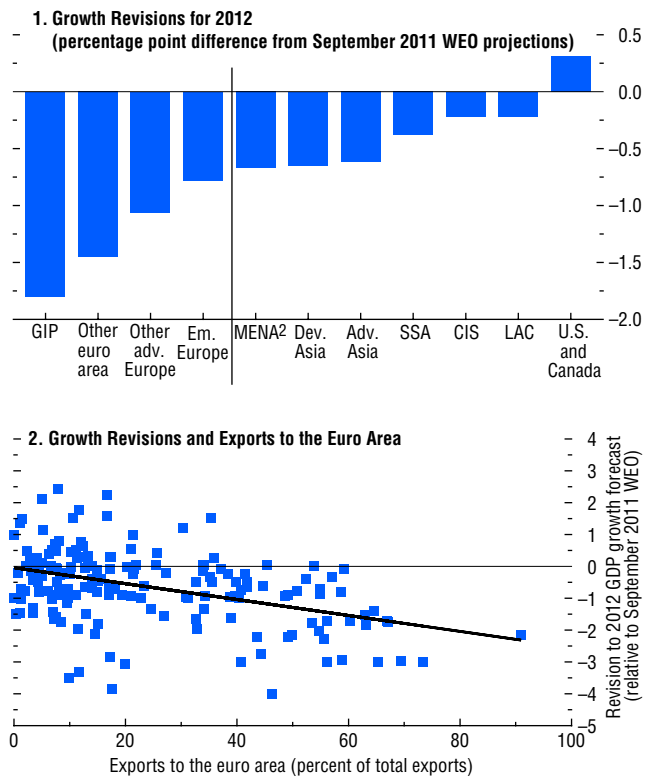


The world economy has changed dramatically since September 2011. European growth has slowed sharply, and many economies in the region are now in or close to recession. In the Middle East and North Africa (MENA), unrest has spread, further depressing the outlook for the region even as some economies rebuild after earlier conflicts. In other regions, however, developments have been more positive. The United States has seen a spate of encouraging economic news, with growth increasing and unemployment falling. Asia has weathered the global slowdown well and looks headed for a soft landing. Latin America has shown resilience to the swings in risk aversion flowing from European developments over recent months. Finally, sub-Saharan Africa (SSA) has been surprisingly resilient to the European slowdown, reflecting an ongoing redirection of its economic linkages toward Asia.

While growth prospects in much of the world have been marked down since the September 2011 *World Economic Outlook*, they are expected to improve in the latter half of 2012 as a result of the combined policy measures taken across developed and emerging market economies. These developments are reflected in Figure 2.1, which shows revisions to the 2012 growth forecasts relative to the September 2011 *World Economic Outlook*. Revisions to the outlook have generally been negative, but to varying degrees. And the revisions partly reflect spillovers from the deterioration of prospects in Europe—the scatterplot shows that economies with the strongest trade ties to Europe have generally seen the largest downgrades. We return to this theme of spillovers throughout the chapter. To set the scene for the discussion of spillovers, Figure 2.2 shows the average effects of the euro area crisis scenario discussed in Chapter 1 on each of the regions considered in this chapter. This scenario models the likely effects of an intensification of the euro area crisis—a sharp drop in risk appetite, asset and commodity prices, and global demand. While Europe is obviously the region most strongly affected, the pattern of spillovers is varied, with the strength of trade

Figure 2.1. Revisions to 2012 WEO Growth Projections and Trade Linkages with Europe¹

Revisions to the outlook have generally been downward, but to varying degrees. And the revisions partly reflect spillovers from the deterioration of prospects in Europe—economies that have the strongest trade ties with Europe have generally seen the largest downgrades.

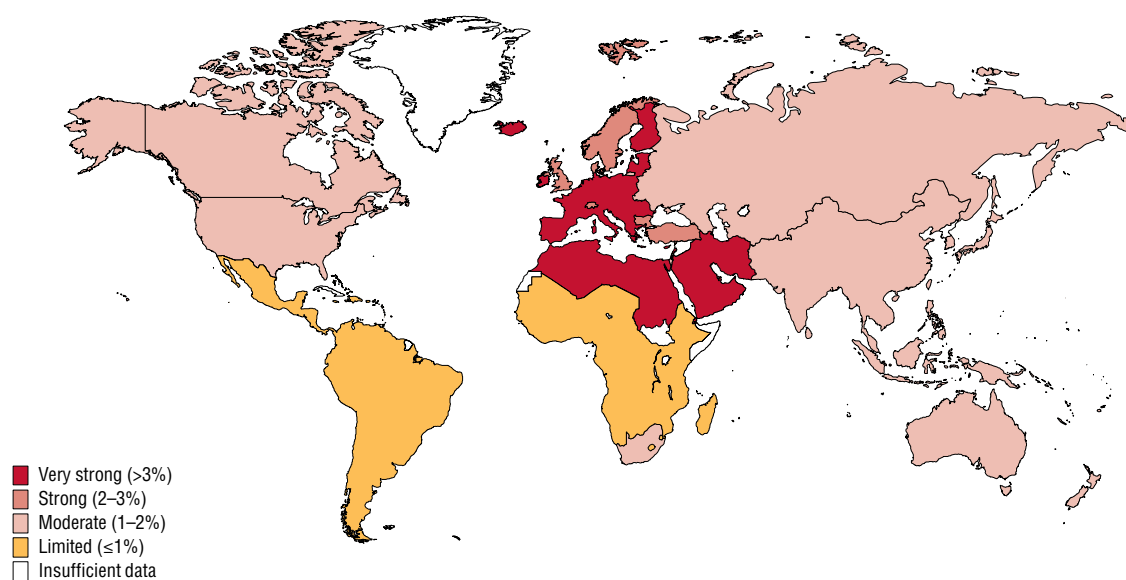


Sources: IMF, *Direction of Trade Statistics*; and IMF staff estimates.

