



Group of Seven

**Meetings of G-7 Finance Ministers and Central Bank Governors
February 5–6, 2010
Iqaluit, Canada**

Global Economic Prospects and Policy Challenges

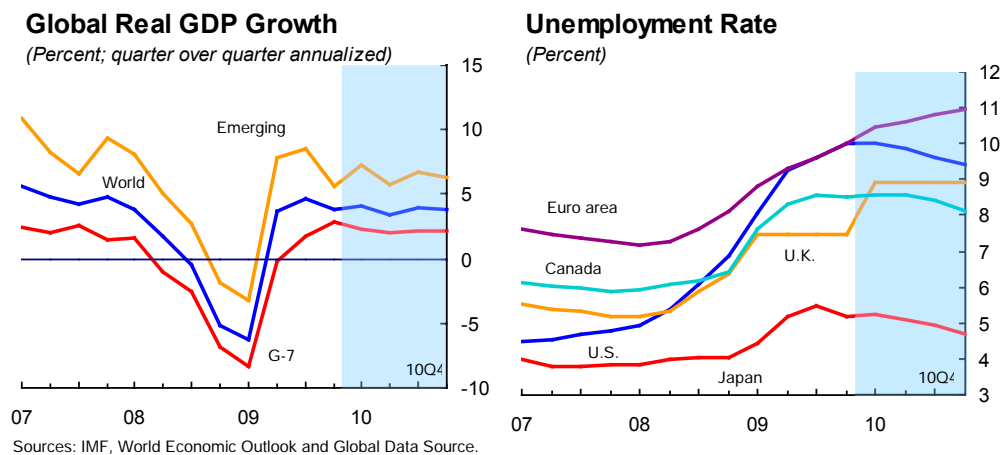
Prepared by Staff of the International Monetary Fund

I. RECENT DEVELOPMENTS, PROSPECTS AND KEY RISKS¹

The global recovery is off to a stronger start than anticipated earlier, albeit proceeding at different speeds in the various regions. Following the deepest global recession in recent history, economic growth returned and broadened to advanced economies in the second half of 2009. In 2010, world output is expected to rise by 4 percent. This represents an upward revision of $\frac{3}{4}$ percentage point from the October 2009 WEO. However, in most advanced economies, the recovery is expected to remain sluggish by past standards. There are no clear signs that domestic demand is self-sustaining and thus policy stimulus needs to be maintained through 2010. In many emerging and developing economies, activity is expected to be relatively vigorous, largely driven by buoyant internal demand, and an earlier exit from policy stimulus than in their counterparts among the advanced economies may be warranted. This outlook is subject to important risks in both directions.

A. Recent Developments

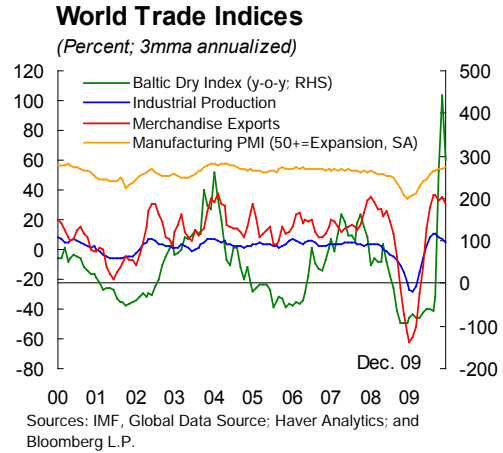
1. **Global output increased by about 4 percent (seasonally adjusted, annualized) in the second and third quarters of 2009, but recovery is lagging across the G7 economies.** Following several quarters of decline, real GDP in the United States and Canada expanded in the third quarter, joining Germany, France, and Japan, where growth resumed in the second quarter. Output in the United Kingdom continued to decline but at a slower pace and stabilized in the fourth quarter. Overall, G7 output expanded by 1.8 percent in the third quarter, underpinned by extraordinary policy stimulus. However, there are few clear signs of self-sustaining private demand, and unemployment continues to increase. Momentum in emerging economies was much stronger, led by China, India, and Brazil, where output expanded rapidly.



¹ Prepared by Krishna Srinivasan, Emil Stavrev, and Elie Canetti of the Research and Monetary and Capital Markets Departments, with input from the Fiscal Affairs Department.

2. The global recovery is being largely driven by rebounding confidence and extraordinary policy support.

Large-scale and wide-ranging policy support has helped avoid a systemic meltdown, prompting a sooner-than-expected return of confidence in the financial system and in the real economy. Global production and trade recovered strongly in the second half of 2009. In advanced economies, the beginning of a turn in the inventory cycle and the unexpected strength of U.S. consumption played an important role, while the recovery in emerging economies has been driven by strong domestic demand in major emerging economies, notably in Asia.



Assessing Growth Momentum 1/ 2/ 3/

	Sep-08	Oct-08	Nov-08	Dec-08	Jan-09	Feb-09	Mar-09	Apr-09	May-09	Jun-09	Jul-09	Aug-09	Sep-09	Oct-09	Nov-09	Dec-09
United States	Red	Red	Red	Red	Red	Red	Red	Red	Red	Red	Red	Red	Red	Red	Red	Red
Canada	Red	Red	Red	Red	Red	Red	Red	Red	Red	Red	Red	Red	Red	Red	Red	Red
Japan	Red	Red	Red	Red	Red	Red	Red	Red	Red	Red	Red	Red	Red	Red	Red	Red
Germany	Red	Red	Red	Red	Red	Red	Red	Red	Red	Red	Red	Red	Red	Red	Red	Red
France	Red	Red	Red	Red	Red	Red	Red	Red	Red	Red	Red	Red	Red	Red	Red	Red
Italy	Red	Red	Red	Red	Red	Red	Red	Red	Red	Red	Red	Red	Red	Red	Red	Red
United Kingdom	Red	Red	Red	Red	Red	Red	Red	Red	Red	Red	Red	Red	Red	Red	Red	Red

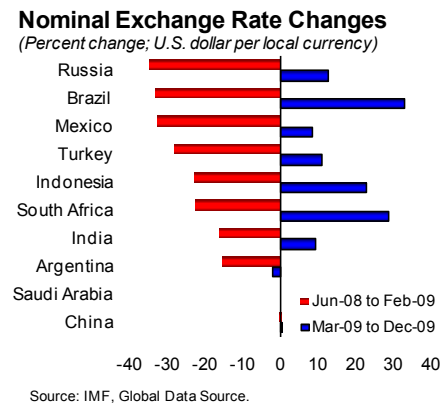
Green	Expansion and level at or above trend (mean)
Light Green	Expansion but level below trend (mean)
Yellow	Moving sideways
Pink	Contraction at a moderating rate
Red	Contraction at a increasing rate
White	Data not available

Sources: Global Data Source; Haver Analytics; Bloomberg L.P.; and staff calculations.
 1/ The above chart is based on the four economic indicators, including industrial production (IP), real retail sales (RS), merchandise exports (EX), and purchasing managers index (PMI).
 2/ Some of the ratings—particularly for recent months—are based on both actual data as well as projections of the underlying variables.
 3/ Retail sales and IP are based on real data, whereas, exports are based on nominal data and PMI on survey data.

