CHAPTER 2

COUNTRY AND REGIONAL PERSPECTIVES

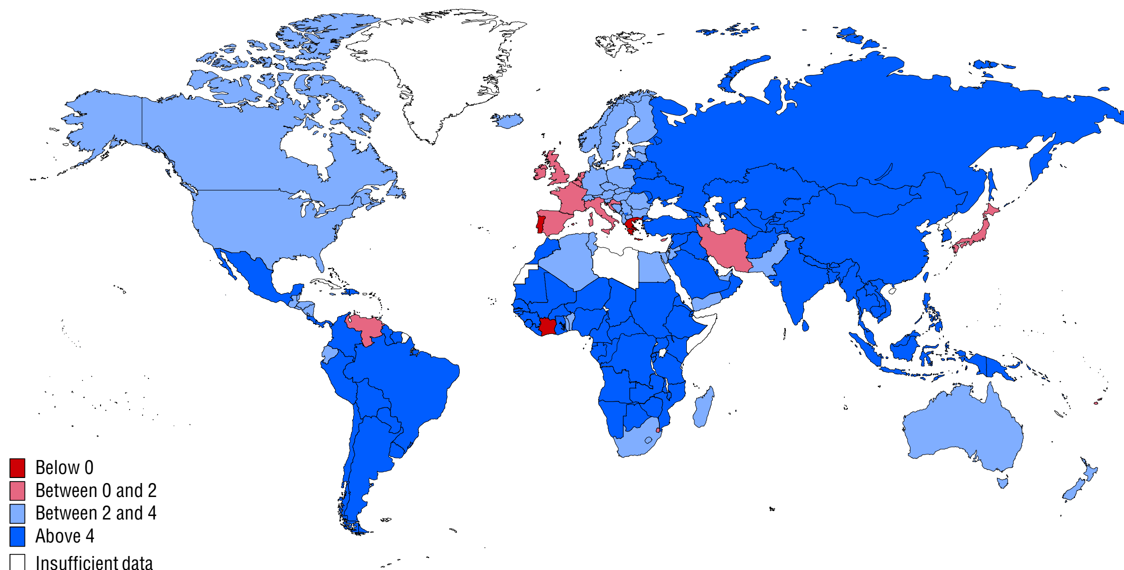
The global economy is now two years into its recovery. From the outset, it was expected to be a multispeed recovery—the April 2009 World Economic Outlook *projected that the economies that would be growing the fastest by 2011 were those that had avoided large precrisis imbalances, had seen the smallest output collapses during the crisis, and had the most room for policy maneuvering after the crisis. Two years later, that picture is broadly unchanged, but the contours of the recovery are clearer (Figure 2.1). Some advanced economies have significant output gaps and elevated unemployment rates; many low-income countries are growing at rapid but sustainable rates; and there are signs of overheating in a number of emerging market economies.*

The uneven nature of this recovery can be seen in the output gaps across regions (Figure 2.2). Emerging Asia and much of Latin America are now operating close to potential, and there are economies in these regions where credit is reaccelerating and signs of overheating are emerging. Meanwhile, the economies at the center of the recent crisis, the United States and Europe, have substantial excess capacity. These divergences have important implications for the outlook, risks, and policy priorities in each region. Therefore, this chapter highlights the extent to which regions differ in their cyclical positions.

Similarly, there are large disparities in some economies' external positions. Past issues of the *World Economic Outlook* have stressed the need for external rebalancing in some regions—most notably the United States and emerging Asia—to reduce global vulnerabilities. This chapter revisits this topic to highlight, where relevant, the extent to which regions diverge in their external (current account balance) positions.

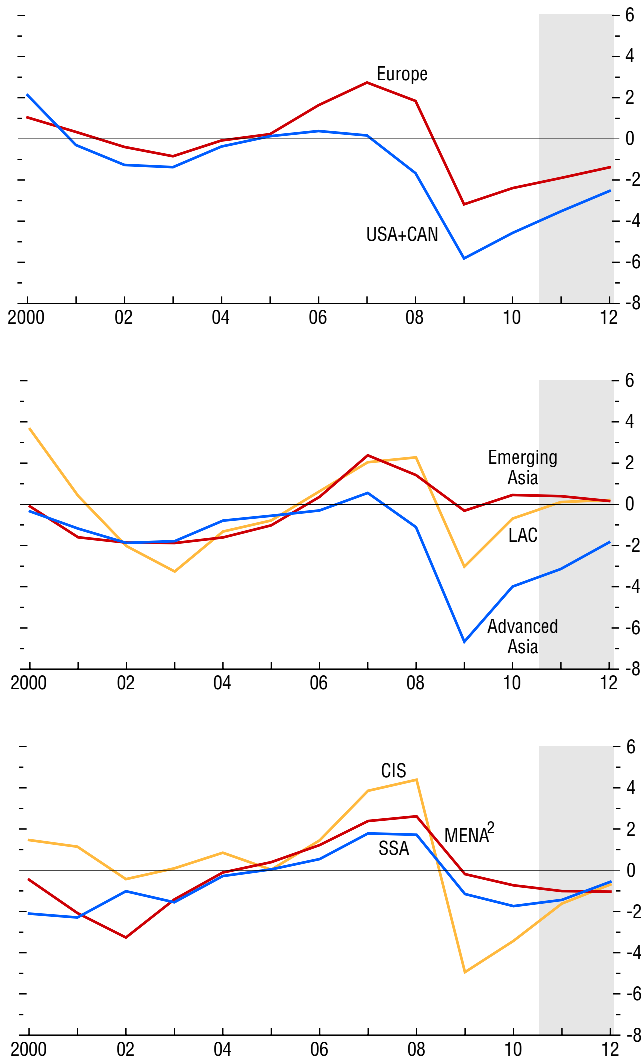
The chapter begins by assessing the outlook and key policy challenges in the regions where large output

Figure 2.1. Global Average Projected Real GDP Growth during 2011–12
(Percent)



Source: IMF staff estimates.
Note: Projections are not provided for Libya due to the uncertain political situation.

Figure 2.2. Output Gaps[1]
(Percent of potential GDP)



Source: IMF staff estimates.
[1]Advanced Asia: Australia, Japan, and New Zealand; CIS: Commonwealth of Independent States, Georgia, and Mongolia; LAC: Latin America and the Caribbean; MENA: Middle East and North Africa; SSA: sub-Saharan Africa; USA+CAN: United States and Canada. Regional aggregates are computed on the basis of purchasing-power-parity weights.
[2]Excludes Libya for the projection years due to the uncertain political situation.

gaps persist—the United States and Canada, Europe, and the Commonwealth of Independent States (CIS). It then examines regions where output gaps are closing or have already closed—Asia, Latin America and the Caribbean (LAC), sub-Saharan Africa (SSA), and the Middle East and North Africa (MENA).

Recovery Proceeds in the United States

The U.S. economy continues to recover, with easing financial conditions supporting private final demand in the face of higher commodity prices (Figures 2.3 and 2.4). Job creation has recently accelerated, but the pace of improvement in the labor market remains disappointing considering the size of the job losses during the decline. A further rebalancing from domestic to external demand would add to growth and help to close the large U.S. output gap.

Following a burst of strong growth driven by inventory restocking in late 2009 and early 2010, economic growth slowed but then strengthened again in the second half of 2010. This strengthening was supported by private final demand, and by the fourth quarter consumer spending was rising at its fastest pace in five years. Although overall credit growth remains weak and household deleveraging continues, financial conditions have generally improved—corporate borrowing rates remain very low, and tight bank lending conditions are now starting to ease not just for large firms but for small and medium-size firms. Reflecting the pickup in economic activity and supported by unconventional monetary easing, equity markets have recovered about two-thirds of the capitalization lost during the crisis. This has helped rebuild consumer confidence, which is still being held down by labor and housing headwinds.

Recovery in the labor market remains lackluster. After shedding more than 8½ million jobs in 2008 and 2009, the labor market has added just under 1½ million jobs since the trough, barely sufficient to keep up with the growth of the working-age population. The employment-population ratio is thus largely unchanged since the start of the recovery. About a third of the decline in the unemployment rate since October 2009—to 8.8 percent in March—is attributable to a decline in labor force participation, which now stands at its lowest level in a quarter century.

Figure 2.3. United States and Canada: Average Projected Real GDP Growth during 2011–12
(Percent)

Source: IMF staff estimates.

Long-term unemployment and broader measures of underemployment—including the share of workers involuntarily working part-time or only marginally attached to the labor force—remain well above historic highs. The crisis may also have increased structural unemployment in the United States, because severe sectoral and regional shocks created mismatches between labor skill supply and demand. IMF staff research shows that, historically, the negative effect of skill mismatches on unemployment rates is exacerbated by depressed housing markets, a key aspect of the recent crisis.[1]

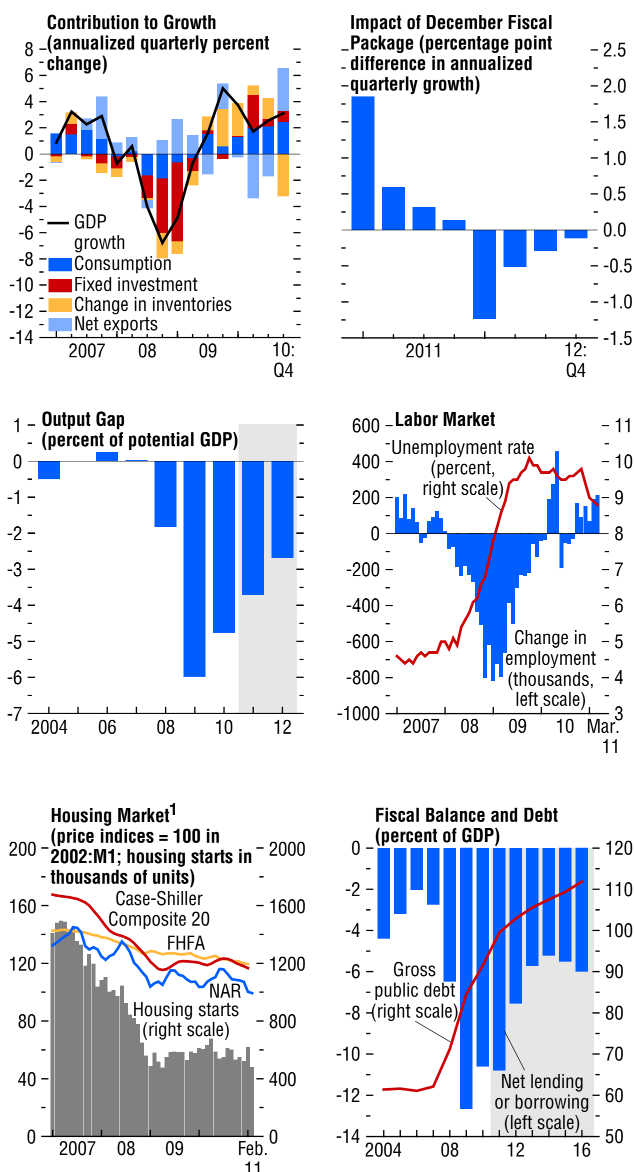
The U.S. economy is projected to grow by 2¾ percent and 3 percent in 2011 and 2012, respectively, with gradually firming private final demand offsetting the waning support from federal fiscal policy (Table 2.1). The fiscal package approved in mid-December implies slightly more than a ½ percentage point addition to growth this year, although recent proposals to curb federal spending would reduce the overall impulse from federal fiscal policy. The drag on 2011 growth from oil price increases largely offsets the boost from the Federal Reserve's unconventional policies and from stronger net exports. Unemployment is projected to remain high, declining only moderately to about 7¾ percent in 2012.

The risks to the outlook remain tilted to the downside. The external environment continues to pose tail risks. Renewed financial turmoil in the euro area could substantially tighten financial conditions and weaken global demand. And a spike in oil and commodity prices, possibly due to continuing tensions in the Middle East and North Africa, could dampen confidence and weaken consumer spending. On the domestic front, house prices could decline by more

[1]See Dowling, Estevão, and Tsounta (2010); and Estevão and Tsounta (2011).

Figure 2.4. United States: Gaining Traction

The recovery is starting to take hold, as private consumption continues to accelerate, albeit slowly. And growth in 2011 will get a boost from the December fiscal package. Quantitative easing has helped fend off deflation pressure arising from a still-large output gap. But vulnerabilities remain: the labor and real estate markets remain weak, and fiscal vulnerabilities need to be addressed.



Sources: Haver Analytics; and IMF staff estimates.
[1]FHFA: Federal Housing Finance Agency. NAR: National Association of Realtors.

than expected, given the large shadow inventory of distressed properties, with adverse effects on household and financial balance sheets. There are, however, a number of upside risks to the outlook. Healthy corporate balance sheets could support stronger hiring and capital investment if business confidence improves. And private consumption, particularly of durables, may surprise on the upside given pent-up demand.

Given the substantial slack in the economy—the output gap is estimated to remain above 3 percent this year—inflation is expected to stay subdued, with price increases of 2¼ percent this year and 1½ percent next year. While food and, especially, energy prices have risen, their share in the consumer basket is small, and second-round effects are likely to be minor because the economy is operating well below potential.

The sluggish pace of the economic recovery calls for supportive macroeconomic policies, but fiscal room is becoming increasingly limited. In this context, the right policy mix for the United States is one of continued monetary accommodation alongside moves to put fiscal balances on a sounder footing. A credible strategy to stabilize public debt in the medium term, and a down payment on fiscal consolidation in 2011, are urgently needed.

With output still significantly below potential, inflation persistently low, and the unemployment rate stubbornly high, continued monetary accommodation is warranted. Although the Federal Reserve's second round of quantitative easing is expected to have only a modest effect on growth, it seems to have reduced perceptions of deflation risks; in the weeks following the news in August that the new round of quantitative easing was imminent, inflation expectations rose and long-term yields fell to new lows. Long-term yields have since increased as signs of a strengthening recovery emerged and traders scaled back their expectations of the extent of future asset purchases by the Federal Reserve.

Although some targeted fiscal measures are justifiable at this point given the weak state of labor and housing markets, the recent stimulus package delivers only a small growth dividend for its considerable budgetary cost. Also, the fiscal deficit is now projected to reach 10¾ percent this year—the largest

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

	Real GDP			Consumer Prices[1]			Current Account Balance[2]			Unemployment[3]		
		Projections			Projections			Projections			Projections	
	2010	2011	2012	2010	2011	2012	2010	2011	2012	2010	2011	2012
Advanced Economies	**3.0**	**2.4**	**2.6**	**1.6**	**2.2**	**1.7**	**–0.2**	**–0.3**	**–0.2**	**8.3**	**7.8**	**7.4**
United States	2.8	2.8	2.9	1.6	2.2	1.6	–3.2	–3.2	–2.8	9.6	8.5	7.8
Euro Area[4,5,6]	1.7	1.6	1.8	1.6	2.3	1.7	–0.6	0.0	0.0	10.0	9.9	9.6
Japan	3.9	1.4	2.1	–0.7	0.2	0.2	3.6	2.3	2.3	5.1	4.9	4.7
United Kingdom[4]	1.3	1.7	2.3	3.3	4.2	2.0	–2.5	–2.4	–1.9	7.8	7.8	7.7
Canada	3.1	2.8	2.6	1.8	2.2	1.9	–3.1	–2.8	–2.6	8.0	7.6	7.3
Other Advanced Economies[7]	5.7	3.9	3.8	2.3	3.1	2.6	5.1	5.5	4.8	5.0	4.5	4.4
Memorandum												
Newly Industrialized Asian Economies	8.4	4.9	4.5	2.3	3.8	2.9	7.1	6.3	6.0	4.1	3.6	3.6

[1]Movements in consumer prices are shown as annual averages. December–December changes can be found in Table A6 in the Statistical Appendix.
[2]Percent of GDP.
[3]Percent. National definitions of unemployment may differ.
[4]Based on Eurostat's harmonized index of consumer prices.
[5]Current account position corrected for reporting discrepancies in intra-area transactions.
[6]Excludes Estonia.
[7]Excludes the United States, Euro Area, and Japan but includes Estonia.

among the advanced economies—and gross debt of the general government will likely exceed 110 percent of GDP by 2016.[2] Indeed, the United States stands out as the only large advanced economy where the cyclically adjusted fiscal deficit is expected to increase in 2011 compared with 2010 despite the ongoing economic recovery.[3] The United States remains committed to meeting the G20 target of halving the deficit between 2010 and 2013, but the high deficit this year may make this difficult.