¹Adv. Asia: advanced Asia; CIS: Commonwealth of Independent States; Dev. Asia: developing Asia; Em. Europe: emerging Europe; GIP: Greece, Ireland, Portugal; LAC: Latin America and the Caribbean; MENA: Middle East and North Africa; Other adv. Europe: Czech Republic, Denmark, Iceland, Norway, Sweden, Switzerland, United Kingdom; Other euro area: Austria, Belgium, Cyprus, Estonia, Finland, France, Germany, Italy, Luxembourg, Malta, Netherlands, Slovak Republic, Slovenia, Spain; SSA: sub-Saharan Africa.

²Excludes Libya and Syrian Arab Republic. Excludes South Sudan after July 9, 2011.

Figure 2.2. The Effects of an Intensified Euro Area Crisis on Various Regions
(Peak deviation of output from WEO baseline)



Source: IMF staff estimates.

Note: Peak deviation of output from the WEO baseline under the first downside scenario described in Chapter 1 (increased bank and sovereign stress in the euro area). Simulations were conducted using the IMF's Global Economic Model, which is a six-region model (supplemented with satellite models) that does not explicitly model individual countries (except the United States and Japan).

ties, financial market linkages, and euro area bank exposures all playing a role. These individual channels, and their regional expression, are discussed in more detail in the sections below.

The chapter begins with a detailed discussion of the outlook for Europe, including intraregional spillovers from the periphery to the core of the euro area and from the euro area to the rest of Europe. The remaining sections discuss the outlook for the United States and Canada, Asia, Latin America and the Caribbean (LAC), the Commonwealth of Independent States (CIS), the Middle East and North Africa, and sub-Saharan Africa.

Europe: Crisis, Recession, and Contagion

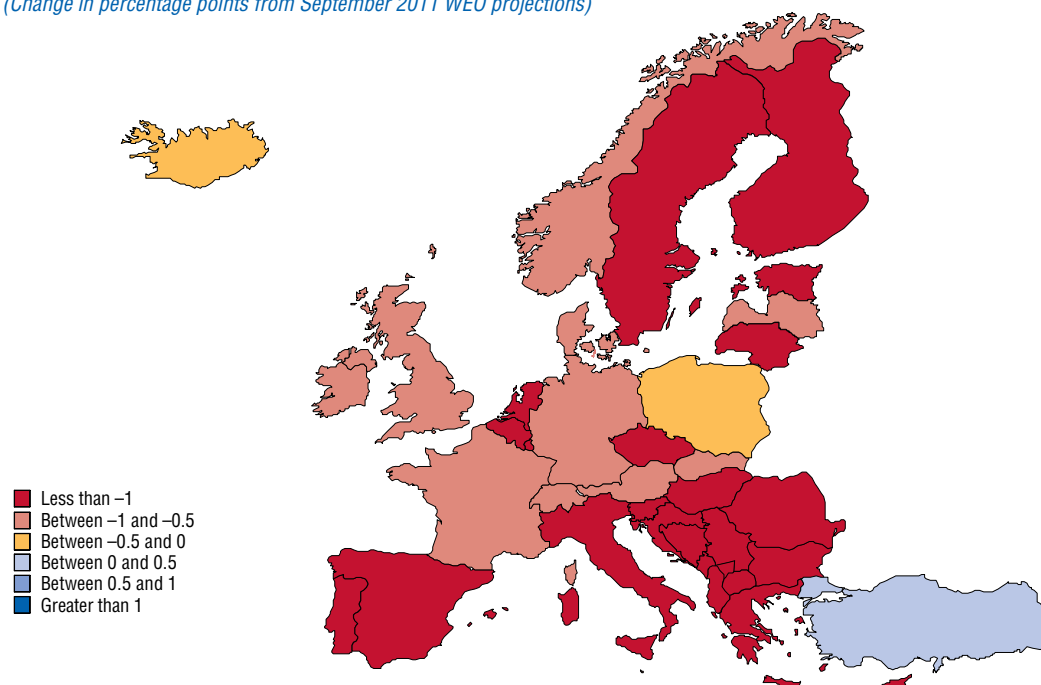
In the last quarter of 2011, renewed fears that the euro area crisis would escalate and spread led to another bout of uncertainty and widening risk spreads that contributed to an unexpectedly sharp slowing in the euro area, with spillovers to the rest of Europe and beyond. The European Central Bank (ECB) alleviated funding pressure in the banking sector through longer-term

refinancing operations (LTROs). These measures, in combination with steps toward strengthening the fiscal compact, structural reforms, and fiscal consolidation, succeeded in stabilizing market sentiment and lowering uncertainty. The recent decision to enhance the European firewall reinforces these policy efforts. The baseline outlook is for a gradual return to recovery through 2012–13. The possibility that the crisis will escalate again remains a major downside risk to growth and financial sector stability until the underlying issues are resolved.

Real activity in Europe slowed by more than expected during the fourth quarter of 2011, with output contracting in many economies. As a result, downward revisions to 2012 growth relative to the September 2011 *World Economic Outlook* are generally larger for Europe than for other regions (Figures 2.1 and 2.3).

The unexpectedly strong slowdown was importantly driven by a spike in perceived risks about growth prospects, competitiveness, and sovereign solvency in crisis-hit periphery countries and Italy. The banking sector has played a key role in transmitting this shock throughout the region.