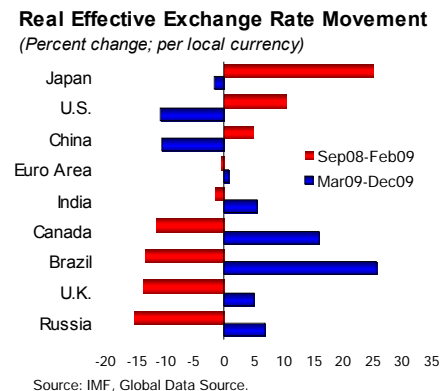
3. Financial market conditions continue to improve, but bank credit is likely to remain sluggish. The financial sector is still benefiting from public support, raising important questions about the timing and coordination of exits. Also, concerns are rising about the shifting in risks from private to sovereign balance sheets as a result of support measures.

- In most G7 countries, bank deleveraging and balance sheet repair has yet to run its course, and funding challenges remain. Despite nascent economic recovery, credit risks are still high, especially in commercial real estate, leaving questions about the sustainability of bank earnings. Bank lending standards continue to tighten, albeit at a more moderate pace. Thus, banks will likely remain a drag on credit.

- Capital markets have rebounded strongly. Corporate bond issuance has reached record levels, and securitization is also recovering, albeit in some cases due to substantial public support. But this has been insufficient to offset the decline in bank financing. Thus, sectors without access to capital markets, namely consumers and SMEs, are likely to face credit constraints going forward. Public lending schemes and guarantees have been critical to channeling credit to these sectors, but have only been partially successful.
- Concerns about sovereign risk are rising. This is reflected in the rising volatility in sovereign CDS spreads or yields of some small countries, as these economies struggle with large government deficits and debt and investors increasingly differentiate across countries. In part, this is due to a shift of balance sheet weaknesses from the private sector to the public sector. However, the global recession has revealed substantial vulnerabilities in the fiscal position of some countries, notably among some of the advanced economies in Europe.
- Capital flows to emerging economies have risen sharply in recent months. This can be explained by a combination of factors, including rapidly improving growth prospects, a rise in risk appetite, and large interest-rate differentials. Capital inflows are complicating monetary policy responses in many of these economies, notably where there may be a need to tighten policy owing to a pick-up in inflation or to slow excessive credit growth. Although the boom in capital flows to emerging markets is in its early stages, it is already raising concerns about the potential for future asset price bubbles.

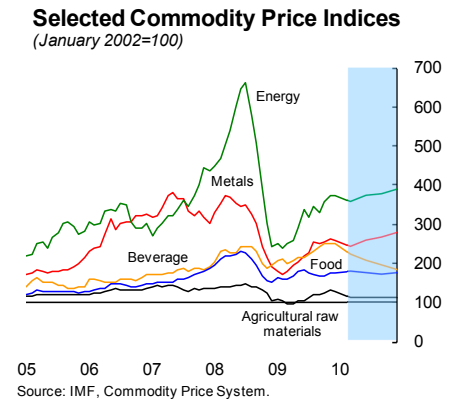


4. **Exchange rate movements reflect renewed risk appetite.** With improving financial conditions and receding systemic fears, the U.S. dollar has depreciated in real effective terms since early 2009, as flight-to-safety flows have unwound. While the dollar is still somewhat overvalued, it has moved closer to its medium-run equilibrium. The euro has appreciated on real effective basis and is on the strong side of equilibrium. The yen is broadly in line with medium-term fundamentals, following a substantial appreciation since late 2008. The Chinese renminbi has depreciated in real effective terms in tandem with the U.S. dollar and is assessed to be substantially undervalued from a medium-term perspective. In response to large capital

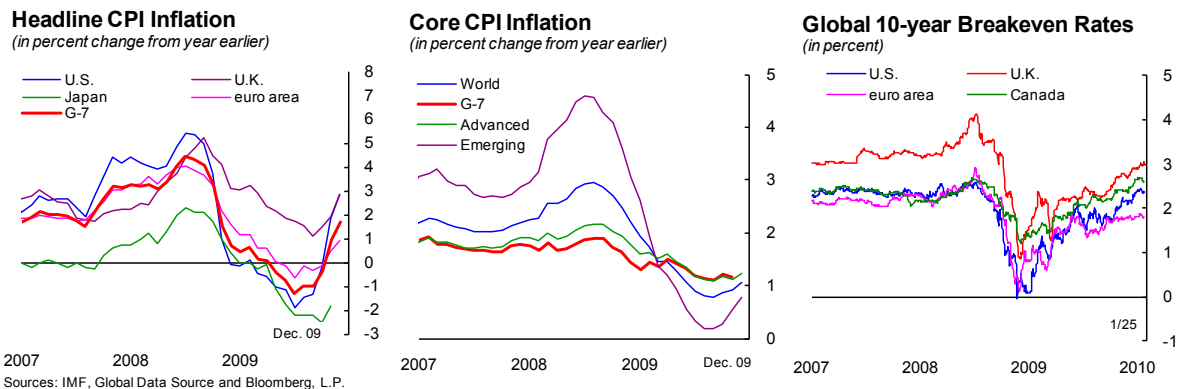


inflows, while several emerging economies have allowed some appreciation of their currencies, others are resisting currency appreciation. While this may be appropriate in some cases, it complicates global rebalancing in other cases.

5. **Commodity prices increased strongly at the onset of the recovery, driven largely by buoyant growth in emerging economies.** Robust growth in Asian emerging economies at the start of the recovery and other emerging economies more broadly, pushed up commodity prices significantly, notwithstanding generally high inventories. Recent data indicating that commodity imports into China remained strong at the end of 2009 have bolstered expectations for ongoing strong Chinese demand across a broad range of commodities, including crude oil. However, upward price pressures are likely to remain moderate, given above average inventories and significant spare capacity for most commodities.



6. **Inflation has remained subdued and inflation expectations well anchored.** Following several month of negative CPI rates, driven largely by base effects from energy prices, twelve-month headline inflation turned positive towards end-2009 in the United States and the euro area, reaching 2.7 percent and 0.9 percent, respectively in December. Consumer prices in Japan continued to decline, but at a slower pace. G7 core inflation has hovered around 1 percent since mid-2009 and inflation expectations remained anchored around central banks' inflation objectives.



B. Prospects

7. **The global economy is recovering earlier and more strongly than previously anticipated, but the recovery is expected to be weak, notably in advanced economies.** After contracting by 0.8 percent in 2009, global output is expected to expand by around 4 percent in 2010 and 4.3 percent in 2011 on annual average basis, an upward revision of

¾ and 0.1 percentage points, respectively, relative to the October World Economic Outlook (WEO). Output in G7 is expected to expand by 2.1 percent in 2010 and by 2.3 percent in 2011, which makes for a sluggish recovery by historical standards. High unemployment rates and public debt, and in some cases weak household balance sheets, are expected to remain a drag on private demand, while credit will be held back by the need to rebuild bank capital further. In *emerging economies*, growth is expected to accelerate sharply to 6 percent in 2010, from 2.1 percent in 2009, and pick up further to 6.3 percent in 2011. Swift policy responses and improved economic frameworks have helped many emerging markets to cushion the impact of the unprecedented external shock and attract capital flows again.