This unsustainable fiscal outlook calls for a down payment on fiscal consolidation this year. The proposals recently put forward by the National Commission on Fiscal Responsibility and Reform and other analysts contain many useful ideas and provide comprehensive blueprints on which policymakers can build. These proposed measures include reforms to entitlement programs, caps on discretionary spending, revenue-raising tax reforms, and strengthening of fiscal institutions. Meanwhile, the president's draft budget implies a very large near-term fiscal withdrawal—a reduction of some 5 percentage points of GDP in the federal structural primary deficit over fiscal years 2012 and 2013 on the basis of IMF staff macroeconomic and policy assumptions—which will be challenging to implement, especially in an environment of weak growth and elevated unemployment. Such an adjustment would be larger than any two-year adjustment since 1960 (the first year for which data on structural balances are available), which strengthens the case for smoothing the fiscal adjustment beginning in 2011 within a credible medium-term framework.

Although the current account deficit is not expected to widen substantially in the coming years, deficits will persist—the medium-term current account deficit is projected to remain close to last year's level, in part because of insufficient fiscal adjustment. Should much-needed fiscal consolidation take place in the coming years, this will help bring down external deficits. A more robust recovery will then require a larger contribution to growth from net exports to offset a smaller contribution from domestic demand.

Despite the restoration of financial stability, fragilities in the housing sector continue to weigh down banks' balance sheets, and there remain difficult challenges in implementing financial sector reforms.

[2]The fiscal projections reflect IMF staff views on the economic outlook (which are generally more pessimistic than the authorities') and assessments of likely policies. Given the ongoing debate in Congress, the IMF staff assumes more front-loaded (and deeper) discretionary spending cuts than proposed in the president's draft budget and delayed action on revenue-raising measures.

[3]The April 2011 *Fiscal Monitor* discusses the U.S. fiscal policy stance in greater detail.

The recent overhaul of financial system regulation and supervision has been encouraging, but implementation will be the key test. Critical priorities will be to implement a systemic approach to oversight, with stronger regulation (especially for systemically important institutions), greater transparency and accountability in securities and derivatives markets, and close monitoring of the shadow banking sector. The U.S. authorities have presented Congress with a set of proposals to reform housing finance markets, as mandated by the Dodd-Frank Act. The recommendations include winding down government-sponsored entities (Fannie Mae and Freddie Mac) and crafting more focused housing policies, including more explicit and targeted government support. The eventual reform will need to strike the right balance between delivering an appropriate level of explicit government intervention and discouraging another cycle of overinvestment.

Economic developments in Canada last year mirrored those in the United States, with the pace of economic activity moderating in midyear. The deceleration reflected not only the drag on Canadian exports from weak U.S. activity and strong import growth from investment spending amid an appreciating currency, but also a cooling of some domestic activity, as housing activity softened from unsustainably high levels, consumer spending temporarily moderated, and the effect of the fiscal stimulus faded. Canada's GDP is projected to expand by 2¾ percent this year, with domestic demand in general and private investment in particular, in line with strong commodity prices, being the primary drivers of growth; the strong loonie is expected to continue to be a drag on growth. Risks to the growth outlook are tilted to the downside, with the main domestic risk being deterioration of housing markets and household balance sheets. Key external risks are lower-than-expected activity in the United States and renewed sovereign strains in Europe.

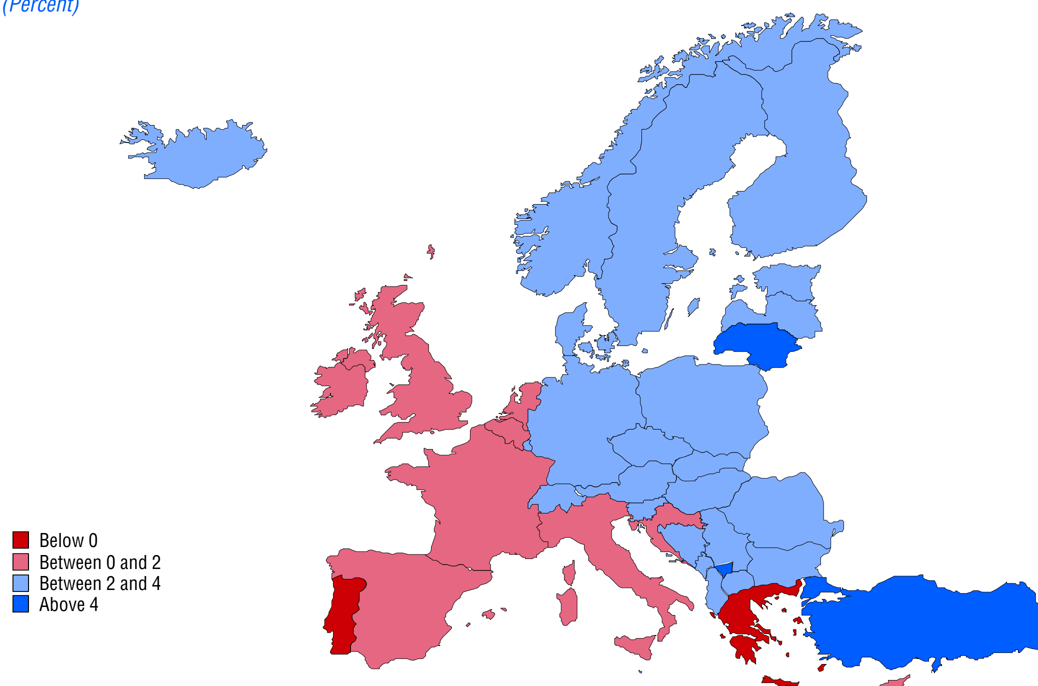
Canada's macroeconomic policies rightly remain accommodative as output remains about 2 percent below potential. Given the downside risks to the growth outlook, muted inflation pressures, and the forthcoming withdrawal of stimulus, a wait-and-see attitude seems appropriate regarding further increases in the policy rate. On the fiscal front, recent moves to smooth the up-front fiscal adjustment are welcome, and the authorities have a sound and credible plan to return to budget surpluses beginning in fiscal year 2015. Over the longer term, challenges from population aging and health care inflation require further plans to cement fiscal sustainability. On the financial front, Canada's supervisory and regulatory approach has been sound, and it has helped prevent the excesses that hurt other advanced economies during the recent crisis. However, continued vigilance is needed to maintain financial stability, particularly in light of high concentration in the financial system, substantial exposure to U.S. risks, and historically high household debt levels.

A Gradual and Uneven Recovery Is under Way in Europe

In Europe, the recovery is proceeding modestly (Figure 2.5). Overall, real activity in the region remains below its potential level and unemployment is still high. There is, however, substantial variation across economies. The degree of economic slack is larger in the periphery of the euro area than in the core, whereas the largest emerging market economies in the region are already operating at or above capacity.

The recovery in Europe has been gaining traction, despite renewed financial turbulence in peripheral countries of the euro area during the last quarter of 2010. Concerns about banking sector losses and fiscal sustainability led to widening sovereign spreads in these countries, in some cases reaching highs not seen since the launch of the Economic and Monetary Union. But the situation was contained by strong policy responses at both the national and the EU level—that is, measures to improve fiscal balances and push forward with structural reforms in the affected countries, extraordinary liquidity support, securities purchases by the European Central Bank (ECB), and funding from the European Financial Stabilization Mechanism (EFSM) and the European Financial Stability Facility (EFSF) to support the joint EU/IMF program for Ireland. Consequently, the damage to economic activity was limited to the affected economies and did not spread to the rest of Europe, where growth has become more broad-based and self-sustained (Figure 2.6).

Figure 2.5. Europe: Average Projected Real GDP Growth during 2011–12
(Percent)



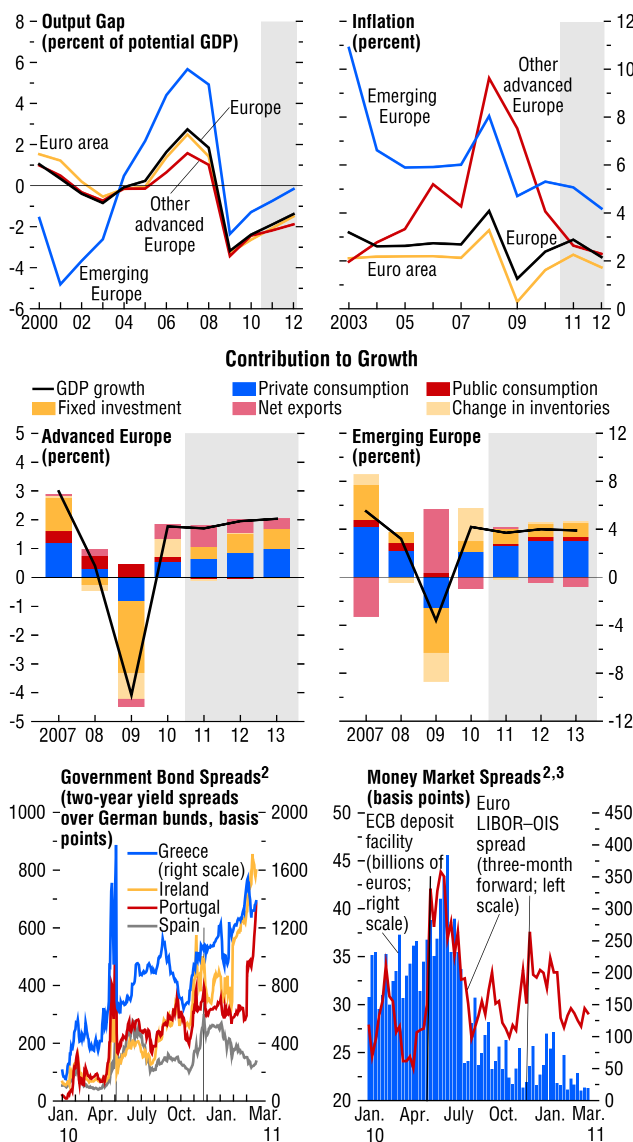
Source: IMF staff estimates.

The outlook is for a continued gradual and uneven expansion (Table 2.2). Advanced Europe's real GDP is projected to grow at 1¾ percent in 2011 and 2 percent in 2012. Emerging Europe's growth is expected to be 3¾ percent in 2011 and 4 percent in 2012. Economic prospects across the region are likewise divergent, largely reflecting differences in the state of public and private sector balance sheets and the stance of macroeconomic policies.

- In Germany, growth is expected to moderate from 3½ percent last year to 2½ percent this year, mainly due to the withdrawal of fiscal support and the slowdown in external demand growth. In France, growth is projected to be modest, at 1½ percent this year, as consumption growth is subdued by the retrenchment of fiscal stimulus and export growth is weakened by slowing external demand. In Italy, the recovery is expected to remain weak, as long-standing competitiveness problems constrain export growth and the planned fiscal consolidation weighs on private demand. Growth is projected to be much lower in the periphery of the euro area because these economies are suffering a sharp and protracted contraction in public and private balance sheets—which is needed to resolve fiscal and competitiveness imbalances—and also face more severe structural unemployment problems (Box 2.1).
- In advanced economies outside the euro area, recovery prospects are similarly differentiated. For instance, growth in the United Kingdom is projected at 1¾ percent in 2011 as necessary front-loaded fiscal consolidation dampens domestic demand. But in Sweden, real activity is expected to expand by 3¾ percent this year amid rapidly improving financial conditions and nascent signs of overheating in the real estate sector.
- In emerging Europe, the rapid recovery is projected to continue in Turkey, where robust private demand and buoyant credit growth are lifting economic activity above its potential level amid still-accommodative macroeconomic policies. In Poland, growth is expected to remain solid at about 3¾ percent this year as corporate profitability rises, the absorption of EU funds continues, and bank lending resumes. The recovery is projected to remain more subdued

Figure 2.6. Europe: A Gradual and Uneven Recovery Continues[1]

The recovery is proceeding at a moderate pace. Real activity in the region remains below its potential level, and inflation pressure is broadly contained. But there are substantial differences across economies. Growth has generally become more broad-based and self-sustained in both advanced and emerging Europe. In the euro area periphery, however, continued financial turbulence is dampening the outlook for these economies.



Sources: Bloomberg Financial Markets; and IMF staff estimates.

[1]Euro Area: Austria, Belgium, Cyprus, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Malta, Netherlands, Slovak Republic, Slovenia, and Spain. Emerging Europe: Albania, Bosnia and Herzegovina, Bulgaria, Croatia, Hungary, Kosovo, Latvia, Lithuania, Former Yugoslav Republic of Macedonia, Montenegro, Poland, Romania, Serbia, and Turkey. Other advanced Europe comprises Czech Republic, Denmark, Estonia, Iceland, Norway, Portugal, Sweden, Switzerland, and United Kingdom. Aggregates are computed on the basis of purchasing-power-parity weights.

[2]Vertical lines on each panel correspond to May 10 and November 30, 2010.

[3]ECB: European Central Bank; LIBOR: London interbank offered rate; OIS: overnight index swap.

in some of the economies that experienced unsustainable domestic booms (Romania).

Downside risks to the outlook continue to prevail. In the near term, continued strains in more vulnerable euro area sovereigns and banks pose a significant threat to financial stability and growth, as discussed in Chapter 1 of the April 2011 *Global Financial Stability Report*. This is mainly due to continuing weakness among financial institutions in many of the region's advanced economies and a lack of transparency about their exposures. Financial institutions and sovereigns are closely linked, with spillovers occurring in both directions. Substantial cross-border linkages, as well as financial spillovers through higher risk aversion and lower equity prices, could generate a slowdown in growth and demand that would hinder the regional and global recoveries. Another downside risk to growth stems from higher-than-expected commodity prices. In the medium term, the main risk remains that deep-rooted fiscal and competitiveness imbalances in peripheral economies and incomplete action to address banking sector vulnerabilities in many euro area economies could lead to a long period of slow growth.

Comprehensive, rapid, and decisive policy actions are required to address these downside risks. Important steps have already been taken at both the national and the EU level. But further bold steps are needed to secure fiscal sustainability, resolve banking sector problems, reform EU policy frameworks, and rekindle growth.

Securing public debt sustainability remains a priority for most European economies. Current fiscal consolidation plans are broadly appropriate and rightfully differentiated in the near term. In 2011, the largest economies in the region (France, Germany, Spain, United Kingdom) will implement differing measures (in size and composition) to reduce their deficits. Sovereigns that have come under market pressure (Greece, Ireland, Portugal) will continue with sizable front-loaded consolidation. Nonetheless, in many European countries, more needs to be done to underpin medium-term adjustment plans with concrete and sustained policies. In addition, current plans for medium-term fiscal adjustment still need to be strengthened in the face of looming increases in pension and health spending.[4] Some economies have taken steps toward entitlement spending reforms (for

[4]See Bornhorst and others (2010) for details.

