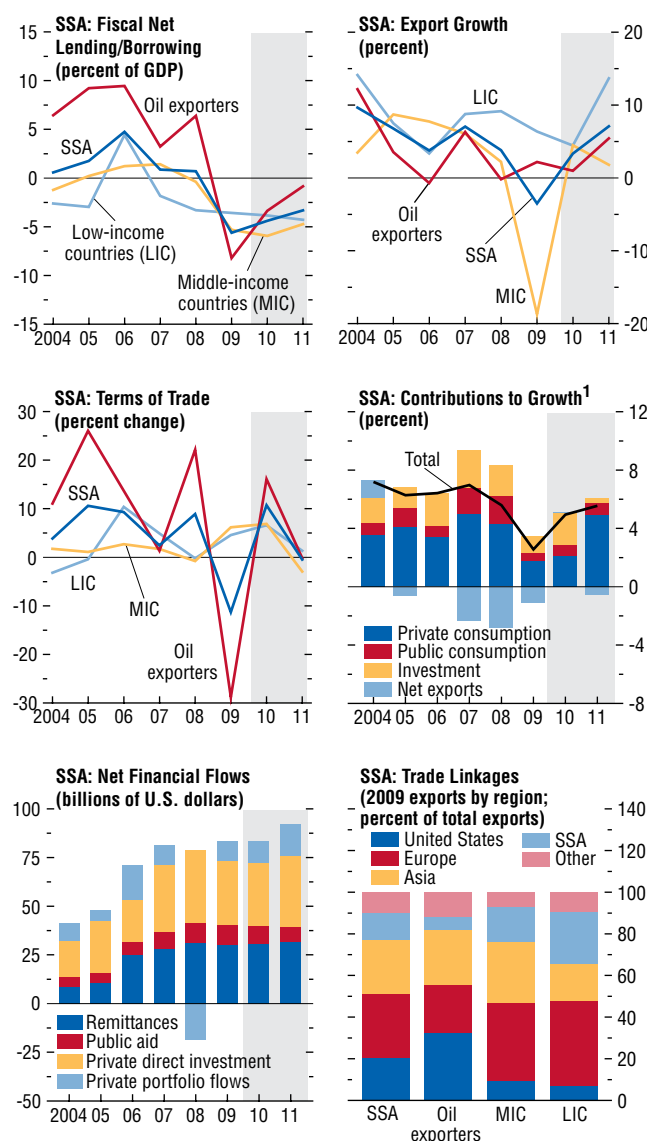
The pickup in global demand and the strengthening of oil prices are supporting growth in Africa's oil-exporting economies. In the region's largest oil exporter, Nigeria, continued strong growth in the non-oil sector is being supported by increasing oil production, a result of reduced instability in the Niger Delta region. Thus, Nigeria's output growth is expected to accelerate from 7 percent in 2009 to 7.4 percent in both 2010 and 2011. Growth in Angola, the region's second-largest oil exporter, is also expected to recover in 2010, following the decline in oil exports and the tightening of its budget in 2009. Angola's growth is projected to increase from less than 1 percent in 2009 to about 6 percent in 2010 and about 7 percent in 2011.

Sub-Saharan Africa's middle-income economies—whose output contracted in 2009 due to their stronger global trade linkages—are now firmly on the path to recovery. The region's largest economy, South Africa, has benefited from continued strong demand for commodities from emerging Asia and from a recovery in demand for manufactures from its largest export market, the euro area. There are also signs that the monetary easing pursued last year is supporting a recovery in domestic demand. After contracting by almost 2 percent in 2009, South Africa's output is expected to grow by 3 percent in 2010 and by 3.5 percent in 2011.

The relatively low degree of exposure of the region's low-income economies to international trade and financial flows shielded them from the worst of the global downturn. Correspondingly, the acceleration of growth this year is expected to be modest. Output growth in these economies is expected to rise from 4.5 percent in 2009 to 4.9 percent in 2010, and further to 6 percent in 2011. Growth in low-income economies is generally expected to be driven as much by domestic factors as by the global recovery. In Kenya, for example, a recovery in tourism inflows and an improvement in

**Figure 2.15. Sub-Saharan Africa (SSA): Growth Is Accelerating**

The slowdown in 2009 was brief, in part due to rapid implementation of countercyclical policies. A recovery in exports and commodity prices is helping support the rebound, as is robust domestic demand in many economies. Nonportfolio flows have been stable. Although the United States is the main trading partner of oil exporters, Europe is the main export destination for many low- and middle-income economies in the region.



Sources: IMF, *Direction of Trade Statistics*; and IMF staff estimates.  
<sup>1</sup>Excluding Liberia, São Tomé and Príncipe, and Zimbabwe.



**Table 2.7. Selected Sub-Saharan African Economies: Real GDP, Consumer Prices, Current Account Balance, and Unemployment***(Annual percent change, unless noted otherwise)*