World Economic Outlook: Real GDP Projections for January 2010 Quarterly Update

(Percent change, unless otherwise noted)

	Year over Year					Q4 over Q4			
	2008	Est.	Proj.		Difference from WEO Oct. 2009 Publication		Est.	Proj.	
		2009	2010	2011	2010	2011	2009	2010	2011
World output 1/	3.0	-0.8	3.9	4.3	0.8	0.1	1.3	3.9	4.3
Advanced economies	0.5	-3.2	2.1	2.4	0.8	-0.1	-0.7	2.1	2.5
Euro area	0.6	-3.9	1.0	1.6	0.7	0.3	-1.8	1.1	1.8
Emerging and developing economies 2/	6.1	2.1	6.0	6.3	0.9	0.2	4.3	6.4	6.9
G7	0.2	-3.5	2.1	2.3	0.8	-0.1	-1.1	2.2	2.4
United States	0.4	-2.5	2.7	2.4	1.2	-0.4	-0.3	2.6	2.4
Germany	1.2	-4.8	1.5	1.9	1.2	0.4	-1.9	1.0	2.5
France	0.3	-2.3	1.4	1.7	0.5	-0.1	-0.5	1.6	1.6
Italy	-1.0	-4.8	1.0	1.3	0.8	0.6	-2.4	1.3	1.1
Japan	-1.2	-5.3	1.7	2.2	0.0	-0.2	-1.8	1.8	2.5
United Kingdom	0.5	-4.8	1.3	2.7	0.4	0.2	-2.8	1.9	3.1
Canada	0.4	-2.6	2.6	3.6	0.5	0.0	-1.6	3.6	3.5

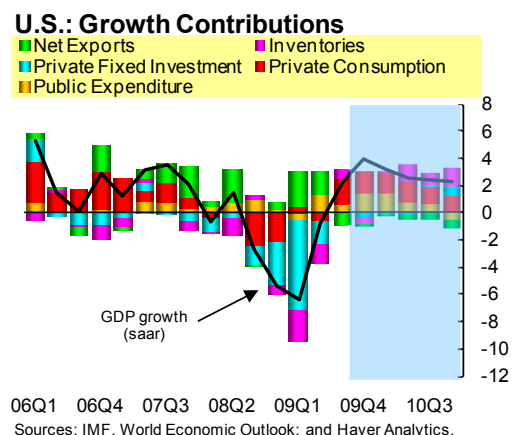
Source: IMF, World Economic Outlook Update, January 2010.

Note: Real effective exchange rates are assumed to remain constant at the levels prevailing during November 19-December 17, 2009. Country weights used to construct aggregate growth rates for groups of countries were revised. When economies are not listed alphabetically, they are ordered on the basis of economic size.

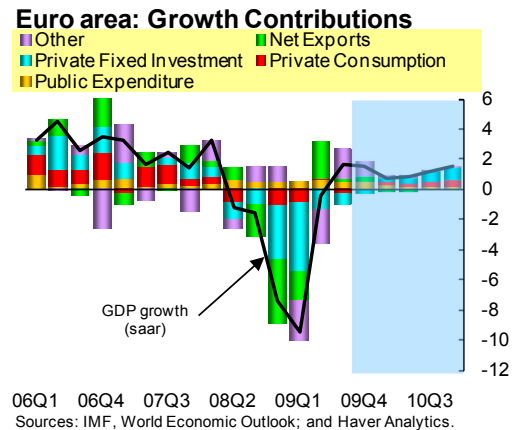
1\ The quarterly estimates and projections account for 90 percent of the world purchasing-power-parity weights.

2\ The quarterly estimates and projections account for approximately 77 percent of the emerging and developing economies.

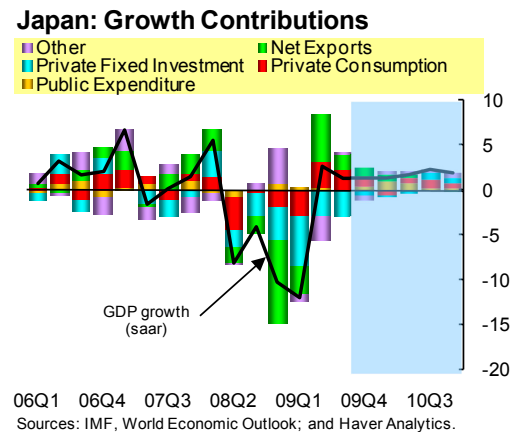
- In the *United States*, growth resumed during 2009H2, led largely by macroeconomic stimulus and a major contribution from inventories at end-year. In line with improving confidence, consumption has registered moderate growth and business investment has picked up, but commercial real estate continues to contract and indicators for the residential real estate market remain mixed. Going forward, high unemployment and weak household balance sheets are likely to weigh on consumption, which coupled with the unwinding of some stimulus measures and still relatively tight financial conditions would imply a sluggish recovery by past standards. On balance, growth in 2010 is projected at about 2¾ percent both on an annual average and a Q4/Q4 basis.



- In the *euro area*, output expanded by 1.7 percent (saar) in 2009Q3, led mainly by policy stimulus and recovering external demand. While the recovery has broadened across countries, significant divergences remain. Looking ahead, the strong euro and diminishing effectiveness of temporary support policies—such as employment support in Germany—are likely to dampen the current momentum, while rising unemployment will weigh on domestic demand. More importantly, the largely bank-based financial system will take time to fully resume a strong intermediation role. As a result, the recovery is expected to be sluggish, with growth in 2010, both on an annual average and Q4/Q4 basis, expected at just over 1 percent.



- In *Japan*, growth in 2009Q3 came in at 1.3 percent (saar). Industrial production and exports are steadily improving, but are still 20 percent below pre-crisis levels and have not yet reinvigorated private domestic demand. Aggressive fiscal and monetary stimulus and strong performance by Asian emerging economies are expected to give a boost to growth in the coming quarters. Nevertheless, against the backdrop of sluggish private spending and investment and historically high unemployment, the recovery is expected to be slow. Growth in 2010, both on an annual average and Q4/Q4 basis, is projected to be around 1¾ percent.



- In the *United Kingdom*, output continued to decline (0.6 percent, saar) in 2009Q3, albeit at a slower pace, and stabilized in 2009Q4. Recent data suggest that short-term momentum is likely to improve, reflecting a deceleration in destocking, continued improvement in the housing market, and improved global financial conditions and economic outlook. Nevertheless, the recovery is expected to be subdued, with growth in 2010 forecast at 1.3 percent on an annual average basis, given that protracted deleveraging by banks and households will limit credit expansion and weigh on private demand, while external demand, albeit improving, is expected to remain soft.

In *Canada*, growth in the third quarter came in at 0.4 percent, driven by strong domestic demand, while net trade was a drag. Data releases since then indicate a stronger outturn going forward. On the back of better balance sheets of banks and

households compared to other G7 countries, housing starts and residential permits rose in recent months, signaling relatively robust domestic demand. Trade figures, though weaker than expected, suggest a significant reduction in the drag from net export on real GDP, pointing to an improved momentum and further support to economic growth. Growth in 2010 is expected to be around 2½ percent on an annual average basis.

