GROUP of TWENTY

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Global Economic Prospects and Policy Challenges

Prepared by Staff of the International Monetary Fund

INTERNATIONAL MONETARY FUND

EXECUTIVE SUMMARY

The global economic recovery is advancing, albeit at an uneven pace. Global GDP increased at a stronger-than-expected annualized rate of over 3½ percent in 2010Q3.

- In *G-20 advanced economies*, activity has moderated less than expected, but growth remains subdued and insufficient to significantly reduce still-high unemployment.

- In *G-20 emerging economies*, growth remains robust, buoyed by strong domestic demand and the recovery of global trade, still-accommodative policy stances, and resurgent capital flows. However, inflationary pressures are building, and there are emerging signs of overheating in some economies.

While financial turbulence has receded in recent weeks, underlying stresses in peripheral euro area economies remain unresolved and are linked to the core through financial exposures. Markets are looking for more capacity and flexibility of the current crisis management facilities and clarification about the permanent European Stability Mechanism (ESM). ECB intervention and strengthening of national policy actions in countries under pressure have led to some recent positive market developments, including the successful bond issuance by the European Financial Stability Facility (EFSF). Nonetheless, banks face continued funding strains and many remain reliant on ECB liquidity support, while banking and sovereigns risks remain closely intertwined.

In line with the two-speed recovery, downside risks remain elevated in advanced economies, while overheating risks are growing in emerging economies. Intensification and broadening of financial sector strains resulting from sovereign and banking sector risks in the euro area periphery is a significant risk to the recovery in the region and possibly beyond. Overheating and building inflationary pressures in some emerging economies, exacerbated by large capital flows and rising commodity prices (with adverse consequences for lower income countries), and a potentially steep correction of property prices in China have emerged as pertinent risks to the recovery. Another downside risk stems from insufficient progress in developing medium-term fiscal consolidation plans, especially in the United States and Japan.

Cooperative and well-timed policy initiatives across the G-20 are critical to sustain the global recovery, while reducing global imbalances.

- In *G-20 advanced economies*, the most urgent requirements are for comprehensive and rapid actions to overcome sovereign and financial stresses in the euro area and accelerate progress in developing medium-term fiscal consolidation plans. Rapid progress in the repair and reform of financial systems—critical to the normalization of credit conditions— would help reduce the burden on monetary and fiscal policy to support the recovery, and potentially help stem volatile capital flows to emerging economies.

- In *G-20 emerging economies*, the key policy challenge is to keep overheating pressures in check and respond appropriately to capital inflows. In key surplus economies, overheating pressures can be alleviated by permitting currency appreciation, facilitating a healthy rebalancing from external to internal demand.

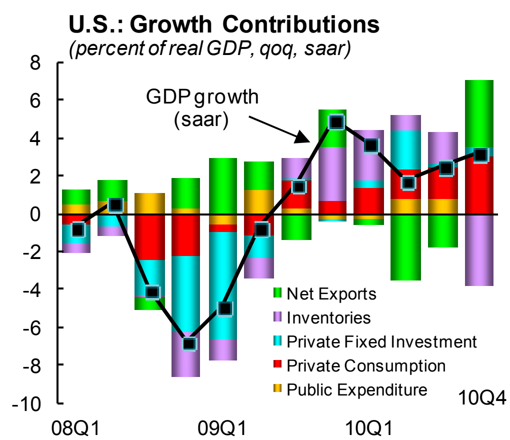
Global Economic Prospects and Policy Challenges[1]

The global economic recovery is advancing. However, the recovery remains uneven, with downside risks in advanced economies remaining elevated, while overheating risks are growing in emerging economies. Financial sector strains resulting from sovereign and banking sector fragilities in the euro area periphery represent a significant risk to recovery in the region and possibly beyond. Another downside risk stems from insufficient progress in developing medium-term fiscal consolidation plans in the United States and Japan. Rising overheating pressures in some emerging economies, exacerbated by large capital flows and rising commodity prices, and a potentially steep correction in property prices in China have also surfaced as pertinent concerns.

I. A TWO-SPEED RECOVERY IS ONGOING

1. **In *G-20 advanced economies*, the pace of growth in the second half of 2010 was somewhat stronger than expected, but insufficient to appreciably lower unemployment**. The recovery in many advanced economies continues to be slow and sluggish, amid persistently high unemployment, significant excess capacity, and subdued private demand. In the United States, this has prompted further monetary and fiscal stimulus, notwithstanding an already challenging fiscal outlook. Meanwhile, in the euro area periphery, austerity measures prompted by market pressures continue to hamper growth in the short term.

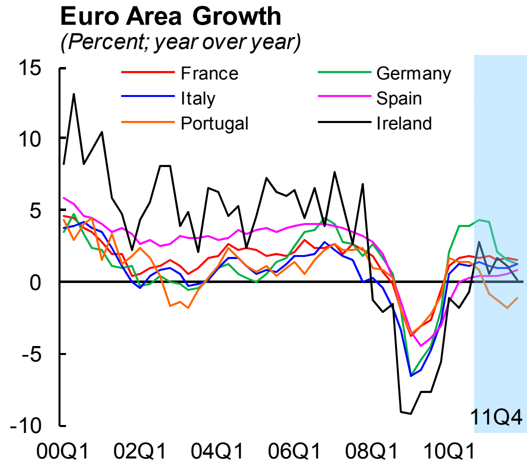
- In the *United States*, data showed some strengthening of the recovery in the fourth quarter, owing to robust growth in private consumption and exports, and a sizable drop in imports. Consumer durables posted particularly strong growth in the quarter, a tentative sign that households are becoming more positive about the economic outlook. However, looking ahead, continued weaknesses in employment and income growth, a sizable overhang in housing markets, and balance sheet repair are expected to remain a drag on private demand.



- *In Japan*, after a strong third quarter, the recovery likely hit a temporary soft patch at the end of the year, reflecting mainly the withdrawal of policy stimulus. Recent indicators point to a resumption of the recovery this year supported by growing exports, especially to the rest of the region. Private demand is expected to recover gradually due to the sluggish labor market and subdued business sentiment.

[1] Prepared by a team from the IMF's Research Department—led by Emil Stavrev, and including Troy Matheson, Eric Bang, Chanpheng Fizzarotti, and Nese Erbil, with contributions from Mitali Das, Prachi Mishra, Shaun Roache, Joong Shik Kang, and Marina Rousset and input from the Monetary and Capital Markets Department.

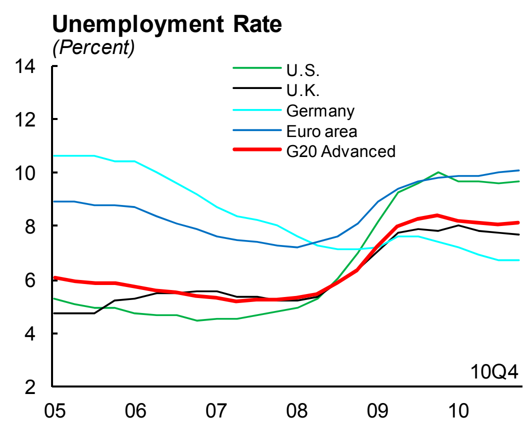
- Growth performance has varied substantially in the euro area, both within the core and across the countries in the periphery. Data suggest that output in the euro area as a whole expanded at about 1½ percent annualized in the second half of 2010. However, while growth in Germany has remained robust, recoveries in other core economies, including France and Italy, have been more subdued, reflecting limited bounce-back in investment and sluggish export growth. In peripheral euro area economies most affected by financial market strains, austerity measures continue to weigh on domestic demand. So far, intra-regional trade has provided limited impetus to growth in these countries due to sluggish activity in trading partners and slow progress being made towards restoring competitiveness.