Figure 2.3. Europe: Revisions to 2012 GDP Growth Forecasts
(Change in percentage points from September 2011 WEO projections)



Source: IMF staff estimates.

Because of banks' holdings of government bonds, the elevation of perceived sovereign risks triggered renewed funding pressures and increased yields and risk premiums. As a result, balance sheet deleveraging accelerated during the second half of 2011, as detailed in the Spillover Feature later in this chapter. This process amounted, in effect, to a bank credit supply shock that contributed to slower growth or outright declines in credit to the private sector. The link between euro area bank deleveraging and credit growth had an important cross-border dimension, notably in eastern Europe (Box 2.1).

The extent to which these broad trends slowed growth in individual European economies reflects both their exposure to crisis conditions and underlying shocks and their initial conditions, especially with respect to fiscal positions and financial sector fragility. Among euro area members, growth divergences are wider than during the 2003–08 expansion (Figure 2.4). Greece, Ireland, and Portugal remain at the heart of the crisis. Its intensification during the fall most strongly affected Italy and, to a lesser

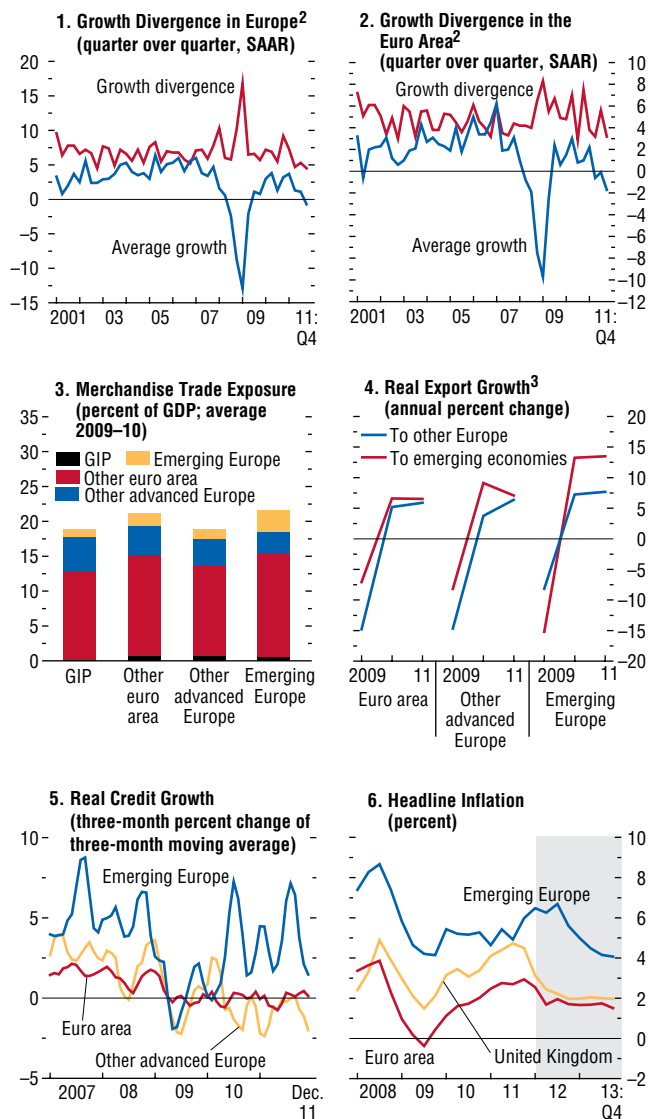
extent, Spain, where economic activity contracted markedly in the fourth quarter. In other European economies, inside and outside the euro area, activity weakened, dipping into or stopping just short of mild recession territory.

The situation stabilized since early January, with improving financial market sentiment and encouraging signals for activity. In bond markets, sovereign yield spreads against German bunds retreated from their recent highs, except for the economies in crisis. This improvement reflects the success of the ECB's three-year LTROs in mid-December in reducing liquidity-related solvency risks for euro area banks, reforms and new consolidation measures, and upside surprises to activity in other regions, notably the United States.

Near-term prospects and risks for Europe depend importantly on the course of events in the euro area. The *World Economic Outlook* (WEO) baseline projections assume that policymakers succeed in containing the sovereign crisis through continued crisis management and further advancing measures toward its resolution. Volatility and sovereign

Figure 2.4. Europe: Back in Recession¹

Europe tipped back into recession, resulting from renewed escalation of perceived euro area crisis risks in late 2011. The aggregate masks growth divergences in the region, with sharp recessions forecast for the euro area crisis economies. Strong regional trade and financial linkages imply a weaker outlook for the rest of Europe as well. Credit conditions are weak and may tighten further. Inflation is expected to retreat throughout the region, as domestic demand remains weak.



Sources: IMF, *Direction of Trade Statistics*; IMF, *International Financial Statistics* (IFS); and IMF staff estimates.

¹GIP: Greece, Ireland, Portugal. Other advanced Europe: Czech Republic, Denmark, Iceland, Norway, Sweden, Switzerland, United Kingdom. Emerging Europe: Albania, Bosnia and Herzegovina, Bulgaria, Croatia, Hungary, Kosovo, Latvia, Lithuania, former Yugoslav Republic of Macedonia, Montenegro, Poland, Romania, Serbia, Turkey.

²Growth divergence is 85th percentile growth minus 15th percentile growth. SAAR: seasonally adjusted annual rate.

³Nominal trade values are deflated using world export price deflators from the IFS database. The country composition of “other Europe” differs for each export group and consists of all European economies not in that export group. Export growth for 2011 is calculated as year-over-year growth from November 2010 through November 2011.

yields are expected to normalize further after recent improvements, although greater fiscal consolidation will weigh on growth in some cases.

