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ASSUMPTIONS AND CONVENTIONS

A number of assumptions have been adopted for the projections presented in the *World Economic Outlook*. It has been assumed that real effective exchange rates remained constant at their average levels during August 4–September 1, 2010, except for the currencies participating in the European exchange rate mechanism II (ERM II), which are assumed to have remained constant in nominal terms relative to the euro; that established policies of national authorities will be maintained (for specific assumptions about fiscal and monetary policies for selected economies, see Box A1); that the average price of oil will be $76.20 a barrel in 2010 and $78.75 a barrel in 2011 and will remain unchanged in real terms over the medium term; that the six-month London interbank offered rate (LIBOR) on U.S. dollar deposits will average 0.6 percent in 2010 and 0.8 percent in 2011; that the three-month euro deposit rate will average 0.8 percent in 2010 and 1.0 percent in 2011; and that the six-month Japanese yen deposit rate will yield on average 0.6 percent in 2010 and 0.4 percent in 2011. These are, of course, working hypotheses rather than forecasts, and the uncertainties surrounding them add to the margin of error that would in any event be involved in the projections. The estimates and projections are based on statistical information available through late September 2010.

The following conventions are used throughout the *World Economic Outlook:*

. . . to indicate that data are not available or not applicable;

– between years or months (for example, 2009–10 or January–June) to indicate the years or months covered, including the beginning and ending years or months;

/ between years or months (for example, 2009/10) to indicate a fiscal or financial year.

"Billion" means a thousand million; "trillion" means a thousand billion.

"Basis points" refer to hundredths of 1 percentage point (for example, 25 basis points are equivalent to ¼ of 1 percentage point).

In figures and tables, shaded areas indicate IMF staff projections.

If no source is listed on tables and figures, data are drawn from the World Economic Outlook (WEO) database.

When countries are not listed alphabetically, they are ordered on the basis of economic size.

Minor discrepancies between sums of constituent figures and totals shown reflect rounding.

As used in this report, the terms "country" and "economy" do not in all cases refer to a territorial entity that is a state as understood by international law and practice. As used here, the term also covers some territorial entities that are not states but for which statistical data are maintained on a separate and independent basis.

Composite data are provided for various groups of countries organized according to economic characteristics or region. Unless otherwise noted, country group composites represent calculations based on 90 percent or more of the weighted group data.

The boundaries, colors, denominations, and any other information shown on the maps do not imply, on the part of the International Monetary Fund, any judgment on the legal status of any territory or any endorsement or acceptance of such boundaries.

FURTHER INFORMATION AND DATA

This version of the *World Economic Outlook* is available in full on the IMF's website, www.imf.org. Accompanying it on the website is a larger compilation of data from the WEO database than is included in the report itself, including files containing the series most frequently requested by readers. These files may be downloaded for use in a variety of software packages.

Inquiries about the content of the *World Economic Outlook* and the WEO database should be sent by mail, forum, or fax (telephone inquiries cannot be accepted) to

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PREFACE

The analysis and projections contained in the *World Economic Outlook* are integral elements of the IMF's surveillance of economic developments and policies in its member countries, of developments in international financial markets, and of the global economic system. The survey of prospects and policies is the product of a comprehensive interdepartmental review of world economic developments, which draws primarily on information the IMF staff gathers through its consultations with member countries. These consultations are carried out in particular by the IMF's area departments—namely, the African Department, Asia and Pacific Department, European Department, Middle East and Central Asia Department, and Western Hemisphere Department—together with the Strategy, Policy, and Review Department; the Monetary and Capital Markets Department; and the Fiscal Affairs Department.

The analysis in this report was coordinated in the Research Department under the general direction of Olivier Blanchard, Economic Counsellor and Director of Research. The project was directed by Jörg Decressin, Assistant Director, Research Department, and Petya Koeva Brooks, Division Chief, Research Department.

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The analysis has benefited from comments and suggestions by staff from other IMF departments, as well as by Executive Directors following their discussion of the report on September 20, 2010. However, both projections and policy considerations are those of the IMF staff and should not be attributed to Executive Directors or to their national authorities.

FOREWORD

Achieving a "strong, balanced, and sustained world recovery"—to quote from the goal set in Pittsburgh by the G20—was never going to be easy. It requires much more than just going back to business as usual. It requires two fundamental and difficult economic rebalancing acts.