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

(Annual percent change unless noted otherwise)

	Real GDP			Consumer Prices[1]			Current Account Balance[2]			Unemployment[3]		
		Projections			Projections			Projections			Projections	
	2010	2011	2012	2010	2011	2012	2010	2011	2012	2010	2011	2012
Europe	**2.1**	**2.0**	**2.2**	**2.4**	**2.9**	**2.2**	**0.3**	**0.2**	**0.2**	...	...	...
Advanced Europe[4]	**1.7**	**1.7**	**1.9**	**1.9**	**2.5**	**1.8**	**0.8**	**0.8**	**0.9**	**9.3**	**9.2**	**8.9**
Euro Area[5,6,7]	1.7	1.6	1.8	1.6	2.3	1.7	–0.6	0.0	0.0	10.0	9.9	9.6
Germany	3.5	2.5	2.1	1.2	2.2	1.5	5.3	5.1	4.6	6.9	6.6	6.5
France	1.5	1.6	1.8	1.7	2.1	1.7	–2.1	–2.8	–2.7	9.7	9.5	9.1
Italy	1.3	1.1	1.3	1.6	2.0	2.1	–3.5	–3.4	–3.0	8.5	8.6	8.3
Spain	–0.1	0.8	1.6	2.0	2.6	1.5	–4.5	–4.8	–4.5	20.1	19.4	18.2
Netherlands	1.7	1.5	1.5	0.9	2.3	2.2	7.1	7.9	8.2	4.5	4.4	4.4
Belgium	2.0	1.7	1.9	2.3	2.9	2.3	1.2	1.0	1.2	8.4	8.4	8.2
Austria	2.0	2.4	2.3	1.7	2.5	2.0	3.2	3.1	3.1	4.4	4.3	4.3
Greece	–4.5	–3.0	1.1	4.7	2.5	0.5	–10.4	–8.2	–7.1	12.5	14.8	15.0
Portugal	1.4	–1.5	–0.5	1.4	2.4	1.4	–9.9	–8.7	–8.5	11.0	11.9	12.4
Finland	3.1	3.1	2.5	1.7	3.0	2.1	3.1	2.8	2.6	8.4	8.0	7.8
Ireland	–1.0	0.5	1.9	–1.6	0.5	0.5	–0.7	0.2	0.6	13.6	14.5	13.3
Slovak Republic	4.0	3.8	4.2	0.7	3.4	2.7	–3.4	–2.8	–2.7	14.4	13.3	12.1
Slovenia	1.2	2.0	2.4	1.8	2.2	3.1	–1.2	–2.0	–2.1	7.2	7.5	7.2
Luxembourg	3.4	3.0	3.1	2.3	3.5	1.7	7.7	8.5	8.7	6.1	5.9	5.8
Estonia	3.1	3.3	3.7	2.9	4.7	2.1	3.6	3.3	3.1	16.9	14.8	12.8
Cyprus	1.0	1.7	2.2	2.6	3.9	2.8	–7.0	–8.9	–8.7	6.8	6.5	6.3
Malta	3.6	2.5	2.2	2.0	3.0	2.6	–0.6	–1.1	–2.3	6.5	6.5	6.4
United Kingdom[6]	1.3	1.7	2.3	3.3	4.2	2.0	–2.5	–2.4	–1.9	7.8	7.8	7.7
Sweden	5.5	3.8	3.5	1.9	2.0	2.0	6.5	6.1	5.8	8.4	7.4	6.6
Switzerland	2.6	2.4	1.8	0.7	0.9	1.0	14.2	13.2	12.8	3.6	3.4	3.3
Czech Republic	2.3	1.7	2.9	1.5	2.0	2.0	–2.4	–1.8	–1.2	7.3	7.1	6.9
Norway	0.4	2.9	2.5	2.4	1.8	2.2	12.9	16.3	16.0	3.6	3.6	3.5
Denmark	2.1	2.0	2.0	2.3	2.0	2.0	5.0	4.8	4.8	4.2	4.5	4.4
Iceland	–3.5	2.3	2.9	5.4	2.6	2.6	–8.0	1.1	2.1	8.1	7.5	6.5
Emerging Europe[8]	**4.2**	**3.7**	**4.0**	**5.3**	**5.1**	**4.2**	**–4.3**	**–5.4**	**–5.7**	...	...	...
Turkey	8.2	4.6	4.5	8.6	5.7	6.0	–6.5	–8.0	–8.2	11.9	11.4	11.0
Poland	3.8	3.8	3.6	2.6	4.1	2.9	–3.3	–3.9	–4.2	9.0	9.0	8.7
Romania	–1.3	1.5	4.4	6.1	6.1	3.4	–4.2	–5.0	–5.2	7.6	6.6	5.8
Hungary	1.2	2.8	2.8	4.9	4.1	3.5	1.6	1.5	0.9	11.2	11.5	10.9
Bulgaria	0.2	3.0	3.5	3.0	4.8	3.7	–0.8	–1.5	–2.0	10.3	8.0	6.7
Serbia	1.8	3.0	5.0	6.2	9.9	4.1	–7.1	–7.4	–6.6	19.4	19.6	19.8
Croatia	–1.4	1.3	1.8	1.0	3.5	2.4	–1.9	–3.6	–3.6	12.3	12.8	12.3
Lithuania	1.3	4.6	3.8	1.2	3.1	2.9	1.8	–0.9	–2.9	17.8	16.0	14.0
Latvia	–0.3	3.3	4.0	–1.2	3.0	1.7	3.6	2.6	1.5	19.0	17.2	15.5

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

example, France, Greece, Ireland, Italy, Spain), but more should be done in this area.

Remaining fragilities in Europe's financial system urgently need to be resolved. As discussed in Chapter 1 of the April 2011 *Global Financial Stability Report,* progress in strengthening capital positions and reducing leverage has been uneven in Europe. Specifically, in the euro area, asset quality is uncertain, and banks face a wall of maturing debt and therefore remain vulnerable to funding pressures in wholesale markets. The desire to reduce the dependence on wholesale funding has sparked a deposit war in several economies, squeezing bank revenues. Overall, some euro area banks face significant capital shortfalls. To

help address such weaknesses, it is critical to reduce uncertainty about asset quality, increase the capital buffers of viable banks, and identify and resolve weak banks. In this respect, some economies (for example, Spain) have made more progress than others. New stress tests that are more realistic, thorough, and transparent will increase clarity. But they will be effective only if embedded in coordinated national strategies to deal with vulnerable institutions—an approach policymakers committed to at the March EU summit. Meanwhile, excess capacity in banking systems needs to be removed by resolving the weak tail of banks. Without these reforms, financial systems in Europe will remain vulnerable, credit growth could come under further pressure, and the economic recovery could be undermined.

In most European economies, monetary policy can stay accommodative for as long as inflation pressures remain subdued. In advanced Europe, core inflation is projected to remain low because inflation expectations are well anchored and excess capacity is still large in most economies. Also, the impact of recent increases in commodity prices should prove temporary. This argues for low policy rates for now to support the recovery and help offset the dampening short-term effects of fiscal consolidation on domestic demand. Still, central banks will have to keep a watchful eye on wage developments and inflation expectations for potential second-round effects, especially in countries that are most advanced in their recoveries. In the euro area, remaining financial fragilities could hold back growth, justifying a slower pace of normalization. Moreover, the ECB's extraordinary measures will need to be removed only gradually as systemic uncertainty recedes. In emerging Europe, inflation prospects are more mixed, which reflects mainly different degrees of economic slack and variable pass-through of commodity prices into overall inflation. In some fast-growing emerging economies, policy rates may need to be normalized sooner to prevent overheating.

A key challenge ahead is to reform euro area and EU policy frameworks to help restore confidence and secure Europe's future stability and growth. The crisis revealed deep-rooted problems, with significant cross-border dimensions, in existing fiscal, structural, and financial stability policies. To address these problems, comprehensive solutions are needed.

The immediate priority is to reassure markets that sufficient resources are available from the euro-wide safety net to deal with downside risks. European leaders committed at the March EU summit to substantially increase the effective lending capacity of the EFSF. While this should bolster market confidence, the mechanism by which this is secured should be clarified as soon as possible, and a decision on adjusting the interest rate charged on EFSF loans is urgently needed to help support fiscal sustainability. Beyond 2013, the proposed permanent European Stability Mechanism provides a robust and orderly framework to assist euro area members, with strict conditionality to support discipline. Some additional flexibility on these instruments would be helpful to deal more directly with the interdependence of national banking systems and sovereign risks.

Beyond crisis-management measures, the crisis has highlighted the need to improve EU policy coordination on fiscal and structural issues. Shared responsibility for fiscal burdens needs to come with shared responsibility for fiscal policies. To this end, policymakers agreed in March to strengthen fiscal frameworks, through a stronger Stability and Growth Pact, minimum standards to be set for national frameworks, and enhanced coordination with the European Semester. Improved surveillance over structural bottlenecks, competitiveness, and imbalances is also needed to help address macroeconomic imbalances. In that respect, the recently agreed Euro Plus Pact and the forthcoming Excessive Imbalances Procedure are welcome coordination tools, but specific reforms will need to be identified and implemented without further delay. Furthermore, the surveillance process should be made more binding by introducing sanctions and ensuring that the delay between diagnosis and policy action is kept short.

Another lesson from the crisis is the need for an integrated, pan-European approach to supervision, regulation, and crisis management and resolution. Financial sector problems in specific countries can spread quickly across the region, and supervisory and regulatory gaps can have major spillovers. Hence, more joint responsibility and accountability for Europe's financial stability are urgently needed. This can be achieved through integrated crisis management and resolution as well as integrated supervision, which should help establish some consensus on

burden sharing. Some steps in this direction are being taken with the creation of the European Systemic Risk Board and the establishment of the European Supervisory Authorities. But the success of these new institutions will depend on adequate resources, good information gathering and sharing, and focused coordination of their activities. More important, overall progress toward an integrated European financial stability framework has been disappointingly slow, especially considering its importance for achieving an efficient and stable market for financial services that spreads risks among countries and fosters economic growth in Europe.

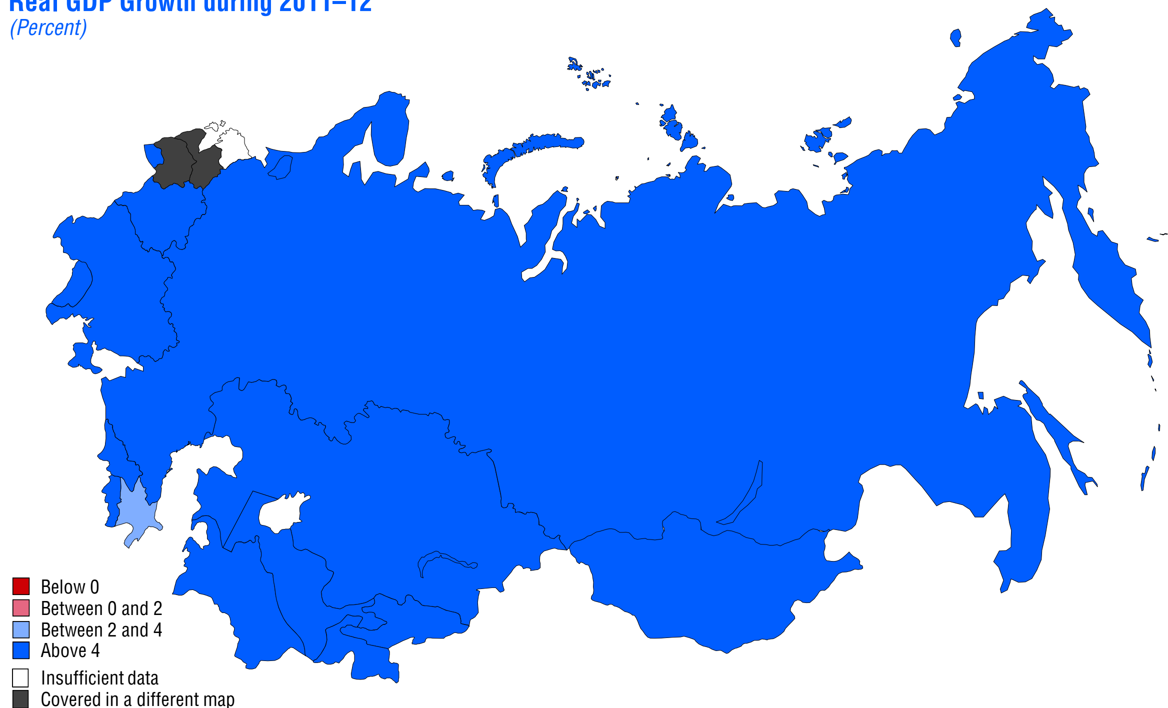
In many ways, the European Union and the euro area are at a crossroads. Popular support for the euro remains strong, considering the tensions created by sharing sovereign risk. But unless economies make a quantum leap toward a more integrated approach to fiscal policy and assume joint responsibility for financial stability, support for burden sharing may be much lower in future crises. If taken, however, these steps can deliver the major benefits that derive from risk sharing via a truly integrated and better supervised and regulated financial market.

A Moderate Recovery Continues in the Commonwealth of Independent States

The recovery in the CIS is proceeding at a steady pace (Figure 2.7). Having suffered a collapse during the crisis, real activity in the region remains substantially below its potential level, despite notable differences across economies.

Several factors are supporting the recovery. Higher commodity prices are boosting production and employment in the region's commodity-exporting economies. Also, the rebound in real activity in Russia is benefiting other CIS economies through trade, remittances, and investment. In addition, there continues to be a gradual normalization of trade and capital flows to the region. Nevertheless, heavy dependence on external financing and lingering banking sector vulnerabilities are holding back growth in several CIS economies.

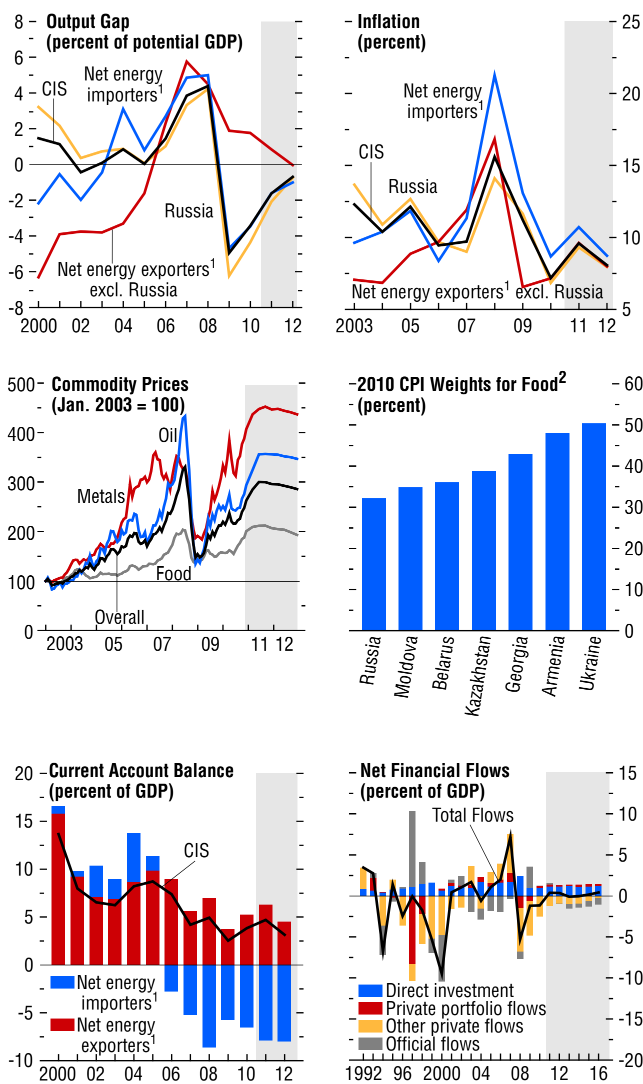
Figure 2.7. Commonwealth of Independent States: Average Projected Real GDP Growth during 2011–12
(Percent)



Source: IMF staff estimates.
Note: Includes Georgia and Mongolia.