- While generally more robust than in advanced economies, the recovery is expected to be uneven among *emerging economies*. The recovery in emerging economies is led by the strong rebound in emerging Asia, notably China, India, and Indonesia, fueled by strong domestic demand and supported by stimulus measures. Other emerging economies are staging modest upturns, supported by policy stimulus, increased momentum in trade, and improvements in financial conditions. Overall, growth in emerging economies in 2010 is projected at 6 percent on annual average and 6.4 percent on a Q4/Q4 basis.

8. **G7 public finances are projected to worsen significantly, while prospects for emerging economies remain more favorable.** For *G7 economies*, large fiscal deficits, reflecting cyclical factors, financial support measures, stimulus packages, and underlying structural spending pressures are expected to raise the general government gross debt-to-GDP ratio to about 120 percent in 2014, from around 80 percent in 2008 (Table S7). The sovereign debt outlook is generally more favorable for *emerging economies*, with debt ratios expected to decline moderately after 2010 and to remain, on average, below 40 percent of GDP in the medium term. This reflects smaller output losses in the major emerging markets and lower primary deficits in the midst of the crisis as well as the stronger rebound in growth accompanied by some discretionary tightening to be implemented in 2010. Nevertheless, there are risks to emerging markets, particularly with weak fundamentals, from potential international spillovers, as the large debt buildup in the advanced economies could lead to higher borrowing costs.

9. **Inflation is expected to remain contained, on the back of increasing unemployment and large output gaps.** Capacity utilization in advanced economies will remain low, given the projected sluggish recovery and large output gaps in 2010, even after accounting for the decline of potential output due to the financial crisis. Accordingly, inflationary pressures will remain subdued, despite the projected increase of commodity prices. In 2010, headline inflation in advanced economies is forecast to increase to 1¼ percent in 2010 (from zero in 2009), as slowing labor costs are more than offset by rebounding commodity prices, while inflation in emerging markets is expected to remain slightly over 5 percent. However, some emerging market economies may face stronger upward price pressure on the back of more limited spare capacity and increased capital inflows.

C. Key Risks

10. **The outlook is subject to important risks in both directions:**

- *On the upside*, the reversal of the confidence crisis and reduction in uncertainty may continue to foster a stronger-than-expected improvement in financial market sentiment and prompt a larger-than-expected surge in capital flows, trade, and private demand. New policy initiatives in the United States to reduce unemployment could provide a further impetus to U.S. and global growth.
- *On the downside*, both a premature and incoherent exit from supportive policies and a lack of further progress in bank restructuring and recapitalization risk undermining global growth and its rebalancing. Another important risk is that impaired financial systems and housing markets or rising unemployment hold back the recovery in household spending more than expected in key advanced economies. In addition, rising concerns about worsening budgetary positions and fiscal sustainability could unsettle financial markets and stifle the recovery by raising the cost of borrowing for households and companies. Yet another downside risk is that rallying commodity prices constrain the recovery in advanced economies.

II. POLICY CHALLENGES

With recovery in most advanced economies expected to be weak, and no signs as yet of a sustained pick-up in private demand, policy stimulus will need to be maintained in these economies at least through 2010. Bank recapitalization needs to proceed with a greater sense of urgency to support a durable recovery. At the same time, however, policymakers need credible and coherent exit strategies to transition from extraordinary short-term support to meeting medium-term policy requirements, including securing fiscal sustainability. Some major emerging economies are already growing rapidly, and may have to unwind stimulus faster than the advanced economies.

A. Macroeconomic Policies

11. **Macroeconomic policy stimulus should be maintained in major advanced economies at least through 2010, but may need to be unwound soon in key emerging economies facing risks of overheating.**

- Notwithstanding the recent uptick in growth prospects, recovery in the major advanced economies will remain sluggish, underpinning the need for continued policy stimulus until private demand gathers momentum on a sustainable basis. G7 central banks should maintain low interest rates until end-2010, given that underlying inflation is expected to remain subdued and unemployment high for some time. Similarly, fiscal policies need to remain supportive of economic activity in the near term, and the fiscal stimulus planned for 2010 should be implemented fully. Moreover, in the context of high unemployment in these economies, there is merit in

considering new policy initiatives aimed at boosting job creation, but such measures should be cast within a framework that ensures sound medium-term fiscal balances.

- In some major emerging economies in Asia and Latin America, output gaps are rapidly closing. There are also nascent signs of asset price booms and, in some cases, deteriorating credit quality. In countries with excessive current account surpluses, exchange rate appreciation could help reign in excess demand, supported by monetary tightening, while fiscal policy continues to ensure a robust transition to private demand. Monetary tightening may be more complicated in countries with broadly balanced external positions, as it could amplify exchange rate pressures. These economies may have to consider macroprudential measures and fiscal tightening and, under some circumstances, reserve accumulation and restrictions on capital inflows.

12. Policymakers in all countries should remain proactive in preparing for exiting from extraordinary stimulus, recognizing the challenge of mapping a course between exiting too early and too late. Unwinding stimulus too early could jeopardize progress in securing economic recovery, while maintaining it for too long could distort private incentives and pose risks to price, financial, and fiscal stability. More generally, exiting from crisis-related public support policies should be viewed in the context of achieving strong, sustained and balanced growth. Attaining this objective will require meeting the onerous challenges to fiscal sustainability, normalizing monetary policy while unwinding crisis-related unconventional measures, carefully withdrawing financial sector support, and avoiding policy inconsistencies across countries, as well as in the policy mix. Moreover, given the different pace of recovery across countries, globally coherent exit from supportive macroeconomic policies calls for a differentiated unwinding of stimulus.

13. In most G7 economies, ensuring fiscal sustainability is a key priority and policy challenge, notably in light of the surge in government debt levels. The long implementation lags in fiscal policy means that policy change will have to be initiated earlier rather than late. By contrast, maintaining an accommodative monetary policy stance does not have a similar downside because it can be reversed quickly and poses few risks in the current inflation environment. Also, a tightening of the fiscal stance may help monetary management, while a monetary tightening could contribute to a worsening of the fiscal position. Hence, fiscal consolidation should generally take priority, particularly in countries that need to raise national saving. Achieving fiscal sustainability will be a difficult and prolonged process, making it imperative for consolidation to begin as soon as there is clear evidence of self-sustaining recovery. Given a path for fiscal policies, monetary policy can be set to achieve a desired level of overall stimulus, tightening as needed to counter inflationary risks and maintain price stability.