First, internal rebalancing: When private demand collapsed, fiscal stimulus helped alleviate the fall in output. But fiscal stimulus has to eventually give way to fiscal consolidation, and private demand must be strong enough to take the lead and sustain growth.

Second, external rebalancing: Many advanced economies, most notably the United States, which relied excessively on domestic demand, must now rely more on net exports. Many emerging market economies, most notably China, which relied excessively on net exports, must now rely more on domestic demand.

These two rebalancing acts are taking place too slowly.

Private domestic demand remains weak in advanced economies. This weakness reflects both a correction of precrisis excesses and the scars of the crisis. U.S. consumers who had overborrowed before the crisis are now saving more and consuming less, and while this is good for the long term, it is a drag on demand in the short term. Housing booms have given way to housing slumps, and housing investment will remain depressed for some time. And weaknesses in the financial system are still constraining credit.

External rebalancing remains limited. Net exports are not contributing to growth in advanced economies, and the U.S. trade deficit remains large. Many emerging market economies continue to run large current account surpluses and to respond to capital inflows primarily through reserve accumulation rather than exchange rate appreciation. International reserves are higher than they have ever been and continue to increase.

The result is a recovery that is neither strong nor balanced and runs the risk of not being sustained. For the past year or so, inventory accumulation and fiscal stimulus were driving the recovery. The first is coming to an end. The second is slowly being phased out. Consumption and investment now have to take the lead. But in most advanced economies, weak consumption and investment, together with little improvement in net exports, are leading to low growth. Unemployment is high and barely decreasing. By contrast, in many emerging market economies, where excesses were limited and the scars are few, consumption, investment, and net exports are all contributing to strong growth, and output is once again close to potential.

What can be done to improve things?

First, and wherever private demand is weak, central banks should continue with accommodative monetary policy. However, one should be realistic. Not much more can be done, and one should not expect too much from further quantitative or credit easing. While there is no evidence yet that sustained low interest rates are leading to excessive risk taking, should such risks materialize, they should be addressed through macroprudential measures, not through increases in policy rates.

Second, and wherever needed, governments must continue both financial repair and financial reform. Many banks remain undercapitalized, and tight credit is constraining segments of demand. Securitization, which must play an important role in any future intermediation system, is still moribund. Financial reform is proceeding, but questions remain about "too-big-to-fail" institutions, the perimeter of regulation, and cross-border issues. The faster reform uncertainty is reduced, the more the financial system will support demand and growth.

Third, and again wherever needed, governments must address fiscal consolidation. What is essential is not so much phasing out fiscal stimulus now, but offering credible medium-term plans for debt stabilization and, eventually, debt reduction. Such credible plans may involve fiscal rules, the creation of independent fiscal agencies, and phased-in entitlement reforms. They have not been offered in most countries, but they are essential and, once in place, will give governments more fiscal flexibility to sustain growth in the short term.

Fourth, emerging market economies with large current account surpluses must accelerate rebalancing. This is not only in the world economy's interest, but also in their own. In many countries, distortions have led to too low a level of consumption or too little investment. Removing these distortions and thus allowing consumption and investment to increase is desirable. To a large extent, market forces in the form of large capital inflows are pushing these countries in the right direction. Unless offset by reserve accumulation, capital inflows will lead to exchange rate appreciation. With the help of macroprudential measures and capital controls, these flows can help reallocate production toward domestic goods. Finally, to the extent that countries remain worried about sudden stops, better provision of global liquidity can play an important role and limit the accumulation of reserves.

All these pieces are interconnected. Unless advanced economies can count on stronger private demand, both domestic and foreign, they will find it difficult to achieve fiscal consolidation. And worries about sovereign risk can easily derail growth. If growth stops in advanced economies, emerging market economies will have a hard time decoupling. The need for careful design at the national level, and coordination at the global level, may be even more important today than at the peak of the crisis, a year and a half ago.