	Real GDP			Consumer Prices <sup>1</sup>			Current Account Balance <sup>2</sup>			Unemployment <sup>3</sup>		
	2009	Projections		2009	Projections		2009	Projections		2009	Projections	
		2010	2011		2010	2011		2010	2011		2010	2011
<b>Sub-Saharan Africa</b>	<b>2.6</b>	<b>5.0</b>	<b>5.5</b>	<b>10.4</b>	<b>7.5</b>	<b>7.0</b>	<b>-1.7</b>	<b>-1.1</b>	<b>-1.9</b>	...	...	...
<b>Oil Exporters</b>	<b>5.0</b>	<b>6.7</b>	<b>7.0</b>	<b>11.6</b>	<b>11.3</b>	<b>9.4</b>	<b>6.0</b>	<b>8.2</b>	<b>7.4</b>	...	...	...
Nigeria	7.0	7.4	7.4	12.4	11.9	9.8	14.1	13.0	11.8	4.5	4.5	4.5
Angola	0.7	5.9	7.1	13.7	13.3	11.3	-5.0	1.6	1.3	...	...	...
Equatorial Guinea	5.3	0.9	2.1	7.2	8.0	7.1	-16.0	-2.8	-11.6	...	...	...
Gabon	-1.4	4.5	5.0	2.1	3.0	3.5	16.6	15.2	14.3	...	...	...
Chad	-1.6	4.3	3.9	10.1	6.0	3.0	-33.7	-32.0	-25.4	...	...	...
Congo, Republic of	7.5	10.6	8.7	4.3	5.2	4.5	-7.7	4.2	7.9	...	...	...
<b>Middle-Income</b>	<b>-1.7</b>	<b>3.3</b>	<b>3.6</b>	<b>7.1</b>	<b>5.5</b>	<b>5.7</b>	<b>-4.1</b>	<b>-4.4</b>	<b>-5.8</b>	...	...	...
South Africa	-1.8	3.0	3.5	7.1	5.6	5.8	-4.0	-4.3	-5.8	24.3	24.8	24.4
Botswana	-3.7	8.4	4.8	8.1	6.7	6.3	-2.1	-0.5	-0.4	...	...	...
Mauritius	2.5	3.6	4.1	2.5	2.5	2.6	-7.8	-9.4	-9.0	8.0	7.5	7.3
Namibia	-0.8	4.4	4.8	9.1	6.5	5.9	-1.7	-2.6	-6.0	...	...	...
Swaziland	1.2	2.0	2.5	7.6	6.2	5.6	-6.2	-12.6	-12.3	30.0	30.0	30.0
Cape Verde	3.0	4.1	6.0	1.0	1.8	2.0	-9.9	-18.6	-18.2	17.0	17.0	17.0
Seychelles	0.7	4.0	5.0	31.8	-2.4	2.5	-35.1	-39.5	-35.5	5.1	4.6	4.1
<b>Low-Income<sup>4</sup></b>	<b>4.5</b>	<b>4.9</b>	<b>6.0</b>	<b>12.6</b>	<b>6.2</b>	<b>6.0</b>	<b>-6.8</b>	<b>-7.4</b>	<b>-8.3</b>	...	...	...
Ethiopia	9.9	8.0	8.5	36.4	2.8	9.0	-5.0	-3.9	-8.0	...	...	...
Kenya	2.4	4.1	5.8	9.3	4.1	5.0	-6.7	-6.7	-7.4	...	...	...
Tanzania	6.0	6.5	6.7	12.1	7.2	5.0	-10.0	-8.8	-8.8	...	...	...
Cameroon	2.0	2.6	2.9	3.0	3.0	2.7	-2.7	-3.9	-4.1	...	...	...
Uganda	7.2	5.8	6.1	14.2	9.4	5.5	-4.0	-6.4	-9.2	...	...	...
Côte d'Ivoire	3.8	3.0	4.0	1.0	1.4	2.5	7.2	6.8	2.5	...	...	...

<sup>1</sup>Movements in consumer prices are shown as annual averages. December–December changes can be found in Table A7 in the Statistical Appendix.<sup>2</sup>Percent of GDP.<sup>3</sup>Percent. National definitions of unemployment may vary.<sup>4</sup>Includes Benin, Burkina Faso, Burundi, Central African Republic, Comoros, Democratic Republic of the Congo, Eritrea, The Gambia, Ghana, Guinea, Guinea-Bissau, Lesotho, Liberia, Madagascar, Malawi, Mali, Mozambique, Niger, Rwanda, São Tomé and Príncipe, Senegal, Sierra Leone, Togo, Zambia, and Zimbabwe.

rainfall are expected to support the acceleration of output growth, to 4.1 percent in 2010.

The primary risk to the outlook for the region is a faltering global recovery. But different economies in the region have differing exposures. For the oil-exporting economies, spillovers from a global slowdown would be manifested primarily through its impact on oil prices. In contrast, middle- and low-income economies' exposure comes from their exports to Europe, which are about one-third of total exports, nearly four times the share of their exports to the United States. In addition to these trade linkages, continued weakness and measures to cut budget deficits in advanced economies may affect the low-income economies of sub-Saharan Africa by reducing aid and private financial flows to the region. For example, remittances are an important source of foreign inflows to the region, amounting, for example, to almost 10 percent of GDP in Senegal. These may be susceptible to

weaker conditions in economies employing migrant workers from sub-Saharan Africa.

Asset market spillovers resulting from increased global volatility or risk aversion are likely to be limited. Portfolio flows are a less critical component of overall capital flows in sub-Saharan Africa than in the rest of the world, and most economies in the region have relatively underdeveloped financial markets. South Africa is the notable exception: its equity and currency markets are often more sensitive to shifts in global sentiment than other emerging markets in Asia or Latin America, because nonresident transactions account for a relatively high share of turnover.

Finally, with the recovery in progress, fiscal policies in many economies in the region should begin addressing medium-term priorities. As private and external demand recovers, economies will need to rebuild fiscal room and reorient its use. Where output growth has recovered, debt levels are rising, and primary deficits are above levels that will stabilize

debt over the medium term, more prudent fiscal balances are in order. However, where output growth is still weak, outstanding debt is low, and fiscal deficits are in check, there may be scope to sustain higher levels of spending in priority areas such as education, health, and infrastructure investment. One of the positive aspects of the response to the recent downturn was the ability of many economies in the region to shield such pro-poor and pro-growth public spending. As highlighted in the April 2010 *Regional Economic Outlook: Sub-Saharan Africa*, spending on health and education actually increased in real terms in 20 of 29 low-income economies in 2009. Public capital spending also increased in real terms in half the economies in the region.

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