Source: IMF, *World Economic Outlook*.

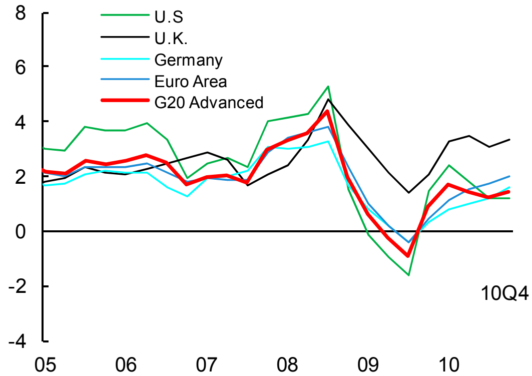
2. **In many *G-20 advanced economies*, high unemployment and balance sheet strains continue to be a drag on a private-sector-led recovery, and core inflation remains low**.

- In several key *G-20 advanced economies*, unemployment rates have persisted at high levels, paralleling their subdued recoveries. Persistent weakness in labor markets is a concern not only due to the economic impact, but also for the large human and social costs of high long-term unemployment. In the United States, the unemployment rate dropped to 9 percent in January 2011, but businesses remain reluctant to hire, given uncertainties about the strength and sustainability of the recovery. Labor markets in the euro area are mixed, reflecting the size, nature, and persistence of crisis-related shocks and divergences in paths of recovery. The unemployment rate has fallen to its lowest level in nearly two decades in Germany, while it has persisted at high levels in other countries (e.g., Ireland and Spain). While core inflation has generally remained low in *G-20 advanced economies*, reflecting still-large output gaps and moderate recoveries, headline inflation rates have been edging up recently in response to rising commodity prices.



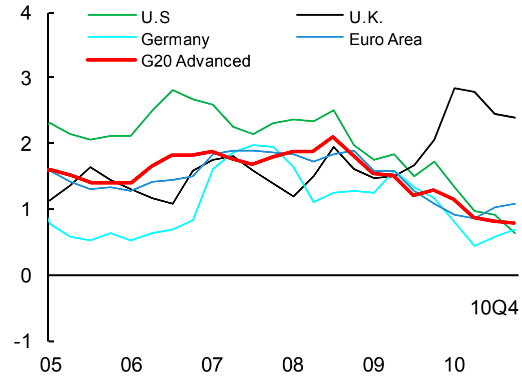
Sources: IMF, *World Economic Outlook* and Haver Analytics.

Consumer Headline Price Inflation
(Percent; year over year)



Sources: IMF, *Global Data Source* and staff estimates

Consumer Core Price Inflation
(Percent; year over year)

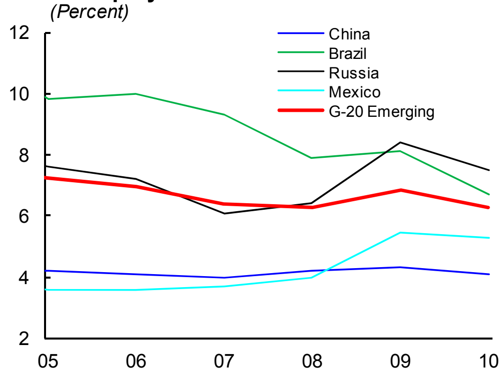


Sources: IMF, *Global Data Source* and staff estimates.

- Private sector balance sheets remain under stress in a number of advanced G-20 economies, as households and banks seek to reduce debt and deleverage. While the scope and intensity of such stress varies across the advanced economies, on-going balance-sheet repair and weaknesses in employment and income growth represent a significant drag on private demand and recovery prospects.

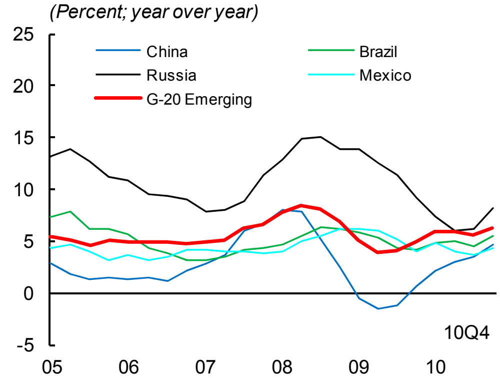
3. **Growth in *G-20 emerging economies* remains robust, but signs of overheating are emerging in some economies**. Robust domestic demand and the recovery of global production continue to power the expansion in emerging economies. Strong growth in key *emerging economies*—China, India, Indonesia, and Turkey—and growing intra-regional trade, particularly in Asia, is offsetting weaker demand from advanced economies. Among *G-20 emerging economies*, with some exceptions (e.g., Mexico and South Africa), unemployment has been trending downward as the expansions have gathered momentum. Output gaps have been closing rapidly, and some countries have begun to experience excess demand. This, combined with rising food and commodity prices, and in some cases strong capital flows, is fueling inflationary pressures in many emerging economies, including Brazil, China, India, Indonesia, and Russia.

Unemployment Rate 1/
(Percent)



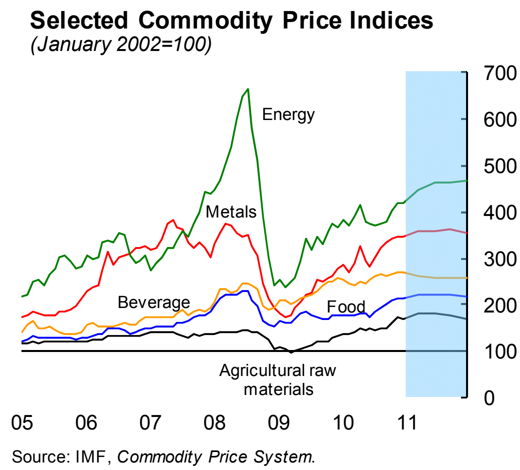
Source: IMF, *World Economic Outlook*.
1/ Excludes India due to data unavailability.

Consumer Headline Price Inflation
(Percent; year over year)

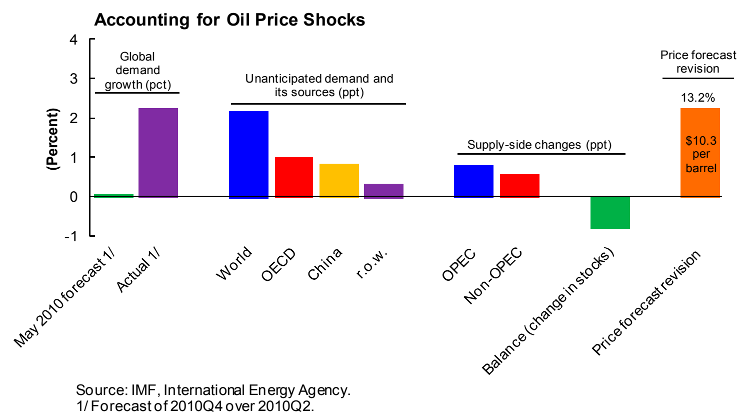


Sources: IMF, *Global Data Source* and Haver Analytics.

4. **Commodity prices have risen sharply in 2010, largely due to unexpectedly strong cyclical demand and commodity-specific supply developments, and are foreseen to remain high in the near term**. Upward price pressures from these factors should ease somewhat through 2011, with the prospect of ongoing supply constraints representing a key risk. The IMF commodity price index has now recovered more than half of the decline from the cyclical peak in July 2008.



- Food price gains, driven mostly by weather-related supply shocks, have been particularly prominent and, as a group, food is now within touching distance of 2008 peaks. The recent Middle East social unrest may place further upward pressure on food prices, if large grain importers step-up their purchases to ensure domestic stability and restrain prices in domestic food markets.