Figure 2.8. Commonwealth of Independent States: A Moderate Recovery is under Way

The recovery is continuing at a steady pace. Having suffered a collapse during the crisis, real activity in the CIS region remains substantially below its potential level, despite notable differences across economies. Inflation is on the rise, led by higher prices for food, which makes up a large share of the consumption basket in the region.



Sources: Haver Analytics; IMF, Primary Commodity Price System; and IMF staff estimates.

[1]Net energy exporters: Azerbaijan, Kazakhstan, Russia, Turkmenistan, and Uzbekistan. Net energy importers: Armenia, Belarus, Georgia, Kyrgyz Republic, Moldova, Mongolia, Tajikistan, and Ukraine. Aggregates for the external economy are sums of individual country data. Aggregates for all others are computed on the basis of purchasing-power-parity weights.

[2]Data for Belarus are for 2008; CPI = consumer price index.

Against this backdrop, real activity in the CIS is projected to expand by 5 percent in 2011 and 4¾ percent in 2012, coming closer to its potential level only gradually. Within the region, however, growth prospects differ substantially (Figure 2.8; Table 2.3):

- In Russia, growth is projected to pick up modestly to 4¾ percent in 2011 and 4½ percent in 2012, only gradually reducing the output gap. Private sector demand is likely to remain subdued as nonperforming loans in the banking system constrain credit and consumption growth.
- Among other energy exporters, economies whose financial sectors have fewer external linkages are expected to continue to perform best. In particular, Turkmenistan is expected to benefit from high gas prices and be among the top performers in the region, growing by 9 percent in 2011. In Uzbekistan, growth is also projected to remain high, at 7 percent in 2011, supported by strong domestic demand, public investment, and commodity exports (including gold and cotton).
- For energy importers as a group, growth is projected at 5¼ percent in 2011 and 5 percent in 2012 as some of these economies (for example, Armenia, Moldova) benefit from the rebound in remittances from Russia and others from the return of financial stability (for example, Ukraine).

Despite the considerable degree of economic slack, inflation is on the rise across the region, led by higher food prices. Unfavorable weather conditions in 2010 reduced grain yields and contributed to price spikes. Food comprises a large share of the region's consumer price inflation basket (30 to 50 percent; see Figure 2.8), and so rising food prices are expected to substantially increase headline inflation. Given the limited credibility of monetary policy frameworks in the region, this will likely feed into more generalized wage and core inflation pressures.

Risks to the outlook in the region are broadly balanced. For most CIS economies, growth prospects remain highly dependent on the speed of recovery in Russia, which could surprise in either direction. Higher commodity prices represent an upside risk to growth in commodity-exporting economies in the region; increased global risk aversion or lower external demand from advanced economies present downside risks to growth.

Table 2.3. Commonwealth of Independent States: Real GDP, Consumer Prices, Current Account Balance, and Unemployment

(Annual percent change unless noted otherwise)

	Real GDP			Consumer Prices[1]			Current Account Balance[2]			Unemployment[3]		
		Projections			Projections			Projections			Projections	
	2010	2011	2012	2010	2011	2012	2010	2011	2012	2010	2011	2012
Commonwealth of Independent States (CIS)[4]	**4.6**	**5.0**	**4.7**	**7.2**	**9.6**	**8.1**	**3.8**	**4.7**	**3.2**	**. . .**	**. . .**	**. . .**
Russia	4.0	4.8	4.5	6.9	9.3	8.0	4.9	5.6	3.9	7.5	7.3	7.1
Ukraine	4.2	4.5	4.9	9.4	9.2	8.3	–1.9	–3.6	–3.8	8.1	7.8	7.2
Kazakhstan	7.0	5.9	5.6	7.4	9.1	6.4	2.5	5.8	4.2	5.8	5.7	5.6
Belarus	7.6	6.8	4.8	7.7	12.9	9.7	–15.5	–15.7	–15.2	0.7	0.7	0.7
Azerbaijan	5.0	2.8	2.5	5.7	10.3	7.5	27.7	28.4	24.2	6.0	6.0	6.0
Turkmenistan	9.2	9.0	6.4	4.4	6.1	7.3	–11.4	–4.7	–3.9	. . .	. . .	. . .
Mongolia	6.1	9.8	7.1	10.2	16.4	16.0	–15.2	–13.3	–14.0	3.3	3.0	3.0
Low-Income CIS	**6.0**	**5.0**	**4.8**	**7.4**	**11.4**	**9.2**	**11.0**	**13.1**	**10.3**	**. . .**	**. . .**	**. . .**
Uzbekistan	8.5	7.0	7.0	9.4	11.6	12.3	6.7	10.0	6.7	0.2	0.2	0.2
Georgia	6.4	5.5	4.8	7.1	12.6	7.9	–9.8	–13.0	–12.0	16.8	16.7	16.5
Armenia	2.6	4.6	4.3	8.2	9.3	5.5	–13.7	–12.4	–11.3	7.0	7.0	7.0
Tajikistan	6.5	5.8	5.0	6.5	13.9	9.7	2.2	–4.1	–7.2	. . .	. . .	. . .
Kyrgyz Republic	–1.4	5.0	6.0	7.8	18.8	9.3	–7.4	–6.7	–7.8	5.8	5.6	5.5
Moldova	6.9	4.5	4.8	7.4	7.5	6.3	–10.9	–11.1	–11.2	7.4	6.5	6.0
Memorandum												
Net Energy Exporters[5]	4.4	5.0	4.6	6.9	9.4	8.0	5.3	6.3	4.5	. . .	. . .	. . .
Net Energy Importers[6]	5.1	5.3	4.9	8.7	10.7	8.7	–6.5	–7.9	–8.0	. . .	. . .	. . .

[1]Movements in consumer prices are shown as annual averages. December–December changes can be found in Table A7 in the Statistical Appendix.

[2]Percent of GDP.

[3]Percent. National definitions of unemployment may differ.

[4]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.

[5]Net Energy Exporters comprise Azerbaijan, Kazakhstan, Russia, Turkmenistan, and Uzbekistan.

[6]Net Energy Importers comprise Armenia, Belarus, Georgia, Kyrgyz Republic, Moldova, Mongolia, Tajikistan, and Ukraine.

The key policy challenge in the region is to exit from crisis-related macroeconomic and financial policies in a way that provides sufficient support to the incomplete recovery but does not jeopardize price stability.

- On the financial front, the main policy task is to address lingering vulnerabilities. The considerable banking risks in Russia, for instance, call for strengthening capital adequacy requirements, enhancing supervisory powers, and implementing legislation on consolidated supervision and connected lending. In several economies (Kazakhstan, Kyrgyz Republic, Tajikistan), the top priority is comprehensive and transparent strategies to address nonperforming loans in the banking sector.
- Because most economies in the region operate under pegged or heavily managed exchange rate regimes, there is only limited scope for monetary policy to respond to shocks. In this context, the increased exchange rate flexibility in Russia is welcome because it reduces the scope for conflict between the exchange rate and inflation and deters speculative capital flows. Given steady increases in nonfood prices and unfavorable inflation prospects, an increase in policy interest rates would help prevent a wage-price spiral.
- On the fiscal front, the specific policy challenges vary across the region. In Russia, following the large fiscal stimulus (about 9 percent of GDP) implemented during the crisis, the main task is to deliver a more ambitious, credible, and growth-friendly plan for medium-term consolidation. In Kazakhstan, where fiscal policy continues to support the recovery, the efficiency of public spending should be ensured. In a number of economies (for example, Armenia, Georgia, Kyrgyz Republic) where the share of food in the consumption basket is high, poor households will bear the brunt of any price increases. Hence, there is a need to better target government support for low-income households.

Rapid Growth Continues in Asia

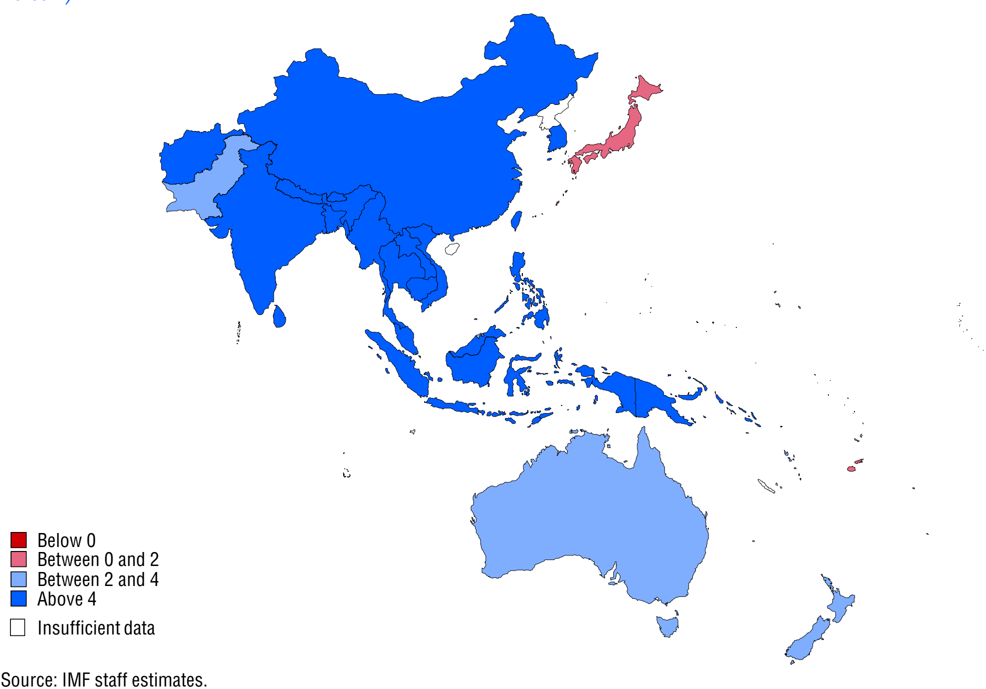
Broad-based recovery is continuing in most Asian economies, supported by strong export performance, buoyant private domestic demand, and in some cases rapid credit growth. Even though growth has moderated from cyclical highs to more sustainable rates, Asia continues to outpace other regions (Figure 2.9; Table 2.4). With the notable exception of Japan, output gaps in much of the region have closed or are quickly closing, inflation is on the rise, and overheating is becoming a concern. At the same time, limited progress has been made on external rebalancing in emerging Asia.

Signs of overheating are starting to materialize in a number of economies. Continued high growth has meant that some economies in the region are now operating at or above potential (Figure 2.10). Credit growth is accelerating in some economies (Hong Kong SAR, India, Indonesia), and it remains high in China. Most of the increase in headline inflation in recent months has been due to a spike in food prices, but core inflation has also been increasing in a number of economies, most notably India. Furthermore, real estate prices have been rising at double-digit rates in a number of economies. Concerns that inflation pressures may induce authorities to tighten the policy stance more rapidly than previously planned may have contributed to recent declines in equity and bond markets.

Against this backdrop, Asia is projected to continue expanding rapidly this year and next. Export growth is expected to moderate from last year's very rapid pace but will remain robust as gains in market share and increased intraregional trade partially offset the weakness in final demand from advanced economies. Capital flows to Asia are likely to continue, driven by both cyclical and structural factors. Autonomous private consumption growth should remain strong, supported by still-rich asset valuations and improved labor market conditions.

- After growing by 10¼ percent in 2010, China's growth is expected to remain robust at 9½ percent this year and next, with the drivers of growth shifting increasingly from public to private demand. Consumption will be buttressed by rapid credit growth, supportive labor market conditions, and continued policy efforts to raise household disposable income.
- Growth in India is expected to moderate but remain above trend, with GDP growth projected at 8¼ percent in 2011 and 7¾ percent in 2012.

Figure 2.9. Asia: Average Projected Real GDP Growth during 2011–12
(Percent)



Source: IMF staff estimates.

Table 2.4. Selected Asian Economies: Real GDP, Consumer Prices, Current Account Balance, and Unemployment

(Annual percent change unless noted otherwise)

	Real GDP			Consumer Prices[1]			Current Account Balance[2]			Unemployment[3]		
		Projections			Projections			Projections			Projections	
	2010	2011	2012	2010	2011	2012	2010	2011	2012	2010	2011	2012
Asia	**8.2**	**6.7**	**6.8**	**4.3**	**4.7**	**3.4**	**3.3**	**3.1**	**3.1**	...	...	...
Advanced Asia	**5.3**	**2.8**	**3.1**	**0.8**	**1.8**	**1.5**	**3.4**	**2.8**	**2.4**	**4.8**	**4.5**	**4.3**
Japan	3.9	1.4	2.1	–0.7	0.2	0.2	3.6	2.3	2.3	5.1	4.9	4.7
Australia	2.7	3.0	3.5	2.8	3.0	3.0	–2.6	–0.4	–2.1	5.2	5.0	4.8
New Zealand	1.5	0.9	4.1	2.3	4.1	2.7	–2.2	–0.2	–4.4	6.5	6.7	6.2
Newly Industrialized Asian Economies	**8.4**	**4.9**	**4.5**	**2.3**	**3.8**	**2.9**	**7.1**	**6.3**	**6.0**	**4.1**	**3.6**	**3.6**
Korea	6.1	4.5	4.2	3.0	4.5	3.0	2.8	1.1	1.0	3.7	3.3	3.3
Taiwan Province of China	10.8	5.4	5.2	1.0	2.0	2.0	9.4	11.6	10.9	5.2	4.6	4.5
Hong Kong SAR	6.8	5.4	4.2	2.4	5.8	4.4	6.6	5.2	5.5	4.3	3.6	3.8
Singapore	14.5	5.2	4.4	2.8	3.3	3.0	22.2	20.4	19.0	2.2	2.2	2.2
Developing Asia	**9.5**	**8.4**	**8.4**	**6.0**	**6.0**	**4.2**	**3.3**	**3.3**	**3.6**	...	...	...
China	10.3	9.6	9.5	3.3	5.0	2.5	5.2	5.7	6.3	4.1	4.0	4.0
India	10.4	8.2	7.8	13.2	7.5	6.9	–3.2	–3.7	–3.8	...	...	...
ASEAN-5	**6.9**	**5.4**	**5.7**	**4.4**	**6.1**	**4.7**	**3.5**	**2.7**	**2.2**	...	...	...
Indonesia	6.1	6.2	6.5	5.1	7.1	5.9	0.9	0.9	0.4	7.1	6.7	6.5
Thailand	7.8	4.0	4.5	3.3	4.0	3.4	4.6	2.7	1.9	1.0	1.2	1.2
Malaysia	7.2	5.5	5.2	1.7	2.8	2.5	11.8	11.4	10.8	3.3	3.2	3.1
Philippines	7.3	5.0	5.0	3.8	4.9	4.3	4.5	2.9	2.8	7.2	7.2	7.2
Vietnam	6.8	6.3	6.8	9.2	13.5	6.7	–3.8	–4.0	–3.9	5.0	5.0	5.0
Other Developing Asia[4]	**5.7**	**4.7**	**5.2**	**9.1**	**10.9**	**9.6**	**–0.6**	**–1.3**	**–1.8**	...	...	...
Memorandum												
Emerging Asia[5]	9.4	7.9	7.9	5.5	5.7	4.0	3.9	3.8	4.0	...	...	...

[1]Movements in consumer prices are shown as annual averages. December–December changes can be found in Tables A6 and A7 in the Statistical Appendix.