In this baseline, economic growth in Europe is expected to strengthen during the course of 2012. Annual growth will be ¼ percent in 2012, markedly weaker than in 2011 (2 percent), largely because of the negative carryover from the second half of 2011. The divergence in growth performance among European economies is expected to narrow in the baseline, although prospects still vary considerably for 2012–13 (Table 2.1).

- In the euro area, real GDP is projected to contract at an annual rate of ½ percent in the first half of 2012 and to start recovering thereafter. The recession is expected to be shallow and short-lived in many economies—confidence and financial conditions have already improved, and external demand from other regions will likely strengthen. In contrast, in Greece and Portugal, where adjustment under joint EU/IMF programs continues, and in Italy and Spain, where yield spreads remain elevated despite stepped-up fiscal efforts, the recessions will be deeper and recovery is expected to start only in 2013.
- Growth in other advanced economies in Europe is projected to rebound during 2012, largely on improving global demand and strengthening prospects in the euro area core. Many of these economies avoided large precrisis imbalances, and balance sheet pressure on households and governments has been weaker. This has helped cushion the spillovers from the euro area crisis. In contrast, growth in the United Kingdom, where the financial sector was hit hard by the global crisis, will be weak in early 2012, before recovering there as well.

- Near-term growth prospects in emerging Europe will be closely tied to developments in the euro area core. Under the baseline, much of the spillover from the euro area slowdown in late 2011 will already have been absorbed, and trade growth and manufacturing activity are expected to pick up, both in the euro area and globally, through 2012. However, tighter funding as a result of deleveraging by euro area parent banks is likely to weigh on credit growth.

Inflation in many economies moderated during the second half of 2011 and is expected to remain

Table 2.1. 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		
	2011	Projections		2011	Projections		2011	Projections		2011	Projections	
		2012	2013		2012	2013		2012	2013		2012	2013
Europe	2.0	0.2	1.4	3.2	2.7	2.2	0.5	0.6	0.8	...	...	...
Advanced Europe	1.4	-0.1	1.1	2.8	2.1	1.7	1.1	1.3	1.5	9.4	10.0	9.9
Euro Area ^{4,5}	1.4	-0.3	0.9	2.7	2.0	1.6	-0.3	0.7	1.0	10.1	10.9	10.8
Germany	3.1	0.6	1.5	2.5	1.9	1.8	5.7	5.2	4.9	6.0	5.6	5.5
France	1.7	0.5	1.0	2.3	2.0	1.6	-2.2	-1.9	-1.5	9.7	9.9	10.1
Italy	0.4	-1.9	-0.3	2.9	2.5	1.8	-3.2	-2.2	-1.5	8.4	9.5	9.7
Spain	0.7	-1.8	0.1	3.1	1.9	1.6	-3.7	-2.1	-1.7	21.6	24.2	23.9
Netherlands	1.3	-0.5	0.8	2.5	1.8	1.8	7.5	8.2	7.8	4.5	5.5	5.5
Belgium	1.9	0.0	0.8	3.5	2.4	1.9	-0.1	-0.3	0.4	7.2	8.0	8.3
Austria	3.1	0.9	1.8	3.6	2.2	1.9	1.2	1.4	1.4	4.2	4.4	4.3
Greece	-6.9	-4.7	0.0	3.1	-0.5	-0.3	-9.7	-7.4	-6.6	17.3	19.4	19.4
Portugal	-1.5	-3.3	0.3	3.6	3.2	1.4	-6.4	-4.2	-3.5	12.7	14.4	14.0
Finland	2.9	0.6	1.8	3.3	2.9	2.1	-0.7	-1.0	-0.3	7.8	7.7	7.8
Ireland	0.7	0.5	2.0	1.1	1.7	1.2	0.1	1.0	1.7	14.4	14.5	13.8
Slovak Republic	3.3	2.4	3.1	4.1	3.8	2.3	0.1	-0.4	-0.4	13.4	13.8	13.6
Slovenia	-0.2	-1.0	1.4	1.8	2.2	1.8	-1.1	0.0	-0.3	8.1	8.7	8.9
Luxembourg	1.0	-0.2	1.9	3.4	2.3	1.6	6.9	5.7	5.6	6.0	6.0	6.0
Estonia	7.6	2.0	3.6	5.1	3.9	2.6	3.2	0.9	-0.3	12.5	11.3	10.0
Cyprus	0.5	-1.2	0.8	3.5	2.8	2.2	-8.5	-6.2	-6.3	7.8	9.5	9.6
Malta	2.1	1.2	2.0	2.4	2.0	1.9	-3.2	-3.0	-2.9	6.4	6.6	6.5
United Kingdom ⁵	0.7	0.8	2.0	4.5	2.4	2.0	-1.9	-1.7	-1.1	8.0	8.3	8.2
Sweden	4.0	0.9	2.3	1.4	2.5	2.0	7.2	7.5	7.8	7.5	7.5	7.7
Switzerland	1.9	0.8	1.7	0.2	-0.5	0.5	14.0	12.1	11.6	3.1	3.4	3.6
Czech Republic	1.7	0.1	2.1	1.9	3.5	1.9	-2.9	-2.1	-1.9	6.7	7.0	7.4
Norway	1.7	1.8	2.0	1.3	1.5	2.0	14.6	14.8	13.7	3.3	3.6	3.5
Denmark	1.0	0.5	1.2	2.8	2.6	2.2	6.2	4.8	4.5	6.1	5.8	5.5
Iceland	3.1	2.4	2.6	4.0	4.8	3.5	-6.5	-2.8	-1.5	7.4	6.3	6.0
Emerging Europe⁶	5.3	1.9	2.9	5.3	6.2	4.5	-6.0	-5.6	-5.5	...	...	...
Turkey	8.5	2.3	3.2	6.5	10.6	7.1	-9.9	-8.8	-8.2	9.9	10.3	10.5
Poland	4.3	2.6	3.2	4.3	3.8	2.7	-4.3	-4.5	-4.3	9.6	9.4	9.1
Romania	2.5	1.5	3.0	5.8	2.9	3.1	-4.2	-4.2	-4.7	7.2	7.2	7.1
Hungary	1.7	0.0	1.8	3.9	5.2	3.5	1.6	3.3	1.2	11.0	11.5	11.0
Bulgaria	1.7	0.8	1.5	3.4	2.1	2.3	1.9	2.1	1.6	12.5	12.5	12.0
Serbia	1.8	0.5	3.0	11.2	4.1	4.3	-9.1	-8.6	-7.9	23.7	23.9	23.6
Croatia	0.0	-0.5	1.0	2.3	2.2	2.4	0.9	0.4	-0.2	13.2	13.5	12.7
Lithuania	5.9	2.0	2.7	4.1	3.1	2.5	-1.7	-2.0	-2.3	15.5	14.5	13.0
Latvia	5.5	2.0	2.5	4.2	2.6	2.2	-1.2	-1.9	-2.5	15.6	15.5	14.6