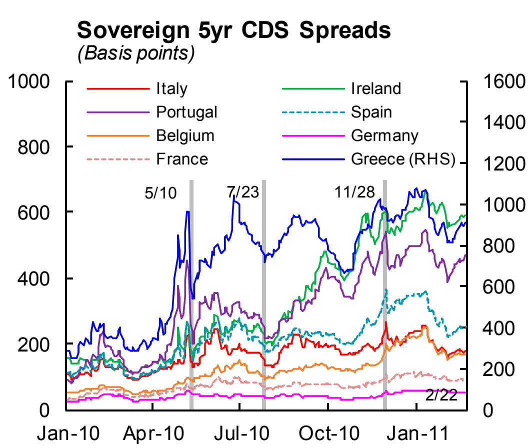
- The increase in oil prices and raw materials was largely driven by stronger-than-anticipated demand growth, notably in China and OECD countries. Supportive monetary policies have kept interest rates (and inventory financing costs) low, with a depreciation of the dollar also contributing to higher prices. The short-term price outlook is mainly dependent upon prospects for ongoing recovery in global activity and the supply response to recent commodity-specific developments.

- In the January 2011 WEO update, oil prices for 2011 were projected to be around 13 percent higher than forecast in the October 2010 WEO ($79 a barrel), largely due to unanticipated demand growth. In recent weeks, social unrest in the Middle East has increased concerns about oil supply disruptions and pushed prices higher, although until now, actual supplies have remained unaffected. Robust oil demand growth in excess of non-OPEC supply growth is expected to increase the call on OPEC capacity from 2011. OPEC producers' decisions will play a key role in price dynamics. They are widely expected to use their capacity more elastically with prices at $100 or above, especially as inventory-to-use ratio are approaching average levels of the cycle, and preliminary estimates of OPEC production in December and January seem to corroborate this view. Nevertheless, there is uncertainty about OPEC producers' price targets. Reflecting these developments, the IMF's current baseline petroleum price projection for 2011 is now for $94.75 a barrel, up from $89.50 in the January 2011 WEO update.

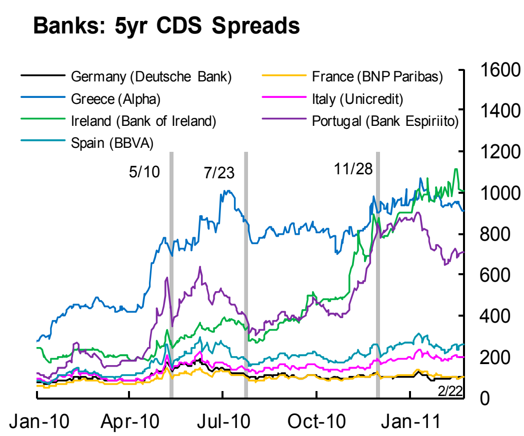
5. **Financial turbulence has receded in recent weeks, but underlying stresses in peripheral euro-area economies remain unresolved and are linked to the core through financial exposures**.

- Markets are anticipating that European policymakers will significantly strengthen their response to the ongoing crisis. They are looking for more capacity and flexibility of the current crisis management facilities and clarification about the permanent European Stability Mechanism (ESM), in particular about the extent of private sector participation, the application of collective action clauses, and the status of existing sovereign debt holders. ECB intervention early in the year and strengthening of national policy action in countries under pressure have led to some recent positive market developments, including the successful bond issuance by the European Financial Stability Mechanism (EFSM) and European Financial Stability Facility (EFSF).

- Nonetheless, banks face continued funding strains, especially those dependent on wholesale funding and subject to market concerns relating to their risk exposure and asset values in countries that experienced real estate bubbles. Many banks remain reliant on ECB liquidity support. Banking and sovereigns risks are closely intertwined, as evidenced by CDS spreads.



Source: Bloomberg, L.P.



Source: Bloomberg, L.P.

6. **Longer-maturity sovereign yields and equity prices in the United States have risen as growth prospects have improved**. The recent run of positive economic data have brightened market perceptions of U.S. growth prospects. Despite concerns about medium-term debt sustainability, the December fiscal package does not seem to have contributed much to recent

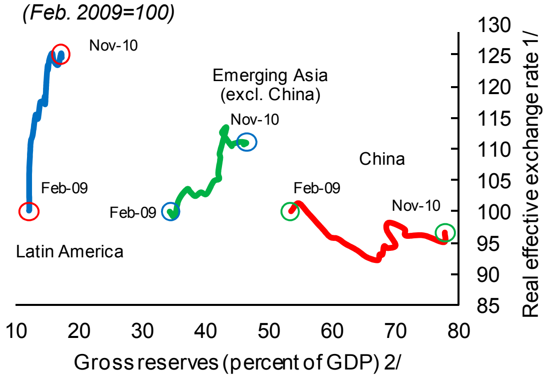
rises in bond yields. The rise of about ¾ of a percentage point in 10-year Treasury yields since early November appears largely due to higher real interest rates, with break-even inflation expectations (inferred from inflation-indexed bonds) remaining little changed since a rise following Chairman Bernanke's speech at Jackson Hole, which hinted that a second round of quantitative easing may be necessary. However, further rises in bond yields due to fiscal concerns remain a key risk to the U.S. fiscal outlook and global growth, particularly if a credible consolidation plan is not expedited.

7. **Capital flows to emerging markets are continuing but volatility has increased somewhat**. During the three months through October 2010, emerging market equity prices increased by almost 9 percent, while foreign currency-denominated bond spreads tightened by 30 basis points, with gains shared broadly across regions. Recently, equity markets have been less buoyant, while fixed income volatility has generally increased and ex-post returns to emerging market bonds turned negative, according to JPMorgan's Emerging Market Bond Index. In contrast to the bond-heavy allocations during the first nine months of 2010, emerging market debt and equity mutual fund contributions since October suggest more balanced portfolio capital inflows.

8. **There have been regional divergences in exchange rate responses to net capital inflows**. In particular:

- Some major economies in Latin America, notably Brazil, and South Africa have seen their currencies appreciate substantially in nominal effective terms since early 2009, boosting real-exchange rates to levels that are looking increasingly overvalued from a medium-term perspective. Meanwhile, some major Asian central banks have accumulated reserves and kept currencies undervalued, contributing to continuing significant exchange rate misalignments relative to fundamentals, and hampering progress towards global rebalancing. For instance, the Chinese renminbi continues to remain substantially undervalued in real effective terms.

Emerging Asia and Latin America: Real Exchange Rates and Reserves
(Feb. 2009=100)



1/ Index Feb. 2009=100. Weighted average using market GDP.
2/ Gross international reserves as a share of 2006–08 average GDP. Weighted average using market GDP.

- Countries in emerging Asia generally compete more directly with China in third markets than Latin American countries, and the fear of being 'priced out' of these markets in Asia is providing a strong incentive to limit appreciation against the Chinese renminbi. In contrast, several Latin American countries as well as South Africa have benefited from strong gains in commodity prices over the past year. These gains have supported export incomes and offered more room to allow currencies to appreciate.

- The real effective values of the euro and the Japanese yen are broadly in line with medium-term fundamentals, while the U.S. dollar remains on the strong side of fundamentals. Some further real effective depreciation of the U.S. dollar would help ensure a sustained decline of the U.S. current account deficit towards a level more consistent with medium-term fundamentals, helping to support more balanced growth.