[2]Percent of GDP.

[3]Percent. National definitions of unemployment may differ.

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

[5]Emerging Asia comprises all economies in Developing Asia and the Newly Industrialized Asian Economies.

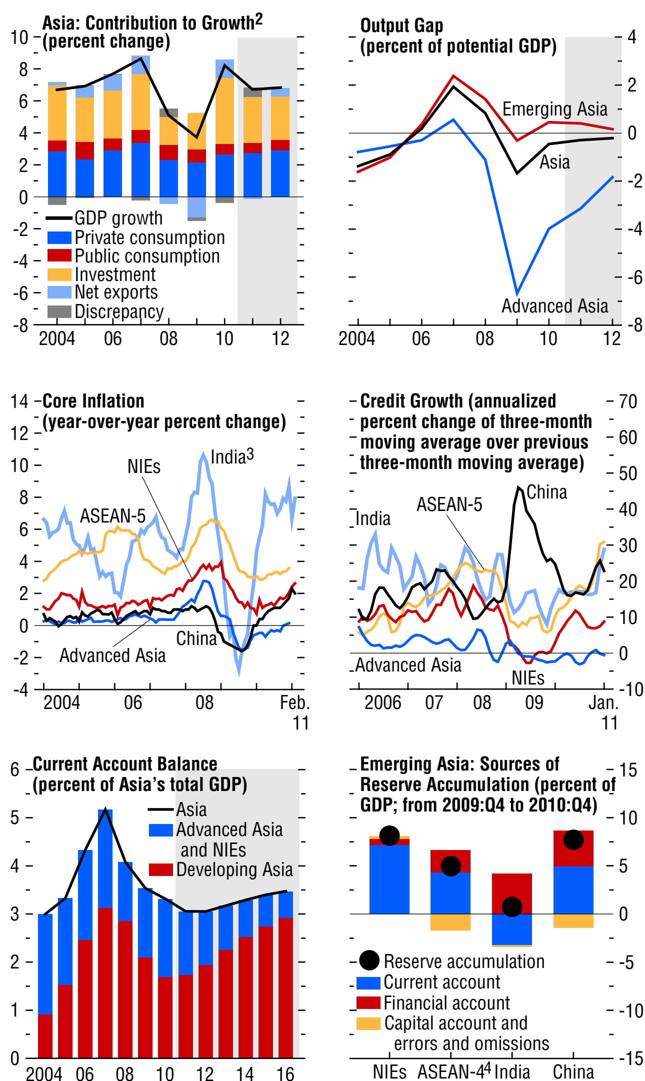
Infrastructure will remain a key contributor to growth, and corporate investment is expected to accelerate as capacity constraints start to bind and funding conditions remain supportive.

- After very rapid growth last year, growth in the newly industrialized Asian economies (NIEs) is expected to moderate to a more sustainable 5 percent in 2011, roughly in line with potential. Although the deceleration reflects the end of the inventory cycle, exports and private consumption will remain important drivers of growth.
- The ASEAN-5 economies[5] are projected to expand by 5½ percent in 2011 and 5¾ percent in 2012. The ASEAN-5 will be led by Indonesia, where strong consumption and a recovery in investment will raise growth to 6¼ percent this year and 6½ percent in 2012.
- Japan's growth of 4 percent in 2010 was one of the fastest among the advanced economies, driven by sizable fiscal stimulus and a rebound in exports. Looking forward, however, there are large uncertainties associated with the Tohuku earthquake. Official estimates of the damage to the capital stock are about 3 to 5 percent of GDP, roughly twice that of the 1995 Kobe earthquake. This figure, however, does not account for the effects of possible power shortages and ongoing risks associated with the crisis at the Fukushima Daiichi nuclear power plant. Assuming that the power shortages and the nuclear crisis are resolved within a few months, growth is projected to slow

[5]The Association of Southeast Asian Nations (ASEAN) includes Indonesia, Malaysia, Philippines, Thailand, and Vietnam.

Figure 2.10. Asia: Still in the Lead[1]

Asia continues to outpace other regions, buoyed by resilient exports and strong domestic demand. In some emerging Asian economies, output gaps have closed, core inflation is on the rise, and credit growth is rapid. Persistently large current account surpluses still dominate capital inflows, but many countries continue to resist currency appreciation.



Sources: CEIC Asia database; Haver Analytics; and IMF staff estimates.

[1]Advanced Asia: Australia, Japan, and New Zealand; newly industrialized Asian economies (NIEs): Hong Kong SAR, Korea, Singapore, and Taiwan Province of China; developing Asia: rest of Asia; ASEAN-5: Indonesia, Malaysia, Philippines, Thailand, and Vietnam; emerging Asia: developing Asia and NIEs. Aggregates for the external economy are sums of individual country data. Aggregates for all others are computed on the basis of purchasing-power-parity weights.

[2]Excludes Bhutan, Brunei Darussalam, Fiji, Kiribati, Lao People's Democratic Republic, Samoa, Timor-Leste, Tonga, Tuvalu, and Vanuatu due to data limitations.

[3]Wholesale price index excluding food and energy.

[4]ASEAN-4: ASEAN-5 excluding Vietnam.

to 1½ percent in 2011 before recovering to 2 percent in 2012.[6]

- In Australia, flooding in key mining and agricultural regions is expected to subtract from growth in early 2011, but over the year this will be offset by stronger private investment in mining and stronger commodity exports; GDP is projected to grow by 3 percent this year and 3½ percent in 2012. Recent earthquakes will slow activity in New Zealand this year, with real GDP growth projected at 1 percent, but growth is expected to rise to 4 percent in 2012, led by reconstruction.

With continued rapid growth, output now close to potential levels, and monetary conditions remaining accommodative, inflation is expected to continue increasing this year across much of developing Asia. Inflation pressure is most evident in India, where despite some moderation, inflation has become more generalized and is projected to remain high—averaging 7½ percent this year. In other parts of developing Asia, inflation is lower but is on the rise. In China, price pressures that started in a narrow range of food products have broadened into other items, including housing, and inflation is projected to reach 5 percent this year. Similar patterns of accelerating and more generalized inflation are becoming evident in the region's other developing economies—for developing Asia as a whole, inflation is projected at 6 percent this year. In stark contrast, mild deflation continues in Japan, and inflation expectations there have not improved substantially.

Risks to the growth outlook come from both outside and inside the region. Despite a substantial increase in intraregional trade, two-thirds of the final demand for Asian exports still comes from outside the region, and renewed turbulence in the euro area would affect Asia primarily through trade linkages. An additional external risk is stronger-than-expected increases in oil and commodity prices. Turning to risks from within Asia, if accommodative policies fail to adjust sufficiently to nascent overheating pressures, near-term growth may surprise on the upside. But that could sow the seeds for a hard landing down the road. In particular, an abrupt slowdown of economic

[6]The April 2011 *Global Financial Stability Report* discusses the financial stability implications of the recent events in Japan.

activity in China, perhaps following a credit and property boom-bust cycle, would adversely affect the whole region. Such boom-bust dynamics are also a possibility in other emerging Asian economies, such as some of the NIEs (Hong Kong SAR, Singapore).

Although Asia's external surplus has narrowed substantially—from a peak of 5¼ percent of regional GDP in 2007 to about 3¼ percent of GDP in 2010—that narrowing is not expected to continue. As external demand recovers and fiscal stimulus is withdrawn, the region's external surpluses are projected to widen again in the coming years, with developing Asia in general and China in particular accounting for the bulk of the surplus, especially in the medium term (see Figure 2.10). In fact, there has been little progress toward rebalancing; the projected surpluses for the region are now larger than they were in the October 2010 *World Economic Outlook,* in both the near and medium term. Developing Asia's current account balances are substantially higher than fundamentals suggest, given the region's relatively low per capita income, higher expected growth rates, and relatively young population.

The primary challenge for Asian policymakers is to quickly normalize the stance of fiscal and monetary policies in the region and ensure that boom-like dynamics do not get out of hand. Monetary policy remains generally accommodative even as many economies have taken steps toward normalization. The further tightening currently expected by markets in some economies is not enough to prevent inflation from increasing. In addition to more rapid tightening of policy rates, greater exchange rate flexibility will be an important component of policy tightening. The primary response to the resurgence of foreign inflows to Asia has been the continued accumulation of reserves. Allowing the exchange rate to appreciate in response to inflows would be more conducive to normalizing the policy stance. In addition, strengthened supervision and prudential measures are needed to address concerns about deteriorating credit quality, which often accompanies credit and asset price booms. In China, for instance, there is rising concern that management of credit aggregates, used to exercise macroeconomic control, is being undermined by banks' financial innovation and off-balance-sheet activities.

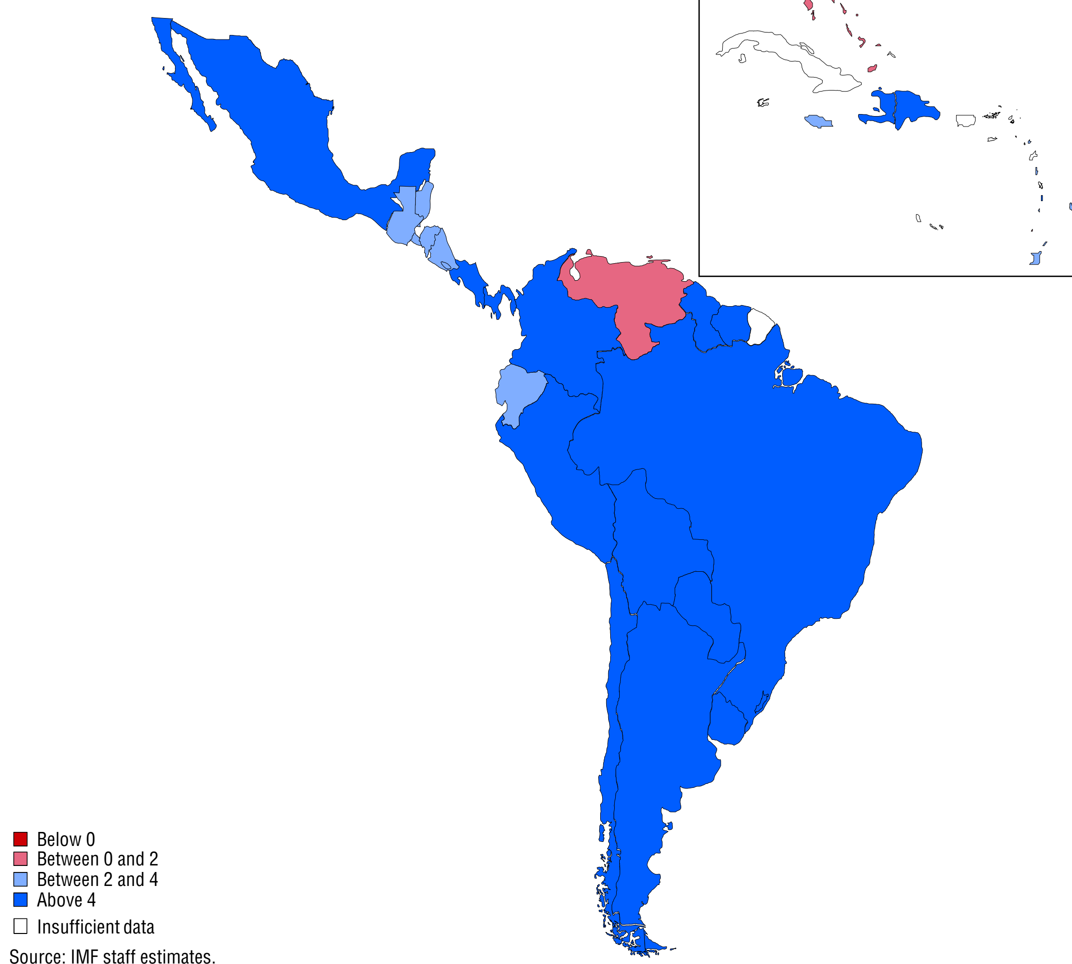
Fiscal policy is projected to be less supportive of growth this year than last, but the pace of withdrawal is slow, given how rapidly the region has been growing. A more rapid exit would allow governments to build the fiscal room they need to cope with adverse shocks in the future. Countercyclical fiscal policy would also help cushion domestic demand against the effect of capital inflows. In Japan, the recent downgrade of sovereign debt has highlighted the importance of having a more credible fiscal adjustment plan. Once the extent of the earthquake's damage becomes clearer and reconstruction efforts are under way, the authorities will need a more credible fiscal strategy that brings down the public debt ratio over the medium term while addressing the need for additional reconstruction spending.

Managing capital inflows is another major policy challenge for Asia. For economies in the region that continue to run large current account surpluses but whose response to capital inflows has been continued reserve accumulation, the policy prescription is clear—greater exchange rate flexibility. Appreciation would not only help address challenges in liquidity management, but could reduce expectations of a large step appreciation, lessening speculative inflows. A stronger prudential framework would also help reduce the vulnerabilities that can arise from sizable and potentially volatile capital inflows.

Although renewed capital inflows have garnered the lion's share of attention in recent months, these flows are still dwarfed by the large current account surpluses in the region. In this area, too, the aforementioned need for greater exchange rate flexibility is critical. Appreciation would help stimulate domestic demand and help shift resources from the tradables to the nontradables sector, facilitating much-needed development of the services sector in some of the region's economies. But exchange rate policy must be complemented by structural reforms. Economies where private investment lags, such as among the ASEAN-5, will benefit from efforts to boost infrastructure and improve the business environment. And continued reforms to raise consumption in economies such as China—including efforts to expand pension and health care coverage and to develop the financial sector—will also be key ingredients of a comprehensive rebalancing package.[7]

[7]See, for example, Baldacci and others (2010).

Figure 2.11. Latin America and the Caribbean: Average Projected Real GDP Growth during 2011–12
(Percent)



Source: IMF staff estimates.

Latin America Faces Buoyant External Conditions

The LAC region has weathered the global recession well and must now contend with the policy challenges of managing two strong tailwinds—high commodity prices and strong capital inflows. In a number of the larger countries, the baseline forecast is for moderation of the rapid rates of growth experienced in 2010 and a level of output more in line with potential, but overheating is a significant risk (Figure 2.11). In other, slower-growing countries that did not emerge as rapidly from the global recession, there are signs that output is moving closer to potential.

Real activity expanded by about 6 percent last year, after contracting by 1¾ percent in 2009. Robust demand from China and rising commodity prices continue to underpin this strength (Figure 2.12). More recently, exports to other destinations have also bounced back. This has encouraged strong capital inflows and moderate current account deficits. Despite the support to current accounts from commodity prices, however, deficits are widening and are projected to continue widening on the back of robust domestic demand. The generally buoyant conditions are associated with rising inflation in South and Central America. On the other hand, Mexico is not

facing overheating pressure at this time (see Figure 1.15).