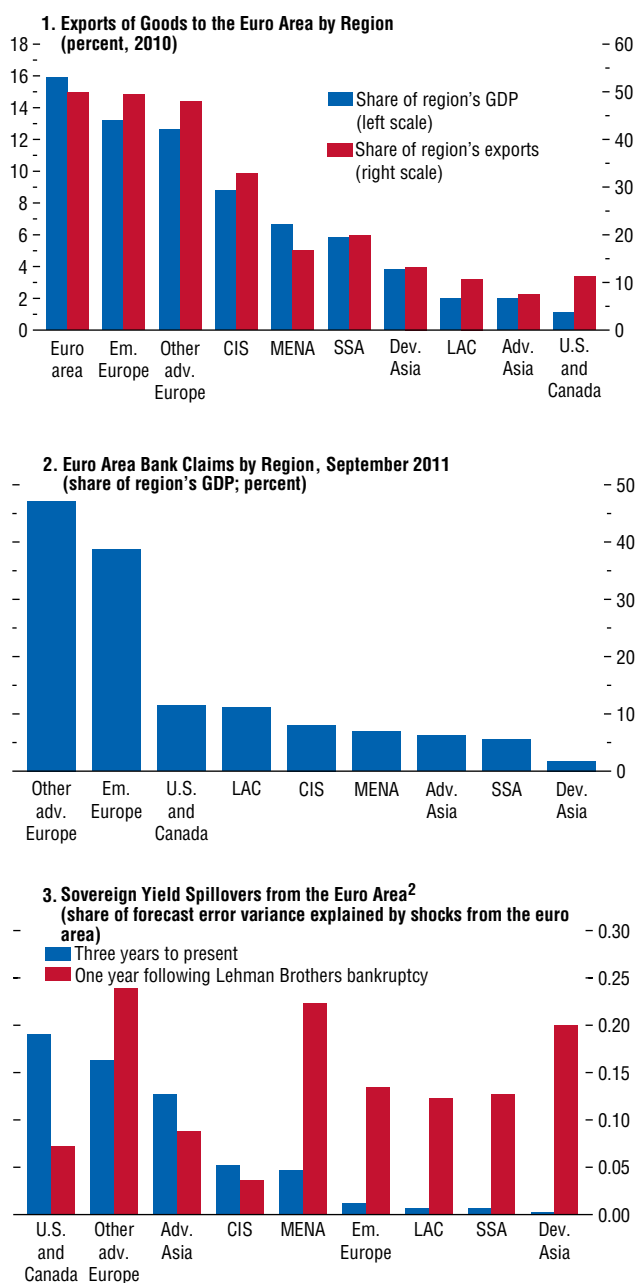
¹Movements in consumer prices are shown as annual averages. December–December changes can be found in Tables A6 and A7 in the Statistical Appendix.²Percent of GDP.³Percent. National definitions of unemployment may differ.⁴Current account position corrected for reporting discrepancies in intra-area transactions.⁵Based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

well contained, given the slowdown in activity and declines in commodity prices. Where inflation either increased or remained above target, the causes were primarily one-time factors such as increases in energy prices and indirect taxes.

The balance of risks to Europe's near-term growth prospects remains to the downside. Despite the progress in strengthening crisis man-

agement in recent months, a renewed escalation of the euro crisis remains a possibility as long as the underlying issues are not resolved. Because most economies in the region are in close orbit, the pull from tight trade and financial linkages means that the possible escalation of the euro area crisis remains the most important downside risk.

Figure 2.5. Trade and Financial Linkages with the Euro Area¹



Sources: Bank for International Settlements; IMF, *Direction of Trade Statistics*; and IMF staff calculations.

¹ Adv. Asia: advanced Asia; CIS: Commonwealth of Independent States; Dev. Asia: developing Asia; Em. Europe: emerging Europe; LAC: Latin America and the Caribbean; MENA: Middle East and North Africa; Other adv. Europe: Czech Republic, Denmark, Iceland, Norway, Sweden, Switzerland, United Kingdom; SSA: sub-Saharan Africa.

² Spillover indices using the Diebold and Yilmaz (2012) methodology, applied to daily changes in long-term sovereign yields for various regions.