Table 1. G-20: Assessment of Real Effective Exchange Rate 1/ 2/
(Percent deviation from medium-term equilibrium valuation)

	MB	ERER	ES
Advanced	5.3	2.5	4.8
Asia	-15.0	-6.8	-12.9
Latin America	8.6	-0.2	4.2
Other	4.4	10.7	13.6

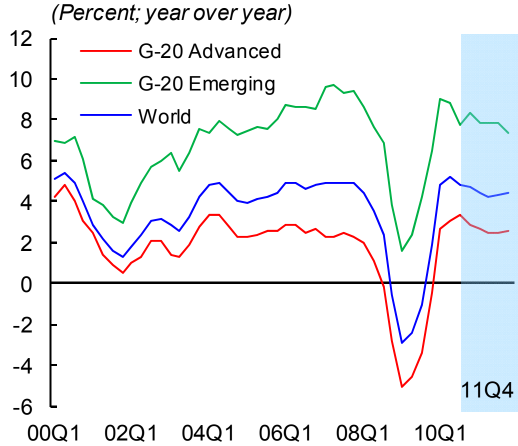
Source: IMF staff estimates.
1/ Advanced (U.S., E.U., Japan, U.K., Canada and Australia); Asia (China, Korea, Indonesia and India); Latin America (Brazil, Mexico and Argentina); Other (Russia, Turkey and South Africa). Estimates based on data up to August 2010.
2/ A negative number means the REER is undervalued and a positive number means the REER is overvalued, based on three approaches used by staff to assess misalignments: Macroeconomic Balance (MB), Equilibrium Real Exchange Rate (ERER) and External Sustainability (ES).

II. Prospects and Risks

Prospects are for a continuing recovery, albeit with limited rebalancing

9. **Financial stress is assumed to be only a modest drag on the global recovery, although global financial stability remains vulnerable**. Policy actions are expected to keep the financial turmoil and its real effects contained in the periphery of the euro area, resulting in only a modest drag on the global recovery. This view reflects the limited financial spillovers observed so far across financial markets and regions, as well as the fact that policy responses following the Greek crisis helped limit its impact on the global recovery in the second half of 2010.

Global Growth
(Percent; year over year)



Sources: IMF, *Global Data Source*; and IMF staff estimates.

- The recovery is projected to continue in *G-20 advanced economies,* but it is generally expected to remain moderate. Growth in the U.S. will benefit from the additional fiscal support in the first half of

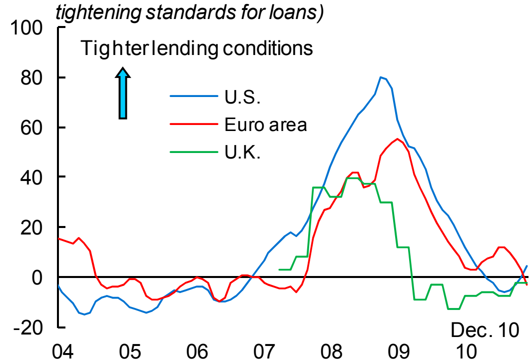
2011 and improving domestic demand, while the effects of the inventory cycle fade. The most likely prospect in the euro area is for a continued, moderate recovery in 2011, with weakening public demand and still-sluggish private demand. Despite support from fiscal stimulus, Japan is expected to have a modest pace of recovery in 2011, reflecting ongoing weakness in domestic demand.

- Growth in *G-20 emerging economies* is expected to remain buoyant. Domestic demand will remain strong, underpinning growth as demand from *G-20 advanced economies* remains subdued. However, activity in these economies, particularly in export-oriented Asia, will remain linked to demand in advanced economies.

10. **Under the baseline projection, financial conditions in the private sector are expected to improve across most regions, but risks and challenges remain**. Financial conditions in most advanced economies remained broadly stable or improved during the second half of 2010, and the trend is expected to continue in 2011.

- Bank lending surveys in the major advanced economies show that credit standards have continued to gradually ease, including for small- and medium-sized firms. The recovery in private credit in *G-20 advanced economies* has also continued, although growth remains very subdued in the major economies. Several important risks remain that could hamper the normalization of credit conditions going forward, including the heavy refinancing schedule facing European banks through the early part of 2011, the threat of financial sector spillovers from the euro area to other regions, and the still-high exposure of small and medium-sized U.S. banks to commercial real estate.

Lending Conditions
(Net percentage of domestic respondents tightening standards for loans)



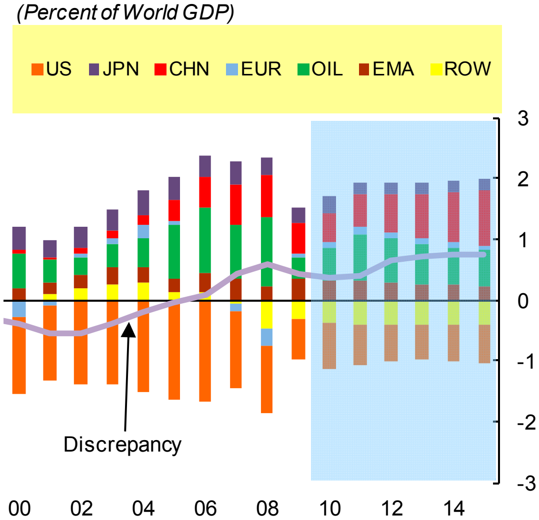
Sources: Lending surveys by the Bank of England, European Central Bank, and the U.S. Federal Reserve for households and corporates; and IMF staff estimates.

- Bond issuance by nonfinancial corporates, notably in the United States, made a strong rebound in the second half of 2010, spurred by historically low borrowing costs. The outlook for U.S. Treasury yields is uncertain, with an improving growth outlook pushing up yields and quantitative easing holding them back. The sluggish recovery in the U.S. and continued high saving in key emerging Asian economies look set to keep U.S. real yields close to historical lows through 2011.

- Securitization markets remain impaired in the U.S., with issuance of mortgage-backed securities continuing to be weak and heavily reliant on government-sponsored entities. Asset-backed-securities linked to consumer credit products saw weak sales volumes, reflecting tight credit conditions. Securitization volumes in Europe remained soft in 2010, and lower than the previous year, in sharp contrast to the strong rebound in covered bond issuance over the same period.

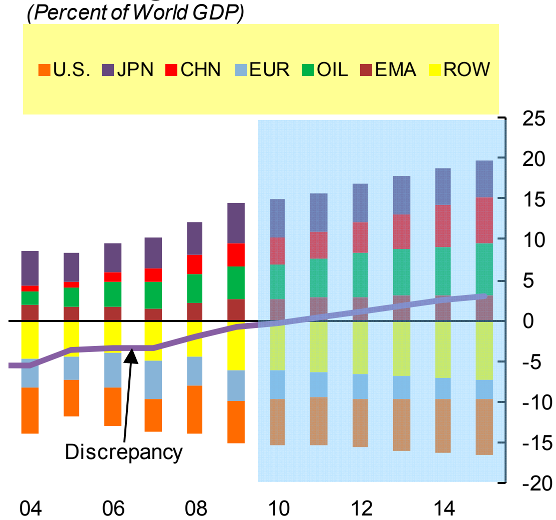
11. **External rebalancing is expected to remain modest**. Global imbalances declined with the collapse in global trade during the crisis, but have increased somewhat during 2010 and are foreseen to remain elevated over the medium term. Surpluses of oil-exporting countries are expected to narrow marginally, and balances of other emerging surplus and advanced deficit economies are expected to widen. Importantly, many of the distortions underlying the large pre-crisis imbalances remain—including undervalued exchange rates in key emerging surplus economies and insufficient domestic saving in advanced deficit economies. Without policies targeted at correcting these underlying distortions, global imbalances will not narrow on a durable basis, and threaten global growth prospects.

Global Imbalances
(Percent of World GDP)



Source: IMF staff estimates.