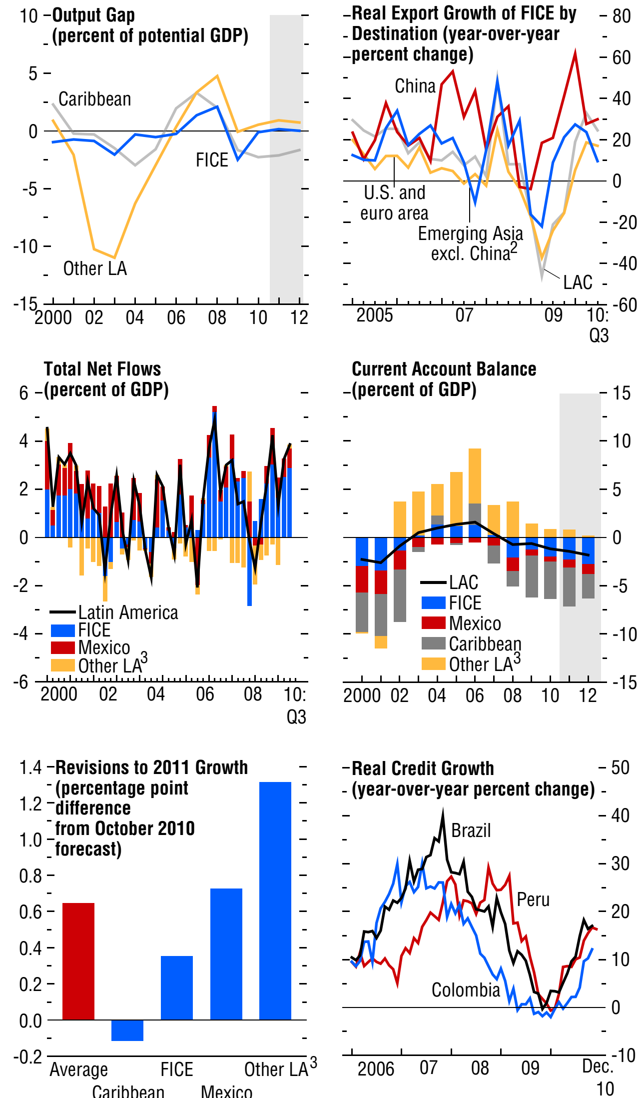
Growth in the region is projected to average 4¾ percent in 2011 and 4¼ percent in 2012 (Table 2.5). The growth rate for 2011 is ⅔ percentage point higher than forecast in the October 2010 *World Economic Outlook* (see Figure 2.12). The main reason for this revision is greater confidence in the strength of the global recovery and improved prospects for commodity prices. As with any region, however, experiences vary.

- The outlook for commodity exporters is generally positive. In the group of financially integrated commodity exporters (FICE—Brazil, Chile, Colombia, Peru, Uruguay), growth is projected at 4¾ percent this year. There are signs, however, of potential overheating, and capital inflows have caused policy tension. For example, real credit growth in Brazil and Colombia is increasing by 10 to 20 percent a year according to the the most recent data (see Figure 2.12). Furthermore, per capita credit in Brazil roughly doubled over the past five years.
- Prospects for Mexico continue to be closely tied to those for the United States. In line with the modest improvement in the outlook for the U.S. economy, real activity in 2011 is now projected to expand by 4½ percent, about ¾ percentage point more than in the October forecast.
- In Central America, and Panama in particular, the recovery is strengthening on the back of external demand, and output gaps are almost closed. Support has also come from a recovery in remittance flows. These trends are expected to continue.
- The outlook for the Caribbean countries has improved in line with the global recovery. Growth in 2011 is now forecast to be 4¼ percent. Much of this, however, reflects the strong performance of the Dominican Republic and post-earthquake rebuilding in Haiti; excluding these countries, growth in the Caribbean is projected to be 2¼ percent. Nonetheless, the constraints on policy stemming from high public debt levels mean that the outlook for these countries remains closely tied to external developments.

There are risks to this forecast in both directions. In the near term, strong commodity export prices and capital flows present upside risks to growth. But these favorable conditions could also be triggers

Figure 2.12. Latin America and the Caribbean: Icarus or Daedalus?[1]

The prospects for Latin America continue to improve, buoyed by China's demand for commodities and strong capital flows. These two forces, however, need to be carefully managed, lest they lead to overheating.



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

[1]Caribbean: 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; financially integrated commodity exporters (FICE): Brazil, Chile, Colombia, Peru, and Uruguay; Other Latin America (Other LA): Argentina, Bolivia, Costa Rica, Ecuador, El Salvador, Guatemala, Honduras, Nicaragua, Panama, Paraguay, and Venezuela; LAC: Caribbean, FICE, Other LA, and Mexico. Aggregates for the external economy are sums of individual country data. Aggregates for all others are computed on the basis of purchasing-power-parity weights.

[2]Emerging Asia comprises Hong Kong SAR, Indonesia, Korea, Malaysia, Philippines, Singapore, Taiwan Province of China, Thailand, and Vietnam.

[3]Other LA excludes Honduras, Nicaragua, and Panama due to data limitations.

Table 2.5. Selected Western Hemisphere Economies: Real GDP, Consumer Prices, Current Account Balance, and Unemployment

(Annual percent change unless noted otherwise)

	Real GDP			Consumer Prices[1]			Current Account Balance[2]			Unemployment[3]		
		Projections			Projections			Projections			Projections	
	2010	2011	2012	2010	2011	2012	2010	2011	2012	2010	2011	2012
North America	**3.1**	**2.9**	**3.0**	**1.9**	**2.3**	**1.8**	**–3.0**	**–3.1**	**–2.7**	**. . .**	**. . .**	**. . .**
United States	2.8	2.8	2.9	1.6	2.2	1.6	–3.2	–3.2	–2.8	9.6	8.5	7.8
Canada	3.1	2.8	2.6	1.8	2.2	1.9	–3.1	–2.8	–2.6	8.0	7.6	7.3
Mexico	5.5	4.6	4.0	4.2	3.6	3.1	–0.5	–0.9	–1.1	5.4	4.5	3.9
South America	**6.5**	**4.8**	**4.2**	**6.7**	**7.8**	**7.1**	**–1.1**	**–1.3**	**–1.8**	**. . .**	**. . .**	**. . .**
Brazil	7.5	4.5	4.1	5.0	6.3	4.8	–2.3	–2.6	–3.0	6.7	6.7	6.7
Argentina[4]	9.2	6.0	4.6	10.5	10.2	11.5	0.9	0.1	–0.5	7.7	9.0	8.5
Colombia	4.3	4.6	4.5	2.3	3.6	2.8	–3.1	–2.1	–2.2	11.8	11.5	11.0
Venezuela	–1.9	1.8	1.6	28.2	29.8	31.3	4.9	7.0	6.3	8.6	8.1	8.6
Peru	8.8	7.5	5.8	1.5	2.7	3.2	–1.5	–2.1	–2.8	8.0	7.5	7.5
Chile	5.3	5.9	4.9	1.5	3.6	3.2	1.9	0.5	–1.3	8.3	7.2	7.2
Ecuador	3.2	3.2	2.8	3.6	3.5	3.2	–4.4	–4.0	–4.0	7.6	7.3	7.5
Uruguay	8.5	5.0	4.2	6.7	7.2	6.0	0.5	–1.0	–1.6	7.0	6.9	6.8
Bolivia	4.2	4.5	4.5	2.5	10.4	5.4	4.8	3.8	4.4	. . .	. . .	. . .
Paraguay	15.3	5.6	4.5	4.7	9.6	9.0	–3.2	–4.1	–3.7	6.1	5.9	5.5
Central America[5]	**3.6**	**4.0**	**4.3**	**3.9**	**5.5**	**5.3**	**–5.1**	**–6.4**	**–6.6**	**. . .**	**. . .**	**. . .**
Caribbean[6]	**3.4**	**4.2**	**4.5**	**7.1**	**7.2**	**5.9**	**–3.9**	**–4.0**	**–2.5**	**. . .**	**. . .**	**. . .**
Memorandum												
Latin America and the Caribbean[7]	6.1	4.7	4.2	6.0	6.7	6.0	–1.2	–1.4	–1.8	. . .	. . .	. . .

[1]Movements in consumer prices are shown as annual averages. December–December changes can be found in Tables A6 and A7 in the Statistical Appendix.

[2]Percent of GDP.

[3]Percent. National definitions of unemployment may differ.

[4]Private analysts estimate that consumer price inflation has been considerably higher than the official estimates from 2007 onward. The Argentine authorities have announced that they are developing a national consumer price index (CPI) to replace the Greater Buenos Aires CPI currently in use. At the request of the authorities, the IMF is providing technical assistance in this effort. Private analysts are also of the view that real GDP growth was significantly lower than the official estimates in 2008 and 2009, although the discrepancy between private and official estimates of real GDP growth narrowed in 2010.

[5]Central America comprises Costa Rica, El Salvador, Guatemala, Honduras, Nicaragua, and Panama.

[6]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.

[7]Includes Mexico and economies from the Caribbean, Central America, and South America.

for demand and credit booms in a number of LAC economies. If unchecked, these could lead to an eventual bust. This pattern of near-term upside risk leading to medium-term downside risk is reinforced through the region's internal and external linkages. Because of Brazil's systemic importance to the region, many neighboring countries are currently benefiting from its strong growth. Conversely, an abrupt slowdown of economic activity in Brazil would adversely affect the region. A related risk is that a potential hard landing in China would bring a sharp drop in the prices of the region's commodity exports, dampening growth prospects. If a spike in oil prices were to dampen global growth, this could also be a trigger for a drop in the region's commodity exports. Finally, another bout of higher global risk aversion or unexpectedly rapid increases in U.S. interest rates could lead to a sharp reversal in capital flows, although the experience during the recent turmoil in the euro area periphery suggests that such disruptions are unlikely to be overwhelming.

Macroeconomic policies in the region should not fall behind the curve, given the risk of overheating. In countries where currencies are not under strong upward pressure on the back of strong capital flows and where monetary policy is still expansionary, policy rates should move faster toward more neutral levels. However, much of the focus should be on fiscal policies, particularly given the historical tendency throughout the region to adopt procyclical policies. In the FICE, this need stems from the pressure of strong capital flows, already-elevated

exchange rates, and monetary policy rates that are higher than in other countries. In other countries, it is important to reduce debt burdens and regain room for fiscal mobility. Exchange rates should be allowed to continue to act as shock absorbers in the face of pressure stemming from economic conditions in the region that have improved more than those in more advanced economies, primarily because of terms-of-trade gains from high commodity export prices.

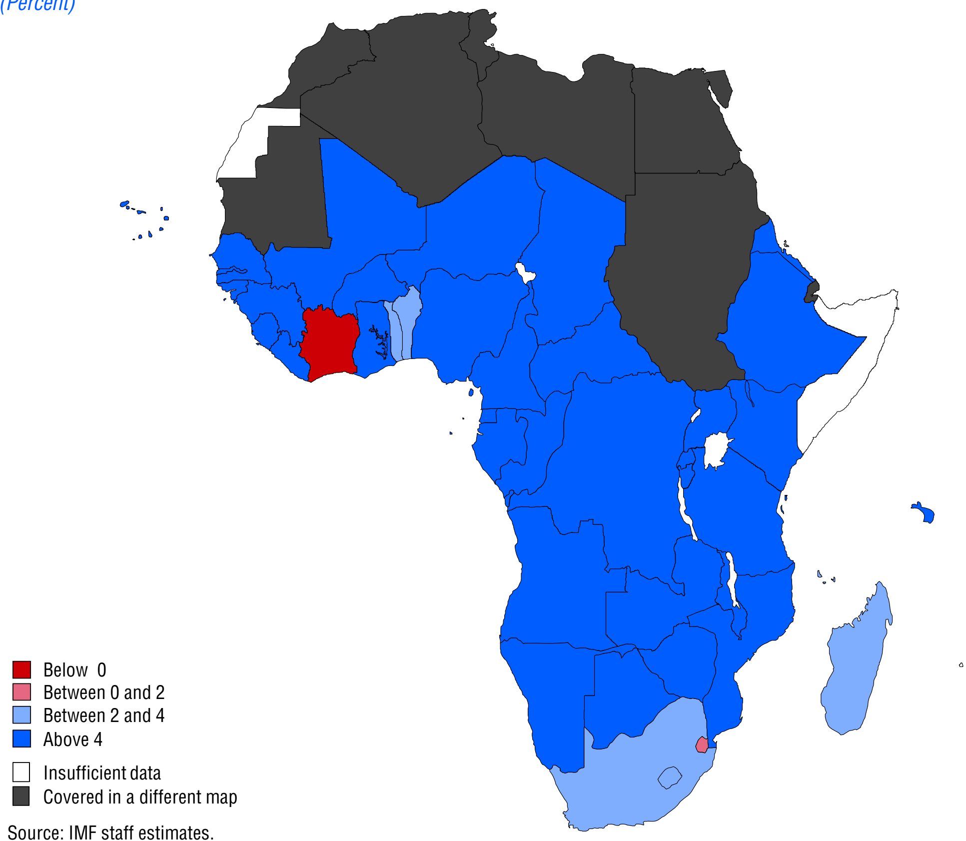
Macroprudential policies need to focus on maintaining and enhancing the resilience of these economies to potential problems from accelerating domestic credit and significant capital flows. This is most imperative in the FICE, but such policy improvements will also benefit other regional economies. As with macroeconomic policies, these need to be implemented in a forward-looking manner to stem potential credit growth excesses and sustained capital inflows. While a number of countries in the region have been quite active on this front recently, introducing prudential measures (see Figure 1.15), more work remains to be done. Policies should ensure that capital flows are directed toward longer-term financing and that balance sheet exposures are actively and prudently managed.

Growth Has Returned to Precrisis Rates in Many African Countries

Sub-Saharan Africa has recovered well from the global financial crisis (Figure 2.13), and the region is now second only to developing Asia in its rate of expansion. Output gaps in many of the region's economies are starting to close, although South Africa is a notable exception.

The region grew rapidly last year. Domestic demand growth remained robust, trade and commodity prices rebounded, and macroeconomic poli-

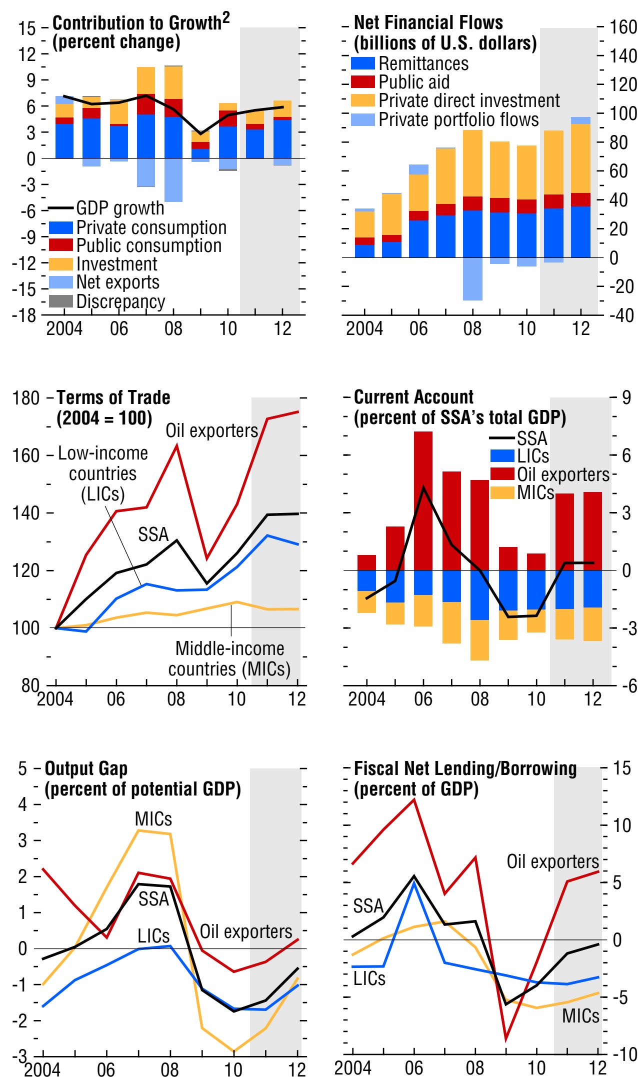
Figure 2.13. Sub-Saharan Africa: Average Projected Real GDP Growth during 2011–12
(Percent)



Source: IMF staff estimates.