14. While provision of fiscal support will need to be maintained until the recovery gains a solid footing, G7 governments should lay out credible medium-term plans to reduce the public debt ratio. Moreover, they should start implementing immediately

elements of these medium-term plans that do not impact negatively on demand. This includes strengthening fiscal institutions to increase the likelihood that fiscal adjustment will take place, and undertaking those reforms of entitlement spending that do not depress consumption—such as increases in the retirement age—or that can be phased in gradually. A failure to implement these measures would raise risks to fiscal sustainability and reduce growth prospects. To achieve fiscal sustainability, authorities need a credible medium-term fiscal policy strategy that would entail:

- **Clear timeframes to bring the gross debt to GDP ratio to sustainable levels that take into account longer-term spending pressures.** Stabilizing debt ratios at their likely post-crisis levels will not be sufficient, as high debt ratios would impede fiscal flexibility, raise economy-wide interest rates, and constrain growth. The appropriate debt target will depend on economy-specific characteristics, including debt composition, depth of domestic financial markets, vulnerability to shocks, and diversification of the investor base.
- **Sustained adjustment in primary structural balances.** Experience in past large consolidations indicates that this is the key element in a successful reduction of the debt ratio. In advanced economies, the primary balance adjustment required over the next ten years to return debt ratios to about 60 percent of GDP by 2030 is of the order of 8 percentage points of GDP (from a deficit of 3½ percent of GDP in 2010 to a surplus of 4½ percent of GDP in 2020 and keeping it at that level for the following decade). Winding down fiscal stimulus measures could provide only about 1½ percent of GDP in adjustment—thus additional fiscal measures will be needed (e.g., reform of pension and healthcare entitlements).
- **Strong fiscal policy frameworks and institutions with comprehensive coverage of the public sector.** Formally adopting or strengthening fiscal rules with explicit fiscal targets and monitoring by independent fiscal agencies could help shore up the necessary broad consensus, anchoring expectations and guiding fiscal policy implementation over the medium term.

15. **Central banks need to prepare and clearly communicate credible strategies for unwinding the extraordinary monetary policy support.** The crisis compelled central banks to employ a wide range of crisis-intervention measures, in many cases unprecedented. Unwinding should be tractable and central banks have the tools needed to tighten policy, but there will be challenges.

- The key objective will be to maintain price stability. However, where financial stability remains fragile, or key markets are not yet functioning, central banks may need to maintain crisis-intervention measures or possibly introduce new ones, even within the context of an overall tightening of the monetary policy stance.

- Central banks will need to unwind conventional and unconventional measures at different paces. Some unconventional (or “balance sheet”) measures are already being unwound, as funding markets improve and certain facilities expire or run off automatically. Central banks can further tighten the parameters of existing facilities, or introduce new liquidity-absorbing instruments, if tightening is needed before central bank balance sheet have been restored to normal levels. However, reducing central banks’ exposure to assets associated with credit easing operations and private or quasi-sovereign financial instruments will depend on the state of financial markets and may take considerable time.

16. **In major emerging (and some advanced) economies experiencing faster recoveries, including those with large fiscal space, the desirable policy mix may be different.** For economies that have relied on export-led growth and with sufficient fiscal space, rebalancing from external to domestic demand may require additional measures to reduce precautionary savings, through further efforts to strengthen social safety nets, pension and healthcare systems reforms, and improvements in corporate governance. In a number of these economies enjoying excessive current account surpluses, monetary conditions may have to be tightened relatively soon (notably through currency appreciation), and might therefore lead fiscal consolidation, owing to rising inflation or incipient financial vulnerabilities.

B. Financial Sector Policies

17. **The concerted policy response to the crisis averted the threat of systemic financial meltdown.** As confidence in financial markets returns amid firming signs of economic revival, the nature of the policy challenge is shifting towards an unwinding of extraordinary support measures and laying the foundation for a more robust financial system that fosters an efficient use of capital.

18. **However, major work still remains to repair damage to the financial system from the crisis.** In many advanced countries and a number of hard-hit emerging market countries, banking systems are still stressed, which is hampering credit growth. In most advanced economies, policymakers still have to address an overhang of impaired assets and the need for more and higher quality capital; also, bank restructuring has not yet taken place to an appreciable degree and needs to be accelerated, including by expeditiously winding up nonviable financial institutions. The absorption of failed financial institutions has led to an exacerbation of the “too-important-to-fail” problem and the associated moral hazard, on which there has been little policy progress. The shortening of bank funding maturities is raising the need to address a rapidly advancing “wall of maturities”.

- Recent measures announced by the United States, aimed at limiting certain activities of commercial banks and to limit bank size, may help reduce systemic risks. However, such direct measures are not a substitute for broader regulatory reforms,

including a strengthening of capital and liquidity requirements, risk management frameworks, and the prevention of regulatory arbitrage. Moreover, there is an urgent need for a broader international consultative process toward a more harmonized approach.

- Other financial sector measures announced by some G7 countries, including those aimed at covering costs associated with bailouts and discouraging leverage and excessive reliance on wholesale funding, will also help reduce systemic risk. But again such measures need to be viewed in the context of broader financial sector reforms, including an assessment of the trade-offs between greater regulation and financial sector taxation. Greater attention also needs to be paid to international coordination, to ensure a level-playing field for internationally active institutions.

19. Designing exits from financial support policies represents a critical challenge.

Exiting from some programs (especially those that support shorter-term funding markets and liquidity provision) could be relatively fast and easy—some are falling into disuse as private market activity revives. However, others (e.g., enhanced credit support programs through purchases of private sector securities) may need to remain in place for some time. Securitization markets, such as for mortgage-backed paper, may also not recover quickly and could continue to depend on public support for some time. As market pricing may give misleading signals on the timing of exit, caution should be exercised on the timing of exit. Beyond this, some facilities may need to be kept in place for some time longer even as their usage ends, in order to guard against unexpected developments. Exits will also need to be made consistent across countries to avoid adverse spillovers, but this does not necessarily imply that they should be synchronized.

20. Designing and implementing financial sector reform will require a high degree of coordination. While there is clearly a need to allow enough time to design and assess the impact of a new regulatory regime, the pace of reform should bear in mind that regulatory uncertainty is an impediment to resumption of lending. Regulators and fiscal authorities will also have to make sure that policies in their respective areas are not working at cross-purposes or collectively leading to unduly burdensome outcomes. For instance, financial sector taxation, if implemented, will need to be coordinated with the prudential regime for financial institutions. The regulatory perimeter may need to be widened, bearing in mind the need for flexibility as reform engenders financial innovations in response. Finally, regulatory regimes will need to be consistent across countries in order to reduce the scope for the inefficiencies that arise from regulatory arbitrage.

21. Some emerging market countries will have to design policies to manage a surge of capital inflows. Macro-prudential policies can be used to address the potential for bubbles at an early stage by limiting a buildup in risks. Limits on leverage, loan-to-value ratios, and well-managed margining and collateral systems in securities' markets will help. In addition, some countries will need to consider increasing currency flexibility and other

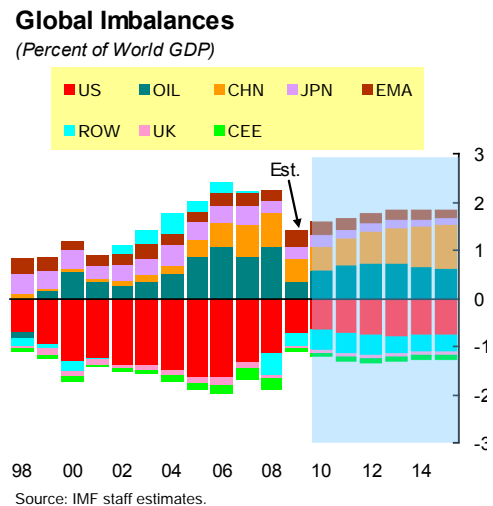
macroeconomic policy adjustments in order to restrain capital inflows that seek to benefit from “one-way bets” in currency markets. Applying direct controls over capital flows (whether inflows or outflows) may reduce gains to carry-type trade, although their effectiveness may only be temporary.