Net Foreign Assets
(Percent of World GDP)



Source: IMF staff estimates.

Downside risks remain elevated in advanced economies

12. **Tensions in the euro area periphery pose a significant risk to the recovery in the region and possibly beyond**. The risk is exacerbated by inadequate progress in the repair of financial institutions in the euro area. Markets are concerned that adverse spillovers between the banking and sovereign sectors in the periphery may affect the banks in the core, given their exposure to the euro area periphery.

- BIS banking statistics suggest that national banks' foreign claims on euro area economies facing varying degrees of market pressure is sizeable. As of 2010Q3, on a consolidated basis (netting out claims between parent and affiliate banks located in host countries), estimates indicate that foreign claims on Greece, Ireland, Portugal, and Spain by banks in the rest of the euro area are around 10 percent of the region's GDP and around 80 percent of its banks' equity, with claims on Greece and Ireland accounting for about 40 percent.

- While there are backstops in place through the ECB and the EFSF and proposals have been tabled for a permanent crisis management mechanism (ESM), a more comprehensive approach is necessary to deal with the sovereign and financial turbulence and secure a durable exit from the crisis. This will require a decisive action on an expedited basis.

13. **Another downside risk stems from insufficient progress in developing medium-term fiscal consolidation plans in the United States and Japan**. The stimulus measures implemented recently in the United States and Japan make it more challenging to ensure medium-term fiscal sustainability.

- In the *United States*, the recent fiscal measures are expected to deliver only a modest increase in growth, while coming at a significant fiscal cost. The U.S fiscal deficit is now projected to be 10¾ percent of GDP in 2011 (more than double that of the euro area), and gross government debt is projected to exceed 110 percent of GDP in 2016. Achieving the Toronto commitment of halving deficit by 2013 appears highly unlikely, requiring a very large adjustment—roughly 5 percentage points of GDP in primary structural terms. Meanwhile, a continued absence of a credible medium term fiscal strategy threatens to eventually drive up U.S. interest rates, disrupt financial markets, and adversely affect global growth prospects.

- In *Japan*, the overall deficit is only expected to narrow modestly (by a ¼ percentage point) to 9.1 percent of GDP in 2011, reflecting some recently-approved expenditure increases. A deficit reduction of only about 1 percent of GDP is projected for 2012. Recently, Standard and Poor's downgraded Japan's sovereign credit rating to AA-, highlighting increasing concerns over medium-term fiscal sustainability.

Risks of a hard landing are rising in emerging markets

14. **In emerging economies, the key risks pertain to overheating, a rapid rise of inflationary pressures, and the risk of a hard landing**.

- Inflationary pressures are building in emerging economies, albeit with some differentiation across and within regions. With rapidly-rising food and commodity prices, headline inflation is already above target in some Latin American countries and is rising fast in some countries in Asia and Eastern Europe. Central Banks recognize the threat of escalating inflation, but some appear to be signaling that policy settings will remain accommodative in the near term. The People's Bank of China, for example, announced that the inflation target will be raised from 3 percent to 4 percent.

- Meanwhile, the expectation of low interest rates in advanced economies for an extended period of time will continue to contribute to capital flows to emerging economies. While capital inflows could promote rebalancing from external to domestic demand in emerging economies, large and volatile capital inflows could also pose policy challenges. If countries do not use existing policy levers, large capital flows may contribute to risks of overheating, a deterioration of current account deficits beyond what is already assumed in the baseline in some countries (e.g., Brazil, India, South Africa, and Turkey), and asset price bubbles that could undermine economic prospects.

- If left unchecked, rising inflationary pressures could become ingrained in inflation expectations, threatening central bank credibility and macro stability. Inflationary concerns will be exacerbated further if commodity prices continue to rise over the short to medium term, notably for countries with a poor record of keeping inflation in check.

- Under the above circumstances, if economic growth continues to gain momentum and inflationary pressures continue to build, it could set the stage for a hard landing across many of these economies.

15. **In addition to well-known downside risks associated with real estate in major advanced economies, an emerging risk to the global recovery stems from a potentially steep price correction in Chinese property markets**. Residential real estate prices in some of China's larger cities have risen rapidly since the crisis, spurred initially by stimulative policies aimed at easing restrictions on real estate lending and subsequently by strong income growth, high savings, and limited alternate investment vehicles. Over the past year, the authorities have stepped up efforts to rein in property prices, recently announcing a range of measures, including raising the minimum down-payment for second-home buyers and enforced a 5½ percent business tax on properties sold within 5 years. Given the government guarantees in place, financial sector risks threaten the fiscal outlook. While it is difficult to predict how significant the stress from potential property price correction would be, if these risks are realized, there could potentially be global ramifications.

III. POLICY CHALLENGES

Cooperative and well-timed policy initiatives—to reduce vulnerabilities and rebalance growth—are needed to sustain the global recovery. In the advanced economies, the most urgent tasks are to alleviate financial stresses in the euro area, develop credible fiscal consolidation plans, boost job creation, and accelerate financial reforms. The key policy challenge in emerging economies is to keep overheating pressures in check and respond appropriately to capital inflows. In key surplus economies, overheating pressures can be alleviated by permitting currency appreciation, facilitating a healthy rebalancing from external to internal demand.

16. **Addressing risks in the euro area will require further comprehensive, rapid, and decisive policy action by Europe's leaders**. In particular:

- Euro-area-wide mechanisms to support member countries need to be strengthened to durably bolster market confidence. This requires: (i) further national action aimed at securing fiscal sustainability, bank soundness, and growth; and (ii) ensuring that the structure of the EFSM and EFSF, and the envisioned ESM, has the ability to quickly raise sufficient resources at low interest rates and flexibly deploy them to address funding and liquidity problems, under proper conditionality, with a view to support fiscal sustainability.

- The transition to the permanent crisis management mechanism (ESM) needs to be managed carefully with further clarification of the specifics of how it will operate, including the extent of private sector participation, the application of collective action clauses, and the status of existing sovereign debt holders.

- Repair and reform of financial systems—critical to the normalization of credit conditions in several countries and to prevent contagion—needs to be accelerated. Concern about asset values and risky exposures should be addressed by forcing banks to build capital buffers, while unviable business models need to be unwound. This would help reduce the burden on monetary and fiscal policy to support the recovery, and minimize the real consequences of deleveraging. In this context, the new round of EU-wide stress test should be transparent, sufficiently stringent, and accompanied by contingent plans for quick recapitalization or resolution of banks to reassure markets.

- Further strengthening of the economic governance of the euro area to prevent future crises would greatly enhance confidence. Building on current proposals, the preventive arm of the Stability and Growth Pact should be enhanced and the procedure to correct imbalances made more binding. Similarly, to decouple banking and sovereign risks and make financial integration safer, a pan-European crisis management and resolution framework for financial institutions with an EU-wide fiscal backstop and a more centralized approach to supervision should be established. This should go a step beyond current plans to foster better cooperation and coordination among national authorities.

17. **Greater commitment is needed to ensure that fiscal policies will restore medium-term debt sustainability in advanced economies**. The vulnerability of some sovereigns emphasizes the urgency of formulating credible, medium-term fiscal consolidation plans—not just for countries in the euro periphery, but also for other advanced economies. In the near term, a solidifying of the recovery and diminishing deflationary risks in many large advanced economies creates room for current fiscal consolidation plans to be accelerated. Given recent stimulus measures, the United States and Japan need to strengthen their adjustment credentials by specifying the measures they intend to adopt to honor their commitments to reduce deficits and debt. Those advanced economies that came under renewed market pressure should underscore their commitment to their deficit targets and set up contingency plans to ensure that adjustment goals are met.