Spillovers from the Euro Area to Other Regions

If the euro area crisis escalates, adverse feedback loops between rising funding pressure in the banking system, increasing fiscal vulnerability, and slowing aggregate demand could start anew. The model simulations underlying the euro area downside scenario described in Chapter 1 and presented in Figure 2.2 illustrate how an escalation of the crisis could play out. First, financial market comovement could increase to much higher levels, such as those seen during 2008–09, with rising yields and risk premiums. Second, the spike in uncertainty and global risk aversion could lead to deterioration in confidence, immediately dampening domestic demand. In addition, international trade (particularly in durables) would decline by more than overall output, which could negatively affect export-oriented economies. Third, oil and other commodity prices would likely decline, affecting commodity-exporting regions.

The impact of the spillovers also depends on exposure. For many countries, the strongest links to Europe are through trade. Panel 1 of Figure 2.5 shows the relative importance of exports to the euro area for each region. Trade linkages are strongest within Europe (both within the euro area and with advanced and emerging European economies outside the euro area). Outside the continent, trade linkages are strongest with the CIS, followed by the MENA and SSA regions; they are relatively small for Asia, Latin America, and the United States.

Exposures through financial linkages have been more limited, except through the role of euro area banks and their central and eastern European subsidiaries (Figure 2.5, panel 2; Spillover Feature; Chapter 1 of the April 2012 *Global Financial Stability Report*). Panel 3 of Figure 2.5 shows that financial market spillovers from Europe have been relatively small—accounting for less than one-fifth of the variation in other regions’ financial market movements—and these spillovers are in general smaller than from U.S. financial markets. Nevertheless, during periods of intense financial stress, such as after the bankruptcy of Lehman Brothers in 2008, financial spillovers could strengthen.

Policy Challenges

The overarching policy priority in Europe is to prevent further escalation of the sovereign debt and growth crisis in the euro area while working toward resolution of the underlying causes. This requires policy adjustment in a number of areas at both the country and the euro area levels. Most economies in the region need a policy mix that supports the recovery while addressing fiscal sustainability challenges and financial sector vulnerabilities.

Appropriate fiscal consolidation is an obvious priority. Euro area economies in crisis and countries with weaker fiscal positions (Italy, Slovenia) need to implement recently agreed plans to tighten the fiscal stance. Spain's new deficit target aims for a large consolidation, which is broadly appropriate, although it could have accommodated more fully the impact of the weak growth outlook. Many other euro area economies, however, should allow automatic stabilizers to operate freely to prevent still-weak activity and downside risks from dampening market confidence about growth prospects. Those with room for fiscal policy maneuvering, in terms of the strength of their fiscal accounts and their credibility with markets, should consider slowing the pace of fiscal consolidation and focusing on measures aimed at enhancing medium-term debt sustainability (Germany). In advanced economies outside the euro area, market pressure has generally remained benign and sovereign funding costs are low, so automatic stabilizers should not be constrained. In addition, some advanced economies in Europe have appropriately allowed the pace of structural fiscal adjustment to slow. Further slowing could be considered if economic conditions deteriorate. In emerging Europe, the need for fiscal consolidation varies widely; economies that have faced increased market pressure and rising yields in recent months must continue with steady consolidation (Hungary).

Given the broad need for fiscal adjustment, much of the burden of supporting growth falls on monetary policy. The policy stance should generally remain accommodative, given downside risks to growth and little danger of inflation pressure in the near term. The ECB should lower its policy rate while continuing to use unconventional policies

to address banks' funding and liquidity problems. Central banks in many other advanced economies in Europe have little or no scope for easing through conventional means and must support the recovery using unconventional policies. In the United Kingdom, with inflation expected to fall below the 2 percent target amid weaker growth and commodity prices, the Bank of England can further ease its monetary policy stance. In emerging Europe, inflation pressure is set to decline rapidly in many countries, giving central banks new room for easing.

Structural reforms to boost growth are also needed urgently given that the sovereign risks at the heart of the current crisis are partly related to growth prospects—or lack thereof. Product and labor market reforms can boost productivity, and they are paramount in economies with competitiveness problems and internal or external imbalances. When implemented, they can support market confidence and the sustainability of fiscal positions.

Forestalling further escalation of the crisis also requires intervention along two dimensions at the euro area level. First, crisis management facilities need to be strong. In this respect, the recent decision to combine the European Stability Mechanism (ESM) with the European Financial Stability (EFSF) is welcome and, along with other recent European efforts, will strengthen the European crisis mechanism and support the IMF's efforts to bolster the global firewall. To limit damaging deleveraging, banks need to raise capital levels, in some cases through direct government support. There is a need for a pan-euro-area facility with the capacity to take direct stakes in banks, including in countries with little fiscal room to do so themselves.

Second, as underscored in Chapter 1, over the medium term policymakers must urgently address the Economic and Monetary Union design flaws that contributed to the crisis. This is essential to the permanent restoration of market confidence. Strong mechanisms are needed to enforce responsible fiscal policies. To make the inevitable loss of national policy discretion palatable, there needs to be more fiscal risk sharing across countries, including, for example, through an expanded ESM. Other priorities are further progress in integrating financial sectors in the

euro area, including through cross-border supervision, as well as resolution mechanisms and deposit insurance with a common backstop.