C. Policies for Strong, Sustainable, and Balanced Global Growth

22. **Reforming financial infrastructure to reduce the risk of future systemic crisis is a critical element towards sustainable and balanced growth.** Reforms in several areas are needed to resolve the deep flaws in the financial system that led to a build-up of systemic risk. In particular: (i) regulatory gaps should be closed by broadening the perimeter of regulation to cover all systemically-important institutions to prevent the transfer of risk to key financial institutions that face different regulatory requirements; (ii) prudential frameworks must play a greater stabilizing role over the business cycle to avoid the build-up of financial vulnerabilities during the boom phase and the fire sales and abrupt deleveraging that amplified the impact of the crisis; (iii) sound compensation policies that reward risk-adjusted long-term returns are key to avoid excessive risk taking. Furthermore, removing the impetus for financial firms to become too important to fail should be high on the reform agenda. It is encouraging that plans are being developed to reform financial infrastructure, but reform momentum must not be lost as market confidence rebounds.

23. **Following a sharp decline in the aftermath of the crisis, global imbalances are projected to widen over the medium term, though not to return to the pre-crisis levels.**

Global imbalances have narrowed sharply after the crisis, mainly as a result of cyclical factors, but also due to painful adjustments in some countries. Specifically, current account deficits in advanced countries that were directly hit by the financial crisis (the United States and the United Kingdom) and in emerging Europe (CEE) have narrowed sharply, as credit and housing booms have turned to busts. Current account surpluses of Japan (JPN) and oil exporters (OIL) have declined largely due to cyclical reasons, as exports and energy demand, respectively, fell sharply in the aftermath of the crisis, but currency appreciation (Japan) and an expansionary fiscal stance in prominent oil exporters (Saudi Arabia) have also contributed. Emerging Asia (EMA)—notably, China—has seen less adjustment in its external balance. Based on current policies, however, imbalances are projected to widen again and, though lower than pre-crisis, point to the need for further adjustment in deficit and surplus countries.



24. **Achieving strong, sustainable, and balanced global growth requires multilateral policy effort, involving both advanced and emerging economies.** For *advanced economies*, rapid progress toward fixing the financial system is essential to support productivity and growth. In addition, in countries with large surpluses and lagging productivity in services sector, there is a scope for structural reforms, which would have a clear domestic payoff by raising growth potential, and also help over time increase investment and rebalance demand. In countries with sizable deficits, rebuilding national savings and competitiveness in tradable sectors are key. For *emerging countries*, particularly major Asian countries, there is (to varying degrees) a need for: (i) financial reforms to improve credit availability for smaller enterprises and households to boost domestic consumption; (ii), enhancing social safety nets to help reduce precautionary saving; and; (iii) opening up the service sector to competition, including from abroad, to facilitate shifting resources to services.

25. **Greater exchange rate flexibility in major emerging market surplus countries would facilitate rebalancing.** Allowing currencies in key emerging markets surplus countries to strengthen on multilateral basis would help rebalance their sources of growth. Stronger currencies will raise purchasing power and expand the opportunity set for domestic consumers these countries and thus, encourage the needed shift in productive resources from export sectors to domestic services sectors. As the counterpart, depreciating currencies in major deficit countries would facilitate a needed adjustment away from overstretched domestic demand. Strengthening multilateral liquidity provisions and insurance mechanisms through IFIs, could promote greater exchange rate flexibility, by limiting incentives for excessive reserve accumulation.

Table S1. Overview of IMF Growth Projections 1/

(Annual percent increase, unless otherwise noted)

	2008	Est. 2009	Proj. 2010	Proj. 2011	Differences from Oct. 2009 WEO Publication	
					2010	2011
Advanced economies	0.5	-3.2	2.1	2.4	0.8	-0.1
United States	0.4	-2.5	2.7	2.4	1.2	-0.4
Japan	-1.2	-5.3	1.7	2.2	0.0	-0.2
Germany	1.2	-4.8	1.5	1.9	1.2	0.4
France	0.3	-2.3	1.4	1.7	0.5	-0.1
Italy	-1.0	-4.8	1.0	1.3	0.8	0.6
United Kingdom	0.5	-4.8	1.3	2.7	0.4	0.2
Canada	0.4	-2.6	2.6	3.6	0.5	0.0
Major Advanced Economies (G-7)	0.2	-3.5	2.1	2.3	0.8	-0.1
<i>Memorandum</i>						
European Union	1.0	-4.0	1.0	1.9	0.5	0.1
Euro area	0.6	-3.9	1.0	1.6	0.7	0.3
Emerging and developing economies	6.1	2.1	6.0	6.3	0.9	0.2
Africa	5.2	1.9	4.3	5.3	0.3	0.1
Developing Asia	7.9	6.5	8.4	8.4	1.1	0.3
Middle East	5.3	2.2	4.5	4.8	0.3	0.2
Western Hemisphere	4.2	-2.3	3.7	3.8	0.8	0.1
Commonwealth of Independent States	5.5	-7.5	3.8	4.0	1.7	0.4
Central and eastern Europe	3.1	-4.3	2.0	3.7	0.2	-0.1
Russia	5.6	-9.0	3.6	3.4	2.1	0.4
World	3.0	-0.8	3.9	4.3	0.8	0.1
<i>Memorandum</i>						
Oil prices (U.S. dollars/barrel) 2/	36.4	-36.1	22.6	7.9	-1.7	4.0

Source: IMF, World Economic Outlook Update, January 2010.

1/ Real GDP; regional and global growth rates are derived using PPP weights.

2/ Simple average of spot prices of U.K. Brent, Dubai and West Texas Intermediate crude oil.

Table S2. Private Consensus Growth Forecasts

(Real GDP percent increase)

	For Year: Projection date: 1/	2010		2011	
		Oct.09	Jan.10	Oct.09	Jan.10
United States		2.6	2.9	...	3.1
Japan		1.5	1.3	...	1.5
Germany		1.4	1.8	...	1.6
France		1.2	1.4	...	1.6
Italy		0.5	0.9	...	1.2
United Kingdom		1.3	1.5	...	2.2
Canada		2.6	2.6	...	3.2
Euro area		1.1	1.3	...	1.6

Source: Consensus Economics, Inc.

1/ Survey dates: October 12, 2009 and January 11, 2010.