Olivier Blanchard
Economic Counsellor

EXECUTIVE SUMMARY

Thus far, economic recovery is proceeding broadly as expected, but downside risks remain elevated. Most advanced economies and a few emerging economies still face large adjustments. Their recoveries are proceeding at a sluggish pace, and high unemployment poses major social challenges. By contrast, many emerging and developing economies are again seeing strong growth, because they did not experience major financial excesses just prior to the Great Recession. Sustained, healthy recovery rests on two rebalancing acts: internal rebalancing, with a strengthening of private demand in advanced economies, allowing for fiscal consolidation; and external rebalancing, with an increase in net exports in deficit countries, such as the United States, and a decrease in net exports in surplus countries, notably emerging Asia. The two interact in strong ways. Increased net exports in advanced economies imply higher demand and higher growth, allowing more room for fiscal consolidation. Strengthened domestic demand helps emerging market economies maintain growth in the face of lower exports. A number of policies are required to support these rebalancing acts. In advanced economies, the repair and reform of the financial sector need to accelerate to allow a resumption of healthy credit growth. In addition, fiscal adjustment needs to start in earnest in 2011. Specific plans to cut future budget deficits are urgently needed now to create new room for fiscal policy maneuver. If global growth threatens to slow appreciably more than expected, countries with fiscal room could postpone some of the planned consolidation. Meanwhile, key emerging economies will need to further develop domestic sources of growth, with the support of greater exchange rate flexibility.

Stronger Activity, but Setbacks to Financial Stability

Economic recovery continued to strengthen during the first half of 2010. Global activity expanded at an annual rate of about 5¼ percent—about ½ percent higher than anticipated in the July *World Economic Outlook* (WEO) *Update.* A surge in inventory and, lately, fixed investment accounted for a dramatic rise in manufacturing and global trade. Low consumer confidence and reduced household incomes and wealth are holding consumption down in many advanced economies. Growth in these economies reached only about 3½ percent during the first half of 2010, a low rate considering that they are emerging from the deepest recession since World War II. Their recoveries will remain fragile for as long as improving business investment does not translate into higher employment growth. However, household spending is doing well in many emerging market economies, which expanded by close to 8 percent and where investment is propelling job creation. This heterogeneity in the pace of recovery across advanced and emerging economies is discussed in detail in Chapter 2.

At the same time, financial stability suffered a major setback, as explained in the accompanying October 2010 *Global Financial Stability Report* (GFSR). Market volatility increased and investor confidence dropped. Prices in many stock exchanges fell, led initially by financial stocks and by European markets. Heavy selling of the sovereign debt of vulnerable euro area economies rattled the banking system, triggering a systemic crisis. This added to existing worries about the sustainability of the recovery and caused a broader decline in stocks. Risk premiums on corporate bonds widened, and corporate bond issues slowed to a trickle in May. Issuance in emerging markets also dropped sharply. Since the beginning of the summer, however, financial conditions have improved again. Tail risks have been reduced by unprecedented European policy initiatives—the European Central Bank's Securities Markets Program and euro area governments' European Stabilization Mechanism—and by a front-loading of fiscal adjustment. However, underlying sovereign and banking vulnerabilities remain a significant challenge amid lingering concerns about risks to the global recovery.

Questions about the Pace of Recovery

The global recovery remains fragile, because strong policies to foster internal rebalancing of demand from public to private sources and external rebalancing from deficit to surplus economies are not yet in place. Global activity is forecast to expand by 4.8 percent in 2010 and 4.2 percent in 2011, broadly in line with earlier expectations, and downside risks continue to predominate. WEO projections are that output of emerging and developing economies will expand at rates of 7.1 and 6.4 percent, respectively, in 2010 and 2011. In advanced economies, however, growth is projected at only 2.7 and 2.2 percent, respectively, with some economies slowing noticeably during the second half of 2010 and the first half of 2011, followed by a reacceleration of activity. Slack will remain substantial and unemployment persistently high. Inflation is projected to stay generally low, amid continued excess capacity and high unemployment, with a few exceptions among the emerging economies. Risks to the growth forecasts are mainly to the downside. However, the probability of a sharp global slowdown, including stagnation or contraction in advanced economies, still appears low.

More Proactive Policies Are Needed

Policies need to become more proactive to achieve the required internal and external rebalancing. Most advanced economies and a few emerging economies still face major adjustments, including the need to strengthen household balance sheets, stabilize and subsequently reduce high public debt, and repair and reform their financial sectors. Monetary policy should stay highly supportive in most of the advanced economies and should be the first line of defense against any larger-than-projected weakening of activity as fiscal support diminishes. With policy rates already near zero in the large advanced economies, monetary policymakers may have to resort to further unconventional measures if private demand weakens unexpectedly as fiscal support wanes.