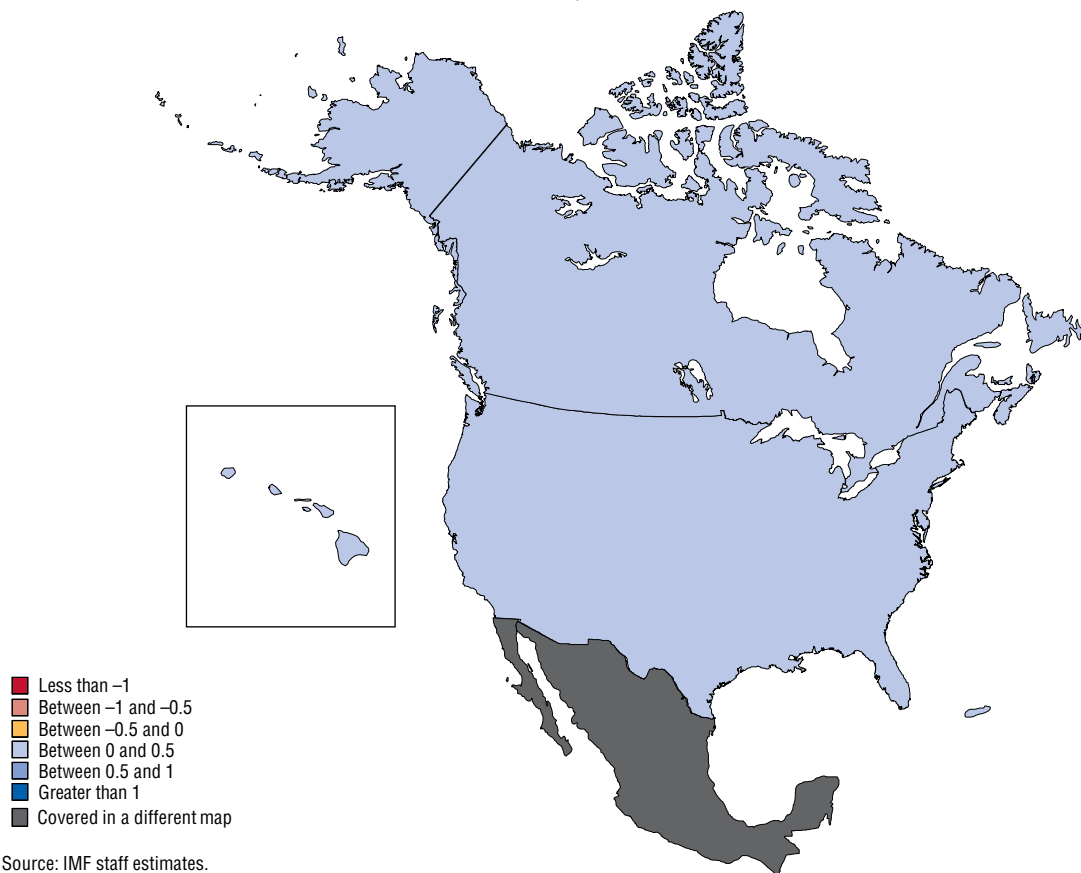
The United States and Canada: Regaining Some Traction

The U.S. economy has gained some traction (Figure 2.6), with growth improving through 2011 and signs of expansion in the job market. Risks to the outlook are more balanced but still tend to the downside given fiscal uncertainty, weakness in the housing market, and potential spillovers from Europe. Bold policy measures in the housing market could help accelerate the recovery. And recent changes to the communications strategy of the Federal Reserve may enhance the expansionary effect of current monetary policy settings. However, the difficulty of reaching agreement on extending temporary policy measures—such as the Bush tax cuts—and the current

inability to agree on a medium-term fiscal consolidation strategy could undermine market confidence and outcomes. In Canada, the recovery is well advanced, and the economy is well positioned with room for policymakers to respond flexibly to changes in the economic outlook, including by allowing full operation of automatic fiscal stabilizers and resorting to stimulus should the recovery threaten to falter.

Growth in the United States was determined primarily by domestic factors in 2011, with the economy pulling itself up by its bootstraps—again. After a weak start, U.S. economic activity gained strength through the year, with the quarterly growth rate rising each quarter (Figure 2.7, panel 1). Inflation has been subdued recently, but higher oil prices may push up inflation in the near term. And while some job growth is evident, wage growth has been negative in real terms for the past two years and remains weak (Figure 2.7, panel 3).

Figure 2.6. United States and Canada: Revisions to 2012 GDP Growth Forecasts
(Change in percentage points from September 2011 WEO projections)



U.S. economic growth is projected at 2 percent in 2012 and 2½ percent in 2013 (Table 2.2), reflecting ongoing weakness in house prices, pressures to deleverage, and a weak labor market. Although recent labor market outcomes have been promising, with unemployment falling to 8¼ percent in March, the outlook is for only modest increases in employment during 2012 and 2013. The persistent output gap will keep inflation in check, with headline inflation receding from 3 percent in 2011 to about 2 percent in 2012 and 2013. External factors have a relatively limited effect on the baseline outlook.