Table S3. Growth of Real GDP and Total Domestic Demand
(Percent)

		2008	Est. 2009	Proj. 2010	Proj. 2011
Real GDP 1/					
United States	(Y/Y)	0.4	-2.5	2.7	2.4
	(Q4/Q4)	-1.9	-0.3	2.6	2.4
Japan	(Y/Y)	-1.2	-5.3	1.7	2.2
	(Q4/Q4)	-4.4	-1.8	1.8	2.5
Germany	(Y/Y)	1.2	-4.8	1.5	1.9
	(Q4/Q4)	-1.8	-1.9	1.0	2.5
France	(Y/Y)	0.3	-2.3	1.4	1.7
	(Q4/Q4)	-1.7	-0.5	1.6	1.6
Italy	(Y/Y)	-1.0	-4.8	1.0	1.3
	(Q4/Q4)	-2.9	-2.4	1.3	1.1
United Kingdom	(Y/Y)	0.5	-4.8	1.3	2.7
	(Q4/Q4)	-2.1	-2.8	1.9	3.1
Canada	(Y/Y)	0.4	-2.6	2.6	3.6
	(Q4/Q4)	-1.0	-1.6	3.6	3.5
Major Advanced Economies (G-7)		0.2	-3.5	2.1	2.3
European Union		1.0	-4.0	1.0	1.9
Euro area		0.6	-3.9	1.0	1.6
Emerging and developing economies		6.1	2.1	6.0	6.3
World		3.0	-0.8	3.9	4.3
Real Total Domestic Demand 1/					
United States	(Y/Y)	-0.7	-3.4	2.9	2.8
	(Q4/Q4)	-2.5	-1.1	2.9	2.7
Japan	(Y/Y)	-1.3	-3.8	0.9	1.8
	(Q4/Q4)	-2.0	-2.6	1.5	1.7
Germany	(Y/Y)	1.7	-1.0	1.3	1.3
	(Q4/Q4)	2.0	-0.3	1.0	1.7
France	(Y/Y)	0.7	-2.3	0.9	1.5
	(Q4/Q4)	-0.7	-1.7	1.8	1.2
Italy	(Y/Y)	-1.3	-4.0	2.2	1.6
	(Q4/Q4)	-2.4	-1.8	3.2	0.5
United Kingdom	(Y/Y)	0.1	-5.3	0.8	2.5
	(Q4/Q4)	-3.4	-3.0	1.3	3.2
Canada	(Y/Y)	2.4	-2.6	2.9	3.4
	(Q4/Q4)	-1.0	-0.7	3.1	3.3
Major Advanced Economies (G-7)		-0.3	-3.3	2.1	2.3
Euro area		0.6	-2.9	0.8	1.3

Source: IMF, World Economic Outlook Update, January 2010.
1/ Year on year change (Y/Y) unless otherwise indicated.

Table S4. Inflation
(Percent)

		2008	Est. 2009	Proj. 2010	Proj. 2011
Consumer Price Index 1/					
United States	(Y/Y)	3.8	-0.4	1.8	1.9
	(Q4/Q4)	1.5	1.2	1.5	2.0
Japan	(Y/Y)	1.4	-1.3	-1.0	-0.4
	(Q4/Q4)	1.0	-1.9	-0.7	-0.2
Germany	(Y/Y)	2.8	0.4	0.9	1.0
	(Q4/Q4)	1.7	1.1	0.8	1.0
France	(Y/Y)	3.2	0.3	1.1	1.4
	(Q4/Q4)	2.0	0.9	0.8	1.7
Italy	(Y/Y)	3.5	0.8	1.3	1.4
	(Q4/Q4)	2.9	0.7	1.4	1.4
United Kingdom	(Y/Y)	3.6	2.1	2.0	1.6
	(Q4/Q4)	3.9	1.9	1.5	1.7
Canada	(Y/Y)	2.4	0.5	1.6	1.9
	(Q4/Q4)	1.9	1.5	1.7	2.0
Major Advanced Economies (G-7)		3.2	-0.1	1.2	1.4
European Union		3.7	1.0	1.4	1.4
Euro area		3.3	0.4	1.1	1.2
GDP Deflator 1/					
United States	(Y/Y)	2.1	1.2	1.0	1.6
	(Q4/Q4)	2.0	0.7	1.3	1.8
Japan	(Y/Y)	-0.9	-0.5	-1.2	-1.3
	(Q4/Q4)	0.4	-1.2	-1.6	-1.5
Germany	(Y/Y)	1.5	1.5	0.5	1.0
	(Q4/Q4)	2.0	1.2	0.4	1.3
France	(Y/Y)	2.5	0.8	0.5	1.1
	(Q4/Q4)	2.5	0.0	0.8	1.3
Italy	(Y/Y)	2.8	2.2	1.1	1.2
	(Q4/Q4)	3.2	0.7	2.7	-1.3
United Kingdom	(Y/Y)	3.0	1.8	2.4	1.9
	(Q4/Q4)	3.4	2.5	2.4	1.5
Canada	(Y/Y)	3.9	-2.1	1.5	2.0
	(Q4/Q4)	1.6	0.0	1.7	1.7
Major Advanced Economies (G-7)		1.8	0.9	0.7	1.1
European Union		2.8	1.5	1.1	1.3
Euro area		2.3	1.1	0.6	1.0

Source: IMF, World Economic Outlook Update, January 2010.

1/ Year on year change (Y/Y) unless otherwise indicated.

Table S5. Labor Markets and Costs

(Percent)

		2008	Est. 2009	Proj. 2010	Proj. 2011
Manufacturing Unit Labor Costs Increase (Y/Y)					
United States		2.2	4.0	-0.8	0.2
Japan		5.6	13.4	-1.5	-0.7
Germany		2.8	14.9	-3.1	0.2
France		3.6	-1.1	0.0	1.4
Italy		4.8	2.9	1.8	1.7
United Kingdom		2.9	5.1	-0.5	0.4
Canada		2.5	2.8	-0.9	0.2
Major Advanced Economies (G-7)		3.1	6.0	-0.9	0.3
European Union 1/		3.5	5.3	-0.4	0.8
Euro area		3.8	5.8	-0.5	1.0
Unemployment Rates					
United States	(Year avg.)	5.8	9.2	9.7	8.3
	(December) 3/	7.4	10.0	...	...
Japan	(Year avg.)	4.0	5.1	5.0	4.8
	(December) 3/	4.3	n.a.	...	...
Germany	(Year avg.) 2/	7.3	7.6	8.9	9.3
	(December) 3/	7.7	8.1	...	...
France	(Year avg.)	7.9	9.5	10.3	10.1
	(December) 3/	8.5	n.a.	...	...
Italy	(Year avg.)	6.8	8.2	9.0	8.7
	(December) 3/	7.0	n.a.	...	...
United Kingdom	(Year avg.)	5.6	7.5	8.4	8.1
	(December) 3/	6.6	n.a.	...	...
Canada	(Year avg.)	6.2	8.3	8.4	8.0
	(December) 3/	6.6	8.5	...	...
Major Advanced Economies (G-7)		5.9	8.1	8.6	7.9
European Union		6.9	9.0	10.0	9.9
Euro area		7.6	9.5	10.6	10.6
Employment Growth (Y/Y)					
United States		-0.5	-3.6	0.4	3.4
Japan		-0.4	-1.6	-0.5	-0.1
Germany		1.4	-0.3	-1.4	-0.5
France		0.5	-1.8	-0.6	0.4
Italy		0.8	-0.7	-0.6	0.6
United Kingdom		0.8	-1.6	-0.7	1.0
Canada		1.5	-1.6	0.6	1.6
Major Advanced Economies (G-7)		0.1	-2.3	-0.2	1.6
European Union		1.1	-2.0	-1.0	0.5
Euro area		0.7	-1.9	-1.2	0.2

Source: IMF, World Economic Outlook Update, January 2010.