- The recently announced tax cuts in the U.S. are projected to only have a modest impact on growth outcomes, but have a large budgetary cost. It has thus become even more important to articulate a credible fiscal consolidation plan, including entitlement reforms, caps on discretionary spending, higher revenues through reforms of the tax system, and the establishment or strengthening of fiscal institutions. Plans should build on constructive ideas from the Fiscal Commission and others.

- Successful fiscal adjustment will require medium-term consolidation plans to be accompanied by structural reforms that increase competitiveness, particularly in the euro area and Japan. These policies would raise potential growth and help to support fiscal solvency in the long term. Reforms are particularly needed in the areas of labor and product and services markets, such as those that facilitate greater competition (and lower markups), lower hiring costs, reduce long-term unemployment (by facilitating re-entry), encourage job search, matching, and mobility, and eliminate dual labor markets.

18. **With inflationary expectations well anchored, accommodative monetary policy in major advanced economies remains appropriate for now**. High unemployment and large output gaps are keeping wages and inflation expectations in the major advanced economies in check, notwithstanding large increases in food and energy prices. Continuing monetary policy accommodation is thus the right policy from a domestic perspective, considering also that the recovery is expected to remain sluggish going forward. From an external perspective, however, there is concern that quantitative easing in the United States could result in a flood of capital. In economies where recovery is already well established, policymakers will need to pay increasing attention to building inflationary pressure. Central banks should continue to stand ready to address liquidity problems in the banking sector, particularly in the euro area.

19. **Sharp food price increases pose a particular challenge for many emerging and developing economies**. The recent food price increases come in the wake of the deepest crisis since the Great Depression, when countries are more vulnerable and have, in general, less fiscal space. In addition to the inflationary implications, the rapid increase in food prices may have adverse social implications, particularly in low income countries (LICs). To minimize the social and economic costs from rapid food price increases, policymakers would need to: (i) avoid discretionary policies, such as export bans and taxes and price controls, that seek to insulate domestic markets, as such actions can increase world food price volatility; (ii) accommodate first-round effects, but be ready to tighten policies to avoid second-round effects that could result in persistent inflation; and (iii) ensure that the poor are protected, ideally through targeted and cost effective social safety net programs. The IMF also stands ready to boost its financial support to LICs and other member countries to help them stem the adverse effects of rapid food price increases.

20. **The macroeconomic policy stance in major emerging economies will need to increasingly reflect rising inflation and overheating pressures**. The appropriate policy stance

will need to reflect both individual country circumstances and the intensity of these pressures. For instance, in G-20 emerging economies with flexible exchange rate regimes, and notably where real-exchange rates are at levels that look increasingly overvalued from a medium-term perspective, greater emphasis may need to be placed on fiscal tightening (e.g., Brazil) or monetary as well as fiscal tightening (e.g., India). In other emerging G-20 economies, greater emphasis will need to be placed on allowing exchange rates to appreciate. For instance, in China, a nominal appreciation of the renminbi would both promote the transition to medium-term rebalancing and help contain inflationary pressures.

21. **Many emerging economies will continue to face policy challenges in managing large and volatile capital flows**. Capital flows should be viewed as an opportunity, since they allow emerging economies to borrow at lower interest rates from the rest of the world and can help these economies rebalance. Capital flows to emerging economies are to a significant extent a longer-term phenomenon, driven by fundamentals, and financial development and structural reforms will be important in helping absorb these flows productively. That said, they could also pose challenges. Capital flows can threaten macro stability and financial stability, by leading to excessive credit growth and localized asset bubbles. In response to these concerns, countries should fully utilize macroeconomic and prudential tools. However, there is no “one-size-fits-all” approach to the choice of policy instruments to manage capital flows, and the appropriate response needs to reflect country-specific circumstances. If capital inflows raise macro- and financial-stability concerns, macroeconomic policies (e.g., adjusting the fiscal-monetary policy mix, exchange rate appreciation, and some accumulation of reserves) may need to be complemented with strengthened prudential measures (e.g., loan to value ratios, funding composition restrictions). Temporary capital controls can also be used in some cases, but they should not be a substitute for the necessary macroeconomic and prudential policies.

APPENDIX TABLES

Table 1. Real GDP Growth 1/

(Percent change)

	Year over Year				Q4 over Q4 2/	
		Est.	Projections		Projections	
	2009	2010	2011	2012	2011	2012
World 3/	**-0.6**	**5.0**	**4.4**	**4.5**	**4.5**	**4.4**
Advanced economies	-3.4	3.0	2.5	2.5	2.6	2.5
Euro area	-4.1	1.8	1.5	1.7	1.2	2.0
Emerging and developing economies 4/	2.6	7.1	6.5	6.5	7.0	6.8
Advanced G-20	-3.4	3.0	2.5	2.4	2.5	2.6
Emerging G-20	3.5	8.3	7.4	7.3	7.4	7.3
G-20 2/	-0.5	5.3	4.7	4.6	4.6	4.7
Argentina	0.9	8.5	4.6	2.6	3.7	2.3
Australia	1.3	2.6	3.2	3.2	4.1	2.9
Brazil	-0.6	7.5	4.5	4.1	5.1	4.0
Canada	-2.5	2.9	2.3	2.7	2.7	2.6
China	9.2	10.3	9.6	9.5	9.5	9.4
France	-2.5	1.6	1.6	1.8	1.5	1.9
Germany	-4.7	3.6	2.2	2.0	1.2	2.7
India	5.7	9.7	8.4	8.0	7.9	8.0
Indonesia	4.5	6.0	6.2	6.5	6.1	6.0
Italy	-5.0	1.0	1.0	1.3	1.2	1.4
Japan	-6.3	4.3	1.6	1.8	1.4	2.4
Korea	0.2	6.1	4.5	4.2	5.1	3.7
Mexico	-6.1	5.2	4.2	4.8	5.0	4.5
Russia	-7.9	3.7	4.5	4.4	4.6	4.3
Saudi Arabia	0.6	3.4	4.5	4.4	…	…
South Africa	-1.7	2.8	3.4	3.8	3.4	4.1
Turkey	-4.7	8.2	4.5	4.3	4.1	4.4
United Kingdom	-4.9	1.7	2.0	2.3	1.5	2.6
United States	-2.6	2.8	3.0	2.7	3.2	2.7
European Union	-4.1	1.8	1.7	2.0	1.4	2.2

1/ IMF, *World Economic Outlook,* January 2011.
2/ G-20 aggregations exclude European Union and quarterly projections exclude Saudi Arabia and European Union.
3/ The quarterly estimates and projections account for 90 percent of the world purchasing-power-parity weights.
4/ The quarterly estimates and projections account for approximately 77 percent of the emerging and developing economies.

Table 2. Inflation 1/
(Percent)

	Year over Year			
		Est.	Projections	
	2009	2010	2011	2012
World	**2.5**	**3.7**	**3.7**	**3.2**
Advanced economies	0.1	1.5	1.6	1.6
Euro area	0.3	1.5	1.6	1.5
Emerging and developing economies	5.2	6.3	6.0	4.8
Advanced G-20	0.1	1.5	1.5	1.5
Emerging G-20	4.4	6.1	5.3	4.3
G-20 2/	1.9	3.5	3.2	2.8
Argentina	6.3	10.6	10.6	11.0
Australia	1.8	2.9	3.0	3.0
Brazil	4.9	5.0	5.6	4.7
Canada	0.3	1.8	2.0	1.9
China	-0.7	3.5	3.8	2.5
France	0.1	1.6	1.8	1.7
Germany	0.2	1.0	1.3	1.5
India	10.9	13.2	7.1	5.5
Indonesia	4.8	5.1	6.1	5.6
Italy	0.8	1.6	1.8	1.8
Japan	-1.4	-0.7	-0.1	0.1
Korea	2.8	3.0	3.4	3.0
Mexico	5.3	4.2	3.2	3.0
Russia	11.7	6.8	8.5	7.3
Saudi Arabia	5.1	5.5	5.3	4.5
South Africa	7.1	4.3	4.5	5.1
Turkey	6.3	8.6	8.6	6.4
United Kingdom	2.1	3.3	3.0	2.0
United States	-0.3	1.6	1.4	1.5
European Union	0.9	1.9	2.0	1.8

1/ IMF, *World Economic Outlook*, January 2011.
2/ G-20 aggregations exclude European Union.