Fiscal adjustment needs to start in 2011. If global growth threatens to slow appreciably more than expected, countries with fiscal room could postpone some of the planned consolidation. One of the most urgent challenges for advanced economies is to legislate plans that help achieve sustainable fiscal positions before the end of the decade. This task is now more pressing than it was six months ago to rebuild room for fiscal policy maneuver in the face of still-volatile sovereign debt markets. Such room could be needed because monetary policy alone might not be able to provide sufficient support to counter the threat of a weakening of activity that is markedly more pronounced than expected.

Fiscal policy tightening will likely prove contractionary in most economies, although the extent is difficult to gauge. The survey of past experience in Chapter 3 suggests that fiscal consolidation in advanced economies typically detracts from short-term growth. The introduction of credible, growth-friendly, medium-term fiscal consolidation plans—currently not on offer in many advanced economies—would help limit the deflationary impact of consolidation on private demand in the short term. Such plans would have to include reforms to rapidly growing spending programs, notably entitlements, and tax reforms that favor production rather than consumption.

Better financial sector policies and practices in advanced economies are critical for strengthening the resilience of the recovery to shocks and sustaining private demand over the medium term. Progress on this front has been very slow. Apparently isolated difficulties in a few spots can have large spillover effects, via complex financial linkages and deterioration of fragile confidence. As the October 2010 GFSR explains, incomplete progress in addressing the legacy problems of the crisis has left systems in advanced economies vulnerable. Failure to rapidly resolve, restructure, or consolidate weak banks and repair wholesale markets raises the need for further fiscal backstopping and low interest rates to support recovery, which can cause other problems, including spillovers to emerging economies. More broadly, policymakers need to continue to clarify and specify regulatory reform, building on the improvements proposed by the Basel Committee on Banking Supervision. This would help financial markets and institutions provide more support, on a sounder basis, for consumption and investment, which is essential for strong, sustainable growth.

Structural policies that strengthen growth over the medium term would also help support the required normalization of macroeconomic policies in advanced economies. While supportive macroeconomic policies and financial sector repair and reform are essential for stronger job creation, in a number of economies, labor market policies could enhance growth and job creation and reduce high unemployment over the medium term. Complementary reforms to product and services markets could strengthen the employment effects by boosting labor demand and real wages through greater competition and lower markups on prices.

Although many emerging economies are seeing high growth again, they continue to rely significantly on demand from advanced economies. Chapter 4 makes clear that demand for imports from the advanced economies will continue to be below precrisis trends, in view of the high share of consumer durables and investment goods in trade. Emerging economies that relied heavily on demand from these economies will therefore have to rebalance growth further toward domestic sources to achieve growth rates similar to those before the crisis, helping the required external rebalancing. In economies with excessive external surpluses, which are mainly in emerging Asia, fiscal tightening should therefore take a backseat to monetary tightening and exchange rate flexibility. Removing distortions that drive high household or corporate saving rates and deter investment in nontradables sectors would facilitate the rebalancing of growth to domestic sources. Such rebalancing will require further deregulation and reform of financial sectors and corporate governance, as well as stronger social safety nets in key Asian economies. In many other emerging economies, fiscal tightening can start immediately, because domestic demand recovery is already well under way or public debt is relatively high. In various emerging economies, rising inflation or high credit growth also signal a need for further monetary tightening.

Many emerging and developing economies have successfully concluded first-generation reforms that improved macroeconomic policy frameworks, strengthening their resilience to macroeconomic shocks. However, to sustain or further raise potential growth and employment, efforts could usefully focus on simplifying product and services market regulation, raising human capital, and building critical infrastructure. Such reforms would also help absorb growing capital inflows in a productive manner, which would accelerate global income convergence and external rebalancing. As Chapter 1 and the October 2010 GFSR underscore, these flows can be expected to grow over the medium term, as the performance of emerging economies improves relative to that of the advanced economies, yields in the advanced economies remain low for some time, and institutional investors in advanced economies continue to diversify their exposures.

Strong, coordinated policy responses by all are essential to limit the fallout of the Great Recession. Historical evidence suggests that countries hit by financial crises typically suffer permanent output losses relative to precrisis trends. However, outcomes after individual crises have varied widely, depending on the policy responses. So far, much progress has been made through coordinated policy responses in alleviating liquidity strains and rebuilding confidence, and this has been essential for activity to rebound. The challenge ahead is for policymakers to put in place, in a coordinated manner, policies that support the fundamental adjustments needed for a return to healthy medium-term growth.