1/ Excludes Cyprus, Estonia, Latvia, Lithuania, and Malta.

2/ The year average figures are on a national accounts definition; the December figures are EU-harmonized unemployment rates.

3/ IMF, Global Data Source data series.

Table S6. External Accounts

		2008	Est. 2009	Proj. 2010	Proj. 2011
Current Account Balance					
United States	(Bill. US\$)	-706.1	-414.0	-415.1	-474.7
	(Percent of GDP)	-4.9	-2.9	-2.8	-3.1
Japan	(Bill. US\$)	157.1	141.2	149.9	126.3
	(Percent of GDP)	3.2	2.8	2.8	2.3
Germany	(Bill. US\$)	235.7	135.7	139.2	130.6
	(Percent of GDP)	6.4	4.0	3.8	3.5
France	(Bill. US\$)	-64.8	-29.7	-36.4	-36.9
	(Percent of GDP)	-2.3	-1.1	-1.3	-1.3
Italy	(Bill. US\$)	-78.9	-49.7	-71.2	-87.5
	(Percent of GDP)	-3.4	-2.3	-3.1	-3.7
United Kingdom	(Bill. US\$)	-40.7	-25.6	-46.2	-45.8
	(Percent of GDP)	-1.5	-1.2	-1.9	-1.8
Canada	(Bill. US\$)	7.6	-38.5	-41.3	-37.6
	(Percent of GDP)	0.5	-2.9	-2.7	-2.4
Euro area 1/	(Bill. US\$)	-71.4	-7.9	-17.1	-37.3
	(Percent of GDP)	-0.5	-0.1	-0.1	-0.3
Export Volume Growth (Y/Y) 2/ <i>(In percent)</i>					
United States		5.4	-10.0	10.1	6.1
Japan		1.9	-24.9	12.9	8.6
Germany		2.9	-14.7	6.9	6.3
France		-0.6	-10.9	4.9	4.6
Italy		-3.7	-18.4	4.2	4.2
United Kingdom		1.1	-11.2	5.8	6.6
Canada		-4.7	-13.9	5.5	5.4
Euro area		0.9	-13.2	4.8	4.8
Import Volume Growth (Y/Y) 2/ <i>(In percent)</i>					
United States		-3.2	-14.0	10.1	8.0
Japan		0.8	-16.5	6.0	7.1
Germany		4.3	-8.2	6.9	5.5
France		0.6	-10.0	3.0	3.6
Italy		-4.5	-14.6	7.3	5.0
United Kingdom		-0.5	-12.9	4.4	5.6
Canada		0.8	-13.7	6.2	4.7
Euro area		0.9	-11.5	3.9	4.2

Source: IMF, World Economic Outlook Update, January 2010.

1/ Calculated as the sum of the balances of individual euro area countries.

2/ Goods and services.

Table S7. Fiscal Policy Indicators

	2008	Est. 2009	Proj. 2010	Proj. 2011
Government Balance per National Definition 1/				
<i>(In percent of GDP; fiscal year basis)</i>				
United States	-3.2	-11.3	-10.0	-7.1
Japan	-4.3	-9.1	-8.7	-8.4
Germany	0.0	-3.2	-6.0	-5.3
France	-2.8	-5.9	-5.4	-3.7
Italy	-2.7	-5.3	-5.3	-5.2
United Kingdom	-6.7	-12.5	-12.0	-9.4
Canada	-0.4	-4.1	-2.8	-1.6
General Government Net Lending/Borrowing				
<i>(In percent of GDP; including social security schemes)</i>				
United States	-6.3	-11.9	-9.6	-6.7
Japan	-5.2	-10.5	-10.1	-9.7
Germany	0.0	-3.2	-6.0	-5.3
France	-3.4	-8.3	-8.4	-6.9
Italy	-2.7	-5.3	-5.3	-5.2
United Kingdom	-4.8	-11.1	-12.2	-10.1
Canada	0.1	-6.0	-4.6	-2.1
Euro area	-2.0	-6.3	-7.1	-6.3
General Government Net Lending/Borrowing				
<i>(In percent of GDP; excluding social security schemes)</i>				
United States	-4.9	-9.8	-7.1	-4.3
Japan	-4.2	-9.1	-8.7	-8.4
Germany	1.5	-0.4	-2.7	-2.3
France	-2.7	-3.7	-3.7	-3.5
Italy	...	...	...	...
United Kingdom	-0.1	-6.4	-7.4	-5.3
Canada	3.0	-2.4	-1.0	1.4
Euro area	-0.3	-2.7	-3.2	-2.8
General Government Structural Balance 2/				
<i>(In percent of potential GDP)</i>				
United States	-4.8	-6.4	-7.7	-5.8
Japan 3/	-4.6	-7.5	-7.6	-7.9
Germany 4/	-0.4	-1.0	-4.2	-4.1
France 4/	-3.3	-4.9	-4.3	-4.6
Italy 4/	-2.7	-3.7	-4.1	-4.5
United Kingdom 4/	-5.2	-8.2	-8.4	-7.0
Canada	0.7	-3.0	-2.2	-0.7
Euro area 5/	-2.7	-4.2	-5.0	-5.0
General Government Gross Debt				
<i>(In percent of GDP)</i>				
United States	70.5	84.0	91.8	95.0
Japan	196.9	219.4	228.6	236.3
Germany 6/	65.9	72.7	77.3	80.5
France	67.5	77.9	84.9	89.5
Italy	105.7	114.5	117.6	120.1
United Kingdom	52.0	68.8	79.6	86.4
Canada	69.7	83.4	84.8	82.4

Source: IMF, World Economic Outlook Update, January 2010.

1/ United States: federal government (fiscal year basis beginning in October); Japan: general government excluding social security; Germany territorial authorities of united Germany; France: central government; Italy: state sector; United Kingdom: general government (fiscal year basis beginning in April); Canada: federal government, public accounts basis (fiscal year basis beginning in April).

2/ The structural budget position is defined as the actual budget deficit (or surplus) less the effects of cyclical deviations of output from potential output. Because of the margin of uncertainty that attaches to estimates of cyclical gaps and to tax and expenditure elasticities with respect to national income, indicators of structural budget positions should be interpreted only as broad orders of magnitude. Moreover, it is important to note that changes in structural budget balances are not necessarily attributable to policy changes but may reflect the built-in momentum of existing expenditure programs. In the period beyond that for which specific consolidation programs exist, it is assumed that the structural deficit remains unchanged.

3/ Figures in brackets indicate the budgetary position excluding social security.

4/ Excludes one-off receipts from the sale of mobile telephone licenses. Also excludes one-off receipts from sizable asset transactions.

5/ Calculated as the sum of the balances of individual euro area countries.

6/ Beginning in 1995, the debt and debt-service obligations of the Treuhandanstalt (and of various other agencies) were taken over by general government. This debt is equivalent to 8 percent of GDP, and the associated debt service to ½ to 1 percent of GDP.