Table 3. Fiscal Balance
(Percent of GDP; general government net lending/borrowing; excludes policy lending)

		Est.	Projections	
	2009	2010	2011	2012
World	**-7.3**	**-6.2**	**-5.4**	**-3.9**
Advanced economies	-8.6	-7.8	-7.0	-5.1
Euro area	-6.3	-6.4	-4.7	-3.9
Emerging and developing economies	-4.2	-3.2	-2.3	-1.8
Advanced G-20	-9.4	-8.4	-7.8	-5.6
Emerging G-20	-4.3	-3.4	-2.7	-2.4
G-20 1/	-8.0	-6.9	-6.3	-4.6
Argentina	-3.7	-2.6	-3.2	-2.9
Australia	-4.1	-4.6	-2.5	-0.6
Brazil	-3.1	-2.6	-3.1	-3.2
Canada	-5.5	-5.9	-4.7	-3.3
China	-3.1	-3.1	-2.1	-1.5
France	-7.6	-7.7	-6.0	-4.9
Germany 2/	-3.0	-3.5	-2.6	-1.8
India	-10.2	-9.8	-9.2	-8.4
Indonesia	-1.6	-0.6	-1.4	-1.4
Italy	-5.2	-5.0	-4.3	-3.5
Japan	-10.1	-9.4	-9.1	-8.0
Korea	0.0	1.9	2.4	2.7
Mexico	-4.8	-3.5	-2.4	-2.5
Russia	-6.2	-4.2	-2.9	-3.0
Saudi Arabia	-2.4	8.0	10.4	9.4
South Africa	-5.3	-5.8	-5.3	-4.4
Turkey	-5.6	-2.5	-1.7	-1.6
United Kingdom	-10.3	-10.3	-8.1	-6.1
United States	-12.7	-10.6	-10.8	-7.2
European Union	-6.6	-6.8	-5.1	-4.1

Source: IMF, *World Economic Outlook* January 2011 update.
1/ G-20 aggregations exclude European Union.
2/ Germany fiscal balance numbers are based on estimates received after the January 2011 WEO update was published.

Table 4. Current Account Balance

(Individual countries in percent of country GDP and aggregates in percent of world GDP)

						Est.	Projections			
	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
G-20 1/	-0.7	-0.7	-0.3	-0.5	-0.1	-0.2	-0.1	0.0	0.1	0.1
Thematic Grouping 2/										
G-20 Advanced Surplus	0.5	0.4	0.5	0.0	0.1	0.3	0.2	0.3	0.3	0.2
Canada	1.9	1.4	0.8	0.4	-2.8	-3.7	-3.8	-2.9	-2.3	-2.0
Euro area	0.1	-0.1	0.1	-1.4	-0.6	0.2	0.4	0.5	0.5	0.4
Japan	3.6	3.9	4.8	3.2	2.8	3.2	2.4	2.4	2.4	2.3
Korea	2.2	1.5	2.1	0.3	3.9	2.7	2.4	2.2	2.1	2.1
G-20 Emerging Surplus	0.4	0.6	0.7	0.7	0.5	0.5	0.6	0.7	0.8	0.8
Argentina	2.6	3.2	2.3	1.5	2.0	1.5	1.4	1.2	1.1	1.3
China	7.1	9.3	10.6	9.6	6.0	5.0	5.7	6.3	6.9	7.4
Indonesia	0.1	3.0	2.4	0.0	2.2	1.0	0.6	-0.6	-1.3	-1.9
G-20 Advanced Deficit	-1.9	-1.9	-1.5	-1.2	-0.8	-0.9	-0.8	-0.8	-0.7	-0.7
Australia	-5.7	-5.3	-6.2	-4.5	-4.2	-2.7	-2.5	-3.6	-4.3	-5.1
United Kingdom	-2.6	-3.4	-2.6	-1.6	-1.7	-2.2	-2.5	-2.3	-1.9	-1.7
United States	-5.9	-6.0	-5.1	-4.7	-2.7	-3.3	-3.0	-2.6	-2.5	-2.7
G-20 Emerging Deficit	-0.1	-0.1	-0.2	-0.3	-0.1	-0.2	-0.3	-0.3	-0.3	-0.3
Brazil	1.6	1.2	0.1	-1.7	-1.5	-2.4	-2.8	-3.1	-3.4	-3.5
India	-1.3	-1.0	-0.7	-2.0	-2.9	-3.2	-3.5	-3.3	-2.9	-2.5
Mexico	-0.6	-0.5	-0.8	-1.5	-0.7	-0.5	-0.6	-1.0	-1.1	-1.2
South Africa	-3.5	-5.3	-7.0	-7.1	-4.1	-3.1	-3.9	-3.6	-4.0	-4.1
Turkey	-4.6	-6.1	-5.9	-5.7	-2.3	-6.0	-6.9	-6.9	-7.0	-7.2
EU (other)	0.3	-0.6	-2.4	-2.0	1.4	1.3	0.6	0.5	0.3	0.2
G-20 Large Oil Exporters	0.4	0.4	0.3	0.4	0.1	0.2	0.2	0.1	0.1	0.1
Russia	11.1	9.5	5.9	6.2	4.0	5.4	4.4	2.1	1.2	0.6
Saudi Arabia	28.5	27.8	24.3	27.8	6.1	8.5	11.4	10.0	8.0	8.9

Source: IMF, *World Economic Outlook,* January 2011.
1/ G-20 consists of Argentina, Australia, Brazil, Canada, China, euro area, EU other, India, Indonesia, Japan, Korea, Mexico, Russia, Saudi Arabia, South Africa, Turkey, United Kingdom, and United States; EU other consists of European Union countries excluding euro area and U.K.
2/ For the analysis of global imbalances, the euro area is treated as a whole given its common monetary and exchange rate policies. Accordingly, the advanced surplus economies in that case comprise Canada, euro area, Japan, and Korea, and advanced deficit economies include Australia, the United Kingdom, and the United States. Emerging surplus countries consists of Argentina, China, and Indonesia, major oil exporters includes Russia and Saudi Arabia, and emerging deficit countries comprises Brazil, India, Mexico, South Africa, Turkey, and other EU.