Figure 2.14. Sub-Saharan Africa: Back to Precrisis Growth[1]

Growth in most economies, particularly the low-income countries, is back to precrisis rates. Recovery has been helped by strong domestic demand, stable financial flows, and terms-of-trade gains from strong commodity prices, which have also improved the region's external balance. As output gaps close, fiscal policy needs to stay countercyclical.



Source: IMF staff estimates.
[1]Aggregates for the external economy are sums of individual country data. Aggregates for terms of trade are weighted by the country's trade share in the group. Aggregates for all others are computed on the basis of purchasing-power-parity weights.
[2]Excludes Liberia and Zimbabwe due to data limitations.

cies continued to be accommodative (Figure 2.14). Terms-of-trade gains are supporting the region's external balances, and the gradual reorientation of exports toward faster-growing regions such as Asia has been sustained.

Against this backdrop, real activity in sub-Saharan Africa is projected to expand by 5½ percent this year and 6 percent next year. Within the region, however, prospects differ considerably.

- Growth in the region is being led by the low-income countries (LICs), which are projected to expand by 6 percent this year (Table 2.6). Ghana—which, following a substantial upward revision to its national accounts, is now the third-largest LIC in the region—is projected to grow by 13¾ percent this year, as oil production commences in the Jubilee oilfield and growth in the non-oil sector remains robust. The recovery in other LICs, such as Kenya and Ethiopia, is also expected to stay strong this year, supported by infrastructure investment and improving agricultural production.
- The expected strengthening of oil prices in 2011 will help sustain the recovery in the region's oil exporters. Following the sharp rebound in oil production last year in Nigeria, oil output is expected to stabilize this year, and the economy is set to expand by 7 percent. Most other oil-exporting economies are planning to use the buoyancy of global oil markets as an opportunity to return to fiscal surpluses and rebuild reserves, but fiscal policy remains procyclical in Nigeria due to the failure to adhere to the oil-price-based fiscal rule, which links spending to long-term average oil prices.
- In marked contrast to the robust growth in most of the region, recovery is expected to be relatively weak in South Africa, the region's largest economy. Despite an already sizable output gap, South Africa is expected to grow by only 3½ percent in 2011—a rate that is insufficient to reverse the substantial job losses of the past two years. The outlook primarily reflects the lack of strong domestic demand, as private investment is held back by excess capacity.

Risks to the region's growth outlook remain tilted to the downside. Despite the increasing importance of Asia, Europe remains a much larger trading

Table 2.6. Selected Sub-Saharan African Economies: Real GDP, Consumer Prices, Current Account Balance, and Unemployment

(Annual percent change unless noted otherwise)

	Real GDP			Consumer Prices[1]			Current Account Balance[2]			Unemployment[3]		
		Projections			Projections			Projections			Projections	
	2010	2011	2012	2010	2011	2012	2010	2011	2012	2010	2011	2012
Sub-Saharan Africa	**5.0**	**5.5**	**5.9**	**7.5**	**7.8**	**7.3**	**–2.4**	**0.4**	**0.4**	**. . .**	**. . .**	**. . .**
Oil Exporters	**6.5**	**6.9**	**7.0**	**12.4**	**10.8**	**9.4**	**2.6**	**10.9**	**11.1**	**. . .**	**. . .**	**. . .**
Nigeria	8.4	6.9	6.6	13.7	11.1	9.5	6.4	14.6	13.3	4.5	4.5	4.5
Angola	1.6	7.8	10.5	14.5	14.6	12.4	–1.8	6.2	9.5	. . .	. . .	. . .
Equatorial Guinea	–0.8	7.2	4.0	7.5	7.3	7.0	–23.8	–10.2	–9.0	. . .	. . .	. . .
Gabon	5.7	5.6	3.3	0.6	2.3	3.4	11.8	17.0	15.3	. . .	. . .	. . .
Republic of Congo	9.1	7.8	4.7	5.0	5.9	5.2	2.7	12.5	16.0	. . .	. . .	. . .
Chad	5.1	4.1	6.0	1.0	3.0	3.0	–21.3	–8.0	–6.1	. . .	. . .	. . .
Middle-Income	**3.1**	**3.7**	**4.0**	**4.4**	**5.2**	**5.8**	**–3.1**	**–4.5**	**–5.1**	**. . .**	**. . .**	**. . .**
South Africa	2.8	3.5	3.8	4.3	4.9	5.8	–2.8	–4.4	–5.1	24.8	24.4	23.7
Botswana	8.6	6.0	6.6	6.9	7.8	7.0	–2.5	–2.4	–0.0	. . .	. . .	. . .
Mauritius	4.0	4.1	4.2	2.9	7.4	4.6	–9.5	–11.6	–9.6	7.5	7.8	7.9
Namibia	4.4	4.8	4.5	4.5	5.9	5.6	–1.1	–0.9	–3.3	. . .	. . .	. . .
Swaziland	2.0	0.5	1.5	4.5	7.9	6.1	–20.6	–16.0	–12.9	25.0	25.0	25.0
Cape Verde	5.4	5.5	6.8	2.1	4.4	5.4	–11.8	–18.0	–15.7	. . .	. . .	. . .
Low-Income[4]	**5.3**	**5.9**	**6.5**	**6.2**	**7.5**	**6.8**	**–7.0**	**–7.1**	**–6.7**	**. . .**	**. . .**	**. . .**
Ethiopia	8.0	8.5	8.0	2.8	12.9	11.2	–4.3	–8.1	–8.1	. . .	. . .	. . .
Kenya	5.0	5.7	6.5	3.9	7.2	5.0	–7.9	–9.3	–7.9	. . .	. . .	. . .
Ghana	5.7	13.7	7.3	10.7	8.7	8.7	–7.2	–6.8	–5.2	. . .	. . .	. . .
Tanzania	6.5	6.4	6.6	10.5	6.3	7.0	–8.6	–9.5	–10.7	. . .	. . .	. . .
Cameroon	3.0	3.5	4.5	1.3	3.0	2.5	–3.9	–3.1	–3.0	. . .	. . .	. . .
Uganda	5.2	6.0	6.5	9.4	6.1	11.0	–9.9	–10.6	–9.2	. . .	. . .	. . .
Côte d'Ivoire[5]	2.6	–7.5	6.0	1.4	5.0	2.5	3.9	. . .	. . .	. . .	. . .	. . .

[1]Movements in consumer prices are shown as annual averages. December–December changes can be found in Table A7 in the Statistical Appendix.

[2]Percent of GDP.

[3]Percent. National definitions of unemployment may differ.

[4]Includes Benin, Burkina Faso, Burundi, Central African Republic, Comoros, Democratic Republic of Congo, Eritrea, The Gambia, Ghana, Guinea, Guinea-Bissau, Lesotho, Liberia, Madagascar, Malawi, Mali, Mozambique, Niger, Rwanda, São Tomé and Príncipe, Senegal, Seychelles, Sierra Leone, Togo, Zambia, and Zimbabwe.

[5]Current account projections are not shown due to the uncertain political situation.

partner for the region's non-oil-exporting economies. A slowdown in Europe would particularly hurt the region's manufacturing exporters, such as South Africa. In addition, a sharper-than-expected pickup in fuel and food prices could adversely affect many of the region's oil-importing economies. This could have major social and fiscal costs in the LICs. Another risk factor is politics. In some economies, such as Côte d'Ivoire, political turmoil has already dampened growth prospects for 2011. But beyond that, with 2011 shaping up to be a busy year politically—with as many as 17 national elections scheduled—activity in some countries could be hindered by related political unrest.

Narrowing output gaps, alongside an incipient rekindling of inflation pressures by rising commodity prices, mean that policies to support demand are no longer appropriate except in a handful of economies. The focus of fiscal policy should therefore turn to medium-term priorities, while monetary policy needs to be increasingly alert to the inflation outlook.

- The active use of countercyclical fiscal policy to support output during the crisis has left a legacy of wider fiscal deficits across the region. With growth in many economies now approaching potential, financing and medium-term debt sustainability considerations mostly point to the need to revisit medium-term trajectories for government spending and revenue. At the same time, fiscal buffers need to be rebuilt and fiscal room needs to be found for spending priorities such as health, education, and infrastructure. Such adjustments are already under way in, for example, South Africa. In Nigeria, however, where growth is much stronger, the fiscal stance has weakened and fiscal consolidation is overdue; anchoring fiscal policy through a strong

oil-revenue-based rule would help maintain a countercyclical fiscal stance.

- Rising food prices are likely to affect the urban poor in particular, given the high share of food in their consumption baskets. In response, governments will need to consider targeted social safety nets—another reason to create greater room for fiscal policy maneuvering. At the same time, policymakers should remain alert to inflation pressure from rising commodity prices, especially with limited spare capacity in many economies. For South Africa and a number of middle-income countries where output remains well below potential, however, continued monetary accommodation will be appropriate.

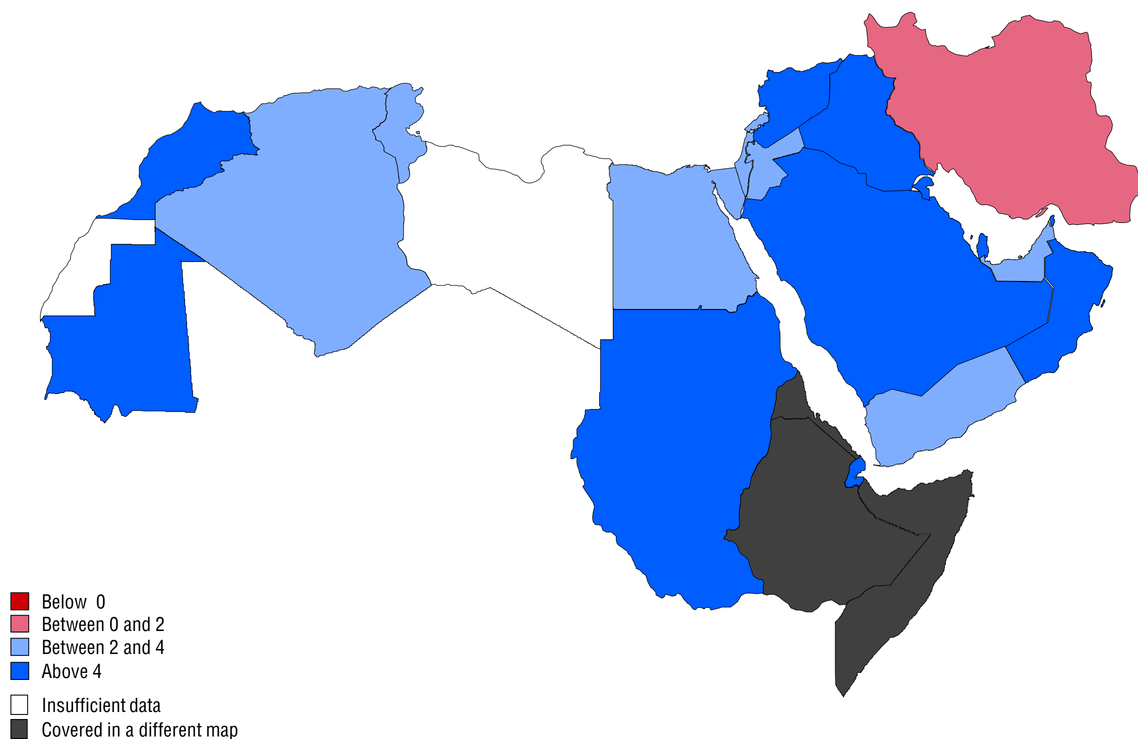
Finally, a number of other policy areas require sustained attention. More intensive monitoring and sounder regulation of the financial sector are needed, as are continuing improvements to the business environment. Robust public financing mechanisms would also facilitate better planning and control of government spending, including infrastructure investment.

The Recovery in the Middle East and North Africa Region Faces an Uncertain Environment

The MENA region weathered the global crisis relatively well, and while the recovery is now proceeding, economic growth varies widely across the region. Spreading social unrest, rising sovereign risk premiums, and elevated commodity import prices will constrain growth prospects in several MENA economies. Although economic prospects across the MENA region are quite diverse, an ongoing regionwide repricing of risk is pushing up borrowing costs.

Higher commodity prices and external demand are boosting production and exports in many economies in the region. In addition, government spending programs are continuing to foster recovery in many oil-exporting economies. At the same time,

Figure 2.15. Middle East and North Africa: Average Projected Real GDP Growth during 2011–12
(Percent)



Source: IMF staff estimates.
Note: Projections are not provided for Libya due to the uncertain political situation.

Table 2.7. 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[1]			Current Account Balance[2]			Unemployment[3]		
		Projections			Projections			Projections			Projections	
	2010	2011	2012	2010	2011	2012	2010	2011	2012	2010	2011	2012
Middle East and North Africa	**3.8**	**4.1**	**4.2**	**6.9**	**10.0**	**7.3**	**6.5**	**12.7**	**11.2**	...	...	...
Oil Exporters[4]	**3.5**	**4.9**	**4.1**	**6.7**	**10.6**	**7.1**	**9.2**	**16.9**	**15.0**	...	...	...
Islamic Republic of Iran	1.0	–0.0	3.0	12.5	22.5	12.5	6.0	11.7	10.4	...	...	...
Saudi Arabia	3.7	7.5	3.0	5.4	6.0	5.5	8.7	19.8	13.8	10.5	...	...
Algeria	3.3	3.6	3.2	4.3	5.0	4.3	9.4	17.8	17.4	10.0	9.8	9.5
United Arab Emirates	3.2	3.3	3.8	0.9	4.5	3.0	7.7	10.4	10.5	...	...	...
Qatar	16.3	20.0	7.1	–2.4	4.2	4.1	18.7	36.1	34.0	...	...	...
Kuwait	2.0	5.3	5.1	4.1	6.1	2.7	31.8	39.4	39.4	1.6	1.6	1.6
Iraq	0.8	9.6	12.6	5.1	5.0	5.0	–6.2	–3.2	–0.7	...	...	...
Sudan	5.1	4.7	5.6	13.0	9.0	7.0	–8.5	–5.5	–6.6	13.7	12.6	11.4
Oil Importers[5]	**4.5**	**1.9**	**4.5**	**7.6**	**8.1**	**8.0**	**–3.8**	**–5.2**	**–4.5**	...	...	...
Egypt	5.1	1.0	4.0	11.7	11.5	12.0	–2.0	–2.7	–2.3	9.2	9.2	9.1
Morocco	3.2	3.9	4.6	1.0	2.9	2.9	–4.2	–5.7	–4.1	9.0	8.9	8.7
Syrian Arab Republic	3.2	3.0	5.1	4.4	6.0	5.0	–4.4	–4.6	–4.8	8.4	...	...
Tunisia	3.7	1.3	5.6	4.4	4.0	3.3	–4.8	–7.8	–5.8	13.0	14.7	14.4
Lebanon	7.5	2.5	5.0	4.5	6.5	3.0	–10.2	–12.9	–12.8	...	...	...
Jordan	3.1	3.3	3.9	5.0	6.1	5.6	–5.4	–8.5	–8.7	12.5	12.5	12.5
Memorandum												
Israel	4.6	3.8	3.8	2.7	3.0	2.5	3.1	3.3	3.1	6.7	5.5	5.0
Maghreb[6]	3.5	3.3	4.1	3.2	4.2	3.7	5.3	7.2	7.6	...	...	...
Mashreq[7]	5.0	1.5	4.2	9.6	10.0	9.8	–3.6	–4.7	–4.4	...	...	...