Table 6. Shares of Real GDP 1/

(Percent)

	Average		Average				Est.		Projections							
	2002-05		2006-08		2009		2010		2011		2012		2013		2014	
	Net Exports	Other 2/	Net Exports	Other 2/	Net Exports	Other 2/	Net Exports	Other 2/	Net Exports	Other 2/	Net Exports	Other 2/	Net Exports	Other 2/	Net Exports	Other 2/
G-20																
Argentina	4.9	95.1	0.6	99.4	1.0	99.0	-0.7	100.7	-0.6	100.6	-0.9	100.9	-1.3	101.3	-1.2	101.2
Australia	5.4	94.6	0.5	99.5	1.6	98.4	-0.1	100.1	-0.7	100.7	-1.1	101.1	-1.4	101.4	-1.7	101.7
Brazil	3.2	96.8	1.8	98.2	0.6	99.4	-1.5	101.5	-2.5	102.5	-2.4	102.4	-2.3	102.3	-1.7	101.7
Canada	1.5	98.5	-5.0	105.0	-6.4	106.4	-9.5	109.5	-9.5	109.5	-8.6	108.6	-8.0	108.0	-7.7	107.7
China	5.7	94.3	8.8	91.2	5.0	95.0	5.2	94.8	6.1	93.9	6.6	93.4	7.1	92.9	7.7	92.3
France	-0.2	100.2	-2.4	102.4	-3.2	103.2	-3.1	103.1	-3.2	103.2	-3.0	103.0	-2.9	102.9	-2.9	102.9
Germany	4.2	95.8	7.0	93.0	4.3	95.7	4.9	95.1	5.6	94.4	6.2	93.8	6.7	93.3	7.0	93.0
India	-1.1	101.1	-4.7	104.7	-5.9	105.9	-5.2	105.2	-6.1	106.1	-6.4	106.4	-6.5	106.5	-6.7	106.7
Indonesia	9.4	90.6	9.5	90.5	10.3	89.7	10.2	89.8	10.4	89.6	10.4	89.6	10.4	89.6	10.4	89.6
Italy	-0.3	100.3	-0.4	100.4	-1.6	101.6	-1.7	101.7	-1.7	101.7	-1.7	101.7	-1.6	101.6	-1.5	101.5
Japan	2.2	97.8	4.4	95.6	3.0	97.0	5.0	95.0	5.3	94.7	5.6	94.4	6.0	94.0	6.3	93.7
Korea	1.1	98.9	3.6	96.4	7.5	92.5	7.2	92.8	8.0	92.0	8.3	91.7	8.5	91.5	8.5	91.5
Mexico	-1.7	101.7	-3.0	103.0	-1.6	101.6	-2.7	102.7	-2.9	102.9	-2.9	102.9	-3.1	103.1	-3.5	103.5
Russia	19.2	80.8	12.5	87.5	15.6	84.4	14.4	85.6	12.0	88.0	10.1	89.9	8.9	91.1	7.8	92.2
Saudi Arabia	25.8	74.2	1.0	99.0	-11.5	111.5	-18.5	118.5	-18.7	118.7	-20.9	120.9	-24.4	124.4	-24.6	124.6
South Africa	1.9	98.1	-3.8	103.8	-3.9	103.9	-3.5	103.5	-3.6	103.6	-3.5	103.5	-3.9	103.9	-3.7	103.7
Turkey	-0.8	100.8	-3.6	103.6	0.0	100.0	-3.7	103.7	-4.7	104.7	-5.4	105.4	-6.1	106.1	-6.7	106.7
United Kingdom	-3.1	103.1	-3.2	103.2	-2.1	102.1	-2.9	102.9	-2.5	102.5	-2.1	102.1	-1.5	101.5	-1.0	101.0
United States	-5.3	105.3	-4.8	104.8	-2.8	102.8	-3.3	103.3	-3.3	103.3	-3.3	103.3	-3.4	103.4	-3.7	103.7
European Union	1.3	98.7	1.4	98.6	0.8	99.2	1.4	98.6	2.1	97.9	2.5	97.5	2.9	97.1	3.1	96.9

Source: IMF, *World Economic Outlook*, January 2011.
1/ Net Exports plus Other equals 100.
2/ Sum of private consumption, investment, government consumption and residual.

Table 5. Contributions to Real GDP Growth 1/

(Percent)

	Average 2002-05		Average 2006-08		2009		Est. 2010		Projections 2011		2012		2013		2014	
	Net Exports	Other 2/	Net Exports	Other 2/	Net Exports	Other 2/	Net Exports	Other 2/	Net Exports	Other 2/	Net Exports	Other 2/	Net Exports	Other 2/	Net Exports	Other 2/
G-20																
Argentina	0.8	3.2	-1.1	9.1	1.8	-1.0	-1.6	10.1	0.1	4.5	-0.4	3.0	-0.4	3.4	0.1	2.9
Australia	-1.5	5.1	-1.4	4.6	2.8	-1.4	-1.7	4.3	-0.7	3.8	-0.4	3.6	-0.4	3.7	-0.3	3.6
Brazil	0.9	2.3	-1.1	6.1	0.1	-0.7	-2.2	9.8	-1.1	5.6	-0.1	4.2	0.1	4.0	0.5	3.7
Canada	-1.2	3.9	-1.6	3.4	0.2	-2.7	-2.5	5.4	0.1	2.2	0.9	1.8	0.6	1.9	0.4	2.0
China	1.0	9.1	1.8	10.4	-3.7	12.9	0.8	9.5	1.5	8.1	1.1	8.4	1.2	8.3	1.3	8.2
France	-0.6	2.2	-0.6	2.2	-0.2	-2.4	0.0	1.6	-0.1	1.7	0.1	1.7	0.0	2.0	0.0	2.1
Germany	0.8	-0.4	0.9	1.5	-3.2	-1.5	0.8	2.8	0.8	1.3	0.7	1.3	0.6	1.2	0.4	1.2
India	-0.7	7.8	-1.7	10.4	0.7	4.9	0.2	9.5	-1.4	9.7	-0.8	8.8	-0.7	8.9	-0.7	8.8
Indonesia	0.4	4.6	0.8	5.1	1.2	3.4	0.5	5.5	0.8	5.4	0.7	5.8	0.7	6.0	0.7	6.3
Italy	-0.4	1.1	0.1	0.6	-1.3	-3.8	-0.2	1.2	0.0	1.1	0.0	1.3	0.1	1.3	0.1	1.2
Japan	0.6	1.0	0.7	0.4	-1.5	-4.8	2.2	2.1	0.3	1.3	0.5	1.3	0.5	1.2	0.4	1.2
Korea	0.8	3.9	0.7	3.5	3.1	-2.9	0.1	6.0	1.1	3.3	0.7	3.5	0.6	3.7	0.4	3.7
Mexico	0.0	2.2	-0.7	4.0	2.2	-8.3	-1.2	6.4	-0.4	4.6	-0.1	4.9	-0.3	4.7	-0.6	4.7
Russia	-0.5	6.9	-2.8	10.1	5.2	-13.1	-1.6	5.3	-2.3	6.8	-1.6	6.0	-1.0	5.3	-0.9	5.1
Saudi Arabia	-0.5	5.1	-8.9	12.0	-3.9	4.5	-7.6	11.0	-1.1	5.6	-3.1	7.5	-4.6	9.1	-1.3	5.9
South Africa	-1.6	5.7	-1.3	6.3	0.1	-1.8	0.3	2.4	-0.3	3.7	0.0	3.8	-0.5	4.7	0.0	4.4
Turkey	-2.3	9.6	0.1	3.9	2.7	-7.4	-4.0	12.2	-1.2	5.7	-1.0	5.3	-0.9	5.0	-0.9	4.9
United Kingdom	-0.5	3.0	0.1	1.7	0.9	-5.7	-0.8	2.5	0.3	1.7	0.4	1.9	0.5	1.9	0.5	2.1
United States	-0.5	3.2	0.6	1.0	1.3	-3.9	-0.6	3.4	-0.1	3.1	-0.1	2.8	-0.3	3.1	-0.3	3.1
European Union	0.0	1.4	0.2	1.9	-0.7	-3.4	0.6	1.2	0.7	0.8	0.5	1.2	0.4	1.4	0.3	1.5

Source: IMF, *World Economic Outlook*, January 2011.
1/ Net Exports plus Other equals annual Real GDP growth.
2/ Sum of private consumption, investment, government consumption and residual.