[1]Movements in consumer prices are shown as annual averages. December–December changes can be found in Tables A6 and A7 in the Statistical Appendix.
[2]Percent of GDP.
[3]Percent. National definitions of unemployment may differ.
[4]Includes Bahrain, Libya, Oman, and Republic of Yemen. Excludes Libya for the projection years due to the uncertain political situation.
[5]Includes Djibouti and Mauritania.
[6]The Maghreb comprises Algeria, Libya, Mauritania, Morocco, and Tunisia. Excludes Libya for the projection years due to the uncertain political situation.
[7]The Mashreq comprises Egypt, Jordan, Lebanon, and Syrian Arab Republic.

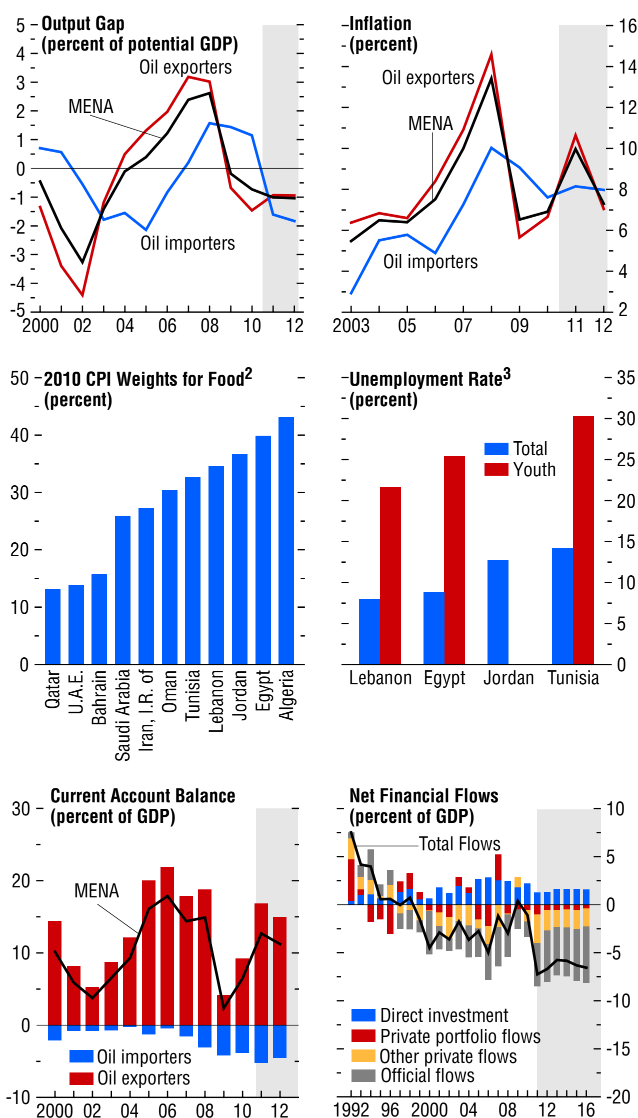
political discontent, high unemployment, and rising food prices are causing social unrest in a number of countries, which is likely to dampen their short-term growth.

Taking into account these factors, GDP in the MENA region is projected to grow at 4 percent in 2011, edging up to about 4¼ percent in 2012. As in other regions, recovery prospects vary substantially across MENA economies (Figure 2.15; Table 2.7).

- In the group of oil exporters, growth is expected to pick up to 5 percent this year. The strongest performer is Qatar, where real activity is projected to expand by 20 percent in 2011, underpinned by continued expansion in natural gas production and large investment expenditures. In Saudi Arabia, GDP is expected to grow at about 7½ percent this year, supported by sizable government infrastructure investment. In the Islamic Republic of Iran, growth in 2011 is expected to stall temporarily as subsidies for energy and other products are phased out—a much-needed reform that will yield benefits in the medium term. Disruption of oil production in Libya means that, given constraints on non-OPEC capacity, oil production from other OPEC suppliers will increase in 2011.
- In the group of oil importers, Egypt's GDP growth will fall significantly below the 5½ percent registered in the second half of 2010. This assumes a modest dampening effect on economic activity from the political turmoil: disruptions to tourism, capital flows, and financial markets are expected to be temporary. In Tunisia, growth is projected to slow to 1¼ percent in 2011, as the expected decline in tourism and foreign direct investment harms other sectors of the economy.

Figure 2.16. Middle East and North Africa: The Recovery Continues in an Uncertain Environment[1]

Having weathered the global crisis relatively well, the recovery is now proceeding. The level of economic activity is still below but getting closer to potential. High unemployment, growing social unrest, and rising food prices are dampening growth prospects, especially in oil-importing economies. Current account surpluses in oil-exporting economies are expected to widen again as the recovery continues.



Sources: Haver Analytics; International Labor Organization; IMF, Primary Commodity Price System; national sources; and IMF staff estimates.

[1] Oil exporters: Algeria, Bahrain, Islamic Republic of Iran, Iraq, Kuwait, Libya, Oman, Qatar, Saudi Arabia, Sudan, United Arab Emirates (U.A.E.), and Republic of Yemen. Oil importers: Djibouti, Egypt, Jordan, Lebanon, Mauritania, Morocco, Syrian Arab Republic, and Tunisia. Aggregates for the external economy are sums of individual country data. Aggregates for all others are computed on the basis of purchasing-power-parity weights.

[2] Data for Algeria, Tunisia, and U.A.E. are for 2009. Data for Saudi Arabia are for 2008. Data for Lebanon are for 2007. CPI: consumer price index.

[3] Youth defined as persons ages 15 to 24 years. Data on youth unemployment rate are not available for Jordan.

As in other regions, inflation is on the rise in the MENA region, as higher commodity prices lift headline inflation (Figure 2.16). For the region as a whole, consumer price inflation is projected to increase to about 10 percent in 2011, led by the Islamic Republic of Iran, where fuel subsidies are being substantially reduced.

The key risks to this outlook are to the downside. Depending on its duration and intensity, the domestic effects of political and social turmoil could be larger than currently expected, particularly if sustained unrest spills over to additional countries in the region. Financial markets have not been immune, and credit default swap and bond spreads have already widened throughout the region. If persistent, such financial market developments could translate into higher funding costs for governments and firms. In addition, slower-than-expected recovery in advanced economies would adversely affect the region's export earnings, fiscal and external balances, and growth.

Turning to the external sector, current account surpluses in the MENA region are expected to widen again as the recovery proceeds, driven in part by elevated energy export prices. The overall regional current account surplus, which declined from 15 percent of GDP in 2008 to 2¼ percent of GDP in 2009, is now projected to rise to over 12 percent of GDP in 2011.

The key policy challenges across the region are daunting. For oil importers, the main priority is to raise growth and tackle chronically high unemployment, especially among young people. For oil exporters, the focus should be to strengthen or develop financial systems and promote economic diversification. Recent increases in public spending on non-energy-related sectors should be helpful in diversifying activity toward these sectors and rebalancing regional growth.

Fiscal policy has played a critical role in cushioning the impact of the global crisis on the region and in supporting its recovery. Government investment programs, especially in infrastructure, will continue to boost domestic demand in the near term in many oil-exporting economies. High debt levels, however, constrain the scope for fiscal maneuver in oil-importing economies. Nevertheless, to shield populations from surging commodity prices, many economies have recently increased food and fuel subsidies (Jordan, Kuwait, Tunisia), increased social transfers (Sudan, Syrian Arab Republic, Tunisia, Republic of Yemen),

expanded civil service employment or salaries (Egypt, Jordan, Saudi Arabia, Sudan, Republic of Yemen), and introduced direct cash transfers (Bahrain, Kuwait).

In most MENA economies, chronically high unemployment, especially among young people and the educated, is a long-standing challenge that now must be tackled urgently. The fact that unemployment has remained high for so long suggests that the problem is largely structural—stemming from skill mismatches, labor market rigidities, and high reservation wages. A lasting solution to the region's unemployment problem will require a combination of permanently higher and inclusive economic growth and reforms to improve the responsiveness of labor markets.[8]

[8] See the IMF's October 2010 and May 2011 *Regional Economic Outlook* for the Middle East and Central Asia.

With regard to financial sector policy, the priorities should vary across economies. For the more financially developed economies of the Gulf Cooperation Council, the key task is to restore capital and liquidity buffers used up during the crisis and to improve regulatory and supervisory regimes in line with global efforts. This will help revive credit, which has been sluggish partly due to still-weak banking and corporate balance sheets following prominent corporate defaults (in Dubai, Kuwait, and Saudi Arabia, for example). For other economies in the region, the main challenge is to prevent a rise in nonperforming loans in countries with unrest, to spur greater financial development by removing barriers to entry and exit and, in some cases, to reduce state banking system ownership. Addressing the high number of nonperforming loans in a number of economies is another priority.

Box 2.1. Unwinding External Imbalances in the European Union Periphery

The Great Recession forced a painful adjustment in external imbalances in the periphery of the European Union. Current account deficits soared in the years leading up to the crisis, with rapid growth in credit and domestic demand and strong increases in unit labor costs relative to the euro area. By 2007, the current account deficit averaged 10.0 percent of GDP in Greece, Ireland, Portugal, and Spain and 17.7 percent of GDP in the Baltic economies of Estonia, Latvia, and Lithuania. Because the nominal exchange rate is fixed, these economies have had to unwind the large imbalances through demand contraction and a decline in inflation and wage growth relative to their trading partners, a process known as internal devaluation. To shed light on how this process is proceeding, this box compares the experience of the Baltics with that of the other economies and discusses some challenges ahead.

Estonia, Latvia, and Lithuania

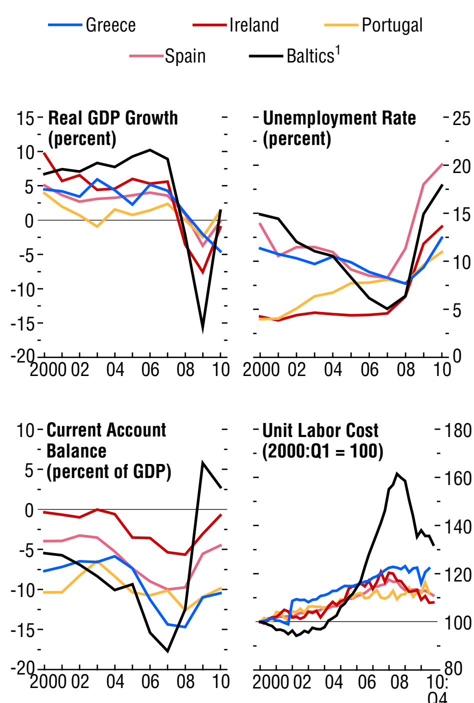
These Baltic economies have eliminated their current account deficits, but the contraction in economic activity has been unusually large. GDP contracted by an average of 15.5 percent in 2009, and the unemployment rate rose by 12.8 percentage points during 2007–10. In terms of external adjustment, these economies' current accounts swung from a deficit averaging 17.7 percent of GDP in 2007 to a surplus averaging 5.8 percent of GDP in 2009, which may be above the long-term level. Indeed, the current account surplus declined in 2010, and the challenge is now to sustain recent improvements in competitiveness to support growth in productive sectors. Unit labor costs also fell sharply relative to the euro area, by 18.1 percent from their peak. The sharp rises in unemployment, as well as the flexibility of these economies' labor markets and large cuts in both public sector and private sector wages, accelerated internal devaluation and the restoration of competitiveness.

The sharp recession meant that the adjustment initially occurred through a contraction of imports, but exports subsequently contributed to the rebalancing. In 2009, the ratio of imports to GDP fell by an average of 14.6 percentage points. In 2010, imports rebounded and exports rose above their 2007 level, possibly reflecting the decline in unit labor costs and the recovery in global trade. In terms of saving and investment, the adjustment has so far been due mainly to a contraction in investment. A decline in public saving, mainly due to decreased government revenue during the recession, has been partly offset by a rise in private saving to more sustainable levels.

Greece, Ireland, Portugal, and Spain

A painful but more gradual process of external adjustment is under way in these economies. GDP contracted by an average of 4.0 percent in 2009, and the unemployment rate rose by an average of

Figure 2.1.1. Economic Activity and External Adjustment in the EU Periphery



Sources: Haver Analytics; and IMF staff calculations.
[1]Baltics: Estonia, Latvia, and Lithuania. Aggregates for the Baltics are simple averages except for current account balance, which is calculated as the sum of the balances.

The authors of this box are Florence Jaumotte and Daniel Leigh.

Box 2.1 *(continued)*

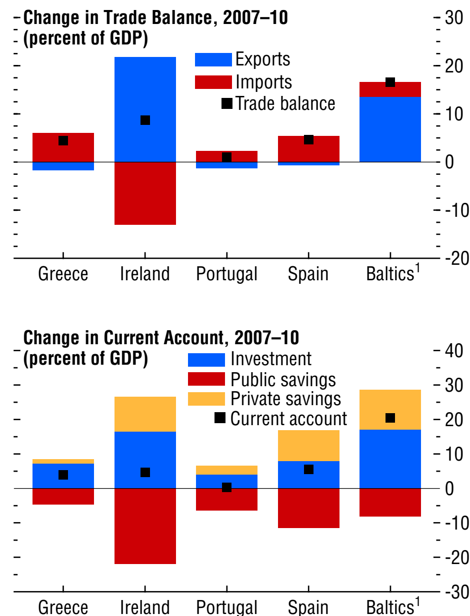
7.0 percentage points during 2007–10. The external adjustment process started later than in the Baltic economies, with the ratio of the current account deficit to GDP falling by 4.3 percentage points—from 10.7 percent of GDP in 2008 to 6.4 percent of GDP in 2010. The current account deficits of Ireland and, to a lesser extent, Spain have moved toward more sustainable levels, but they remain excessively large in Greece and Portugal, at 10.4 and 9.9 percent of GDP, respectively, in 2010. The decline of unit labor costs relative to the euro area averaged 5.1 percent for these economies, but this is skewed by the 10.2 percent decline in Ireland; the decline was more modest in the other three countries.

There are signs of a turnaround in all four of these countries. They initially adjusted through import contraction, but exports started contributing to the adjustment in 2010. Reflecting the smaller contraction in income, the fall in the ratio of imports to GDP in 2009 was smaller than in the Baltics—an average of 4.8 percentage points compared with 14.6 percentage points. In 2010, there was a rebound in both imports and exports, but exports generally increased more, thus furthering the external adjustment process. Exports as a share of GDP rose by much more in Ireland, possibly reflecting the greater decline in unit labor costs there. In real terms, exports grew strongly in Ireland, Portugal, and especially Spain, largely as a rebound. In terms of saving and investment, the adjustment has so far consisted mainly of a contraction in investment, as in the Baltic economies, and the large fall in public saving has been partly offset by a rise in private saving. Wage moderation has played a relatively modest role in Greece, Portugal, and Spain, where labor markets are less flexible than in the Baltics.

A number of policies can contribute to the remaining adjustment that will be required, and many are already being implemented. In Greece and Ireland, they are an integral part of the authorities' adjustment programs, which are supported by the international community. The policies include measures on both the supply side and the demand side of the economy:

- Labor cost adjustment can be facilitated by promoting decentralized wage bargaining, removing indexation mechanisms, and reducing dismissal costs. In addition, building a national consensus so that the burden of the adjustment is shared broadly through wage moderation can help prevent a protracted period of high unemployment.
- Reforms to increase productivity growth also contribute to improving competitiveness.
- The fiscal consolidation under way to address these economies' elevated government debt levels will also contribute to the external adjustment. In the short term, raising taxes or cutting government spending improves the current account balance by restraining domestic demand, including imports. Over the medium term, it would be helpful to create room to cut taxes, thereby supporting private investment and the supply side of the economy.

Figure 2.1.2. External Adjustment in the EU Periphery



Sources: Haver Analytics; and IMF staff calculations.
[1]Baltics: Estonia, Latvia, and Lithuania. Aggregates for the Baltics are calculated as sums of individual country data.

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