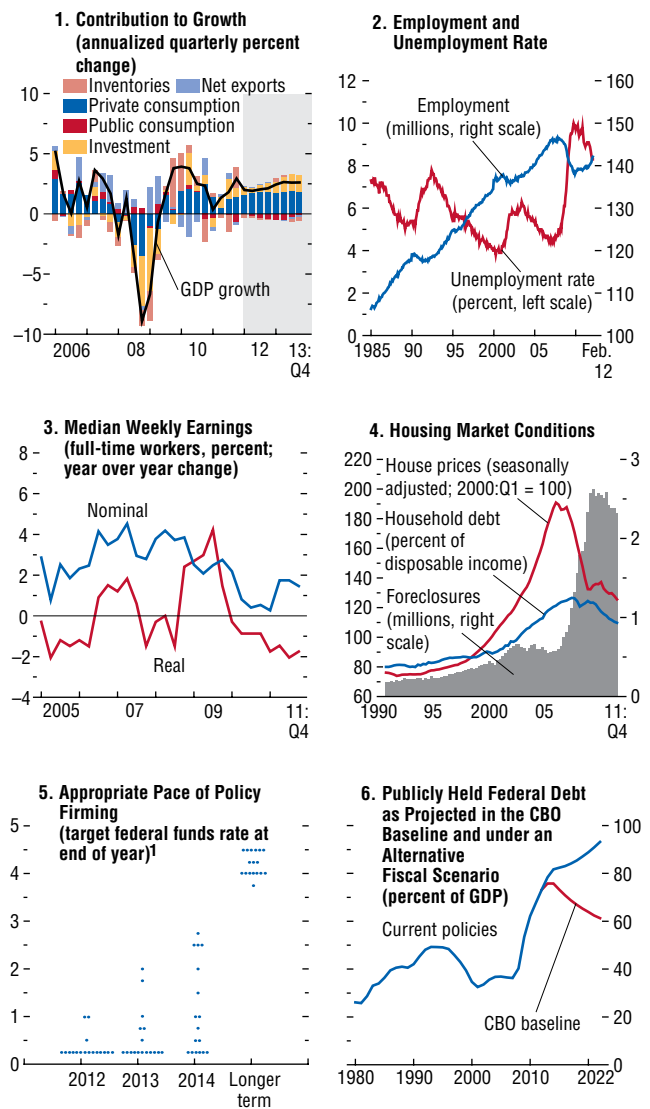
In Canada, in contrast, the determinants of growth are both external and internal—externally, world commodity prices and demand from the United States will influence growth; internally, the planned fiscal tightening and high household debt are constraints. Growth is forecast to moderate from 2½ percent in 2011 to 2 percent in 2012, reflecting retreating commodity prices, ongoing fiscal withdrawal, and slow recovery in the United States. As a result, inflation is projected to fall to the midpoint of the target band by 2013.

Downside risks to the outlook are significant. Financial market spillovers from the euro area to the United States and Canada are relatively strong, reflecting U.S. prominence as a financial center and safe haven (see Figure 2.5, panel 3). While the recent bout of concern over European sovereigns caused a flight to safety, the positive effects of this on government bond yields were offset by higher volatility and other negative effects on bank funding costs, corporate bonds, and equities. A flare-up in the euro area from increased sovereign and bank stress could easily undermine confidence in the U.S. corporate sector and thereby squeeze investment and demand, undermining growth. Modeling (see Figure 2.2) suggests that under such a scenario U.S. output could fall by 1½ percent relative to the baseline, about 40 percent of the size of the decline in Europe. A particularly strong contributor to the magnitude of this spillover is the zero lower bound on monetary policy interest rates.

Despite the importance of Europe for the external outlook, there are other, more pressing domestic sources of risk. Under current U.S. laws many tax provisions, including the tax cuts enacted under President

Figure 2.7. United States: Pulling Itself up by Its Bootstraps

Growth in the United States surprised with the quarterly pace increasing through the year. This was reflected in stronger labor market outcomes, although wage growth is still weak. The United States is facing significant policy challenges related to housing market weakness, the zero lower interest rate bound of monetary policy, and increasing government debt. Recent innovations to the Federal Reserve's communications strategy may help with the zero lower bound, but much more needs to be done on multiple fronts.



Sources: Board of Governors of the Federal Reserve; Congressional Budget Office (CBO); Haver Analytics; and IMF staff estimates.

¹Each dot denotes the value of an individual Federal Open Market Committee (FOMC) participant's judgment of the appropriate level of the target federal funds rate at the end of the specified time period, as recorded during the January 24–25, 2012, FOMC meeting.

Table 2.2. Selected Advanced Economies: Real GDP, Consumer Prices, Current Account Balance, and Unemployment
(Annual percent change unless noted otherwise)

	Real GDP			Consumer Prices ¹			Current Account Balance ²			Unemployment ³		
	2011	Projections		2011	Projections		2011	Projections		2011	Projections	
		2012	2013		2012	2013		2012	2013		2012	2013
Advanced Economies	1.6	1.4	2.0	2.7	1.9	1.7	-0.2	-0.4	-0.2	7.9	7.9	7.8
United States	1.7	2.1	2.4	3.1	2.1	1.9	-3.1	-3.3	-3.1	9.0	8.2	7.9
Euro Area ^{4,5}	1.4	-0.3	0.9	2.7	2.0	1.6	-0.3	0.7	1.0	10.1	10.9	10.8
Japan	-0.7	2.0	1.7	-0.3	0.0	0.0	2.0	2.2	2.7	4.5	4.5	4.4
United Kingdom ⁴	0.7	0.8	2.0	4.5	2.4	2.0	-1.9	-1.7	-1.1	8.0	8.3	8.2
Canada	2.5	2.1	2.2	2.9	2.2	2.0	-2.8	-2.7	-2.7	7.5	7.4	7.3
Other Advanced Economies ⁶	3.2	2.6	3.5	3.0	2.5	2.5	4.9	3.4	3.1	4.5	4.5	4.5
<i>Memorandum</i>												
Newly Industrialized Asian Economies	4.0	3.4	4.2	3.6	2.9	2.7	6.5	5.9	5.7	3.6	3.5	3.5

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

²Percent of GDP.

³Percent. National definitions of unemployment may differ.

⁴Based on Eurostat's harmonized index of consumer prices.

⁵Current account position corrected for reporting discrepancies in intra-area transactions.

⁶Excludes the G7 economies (Canada, France, Germany, Italy, Japan, United Kingdom, United States) and euro area countries.

George W. Bush, begin to expire in 2013, just as deep automatic spending cuts kick in. Such a massive adjustment could significantly undermine the economic recovery. The repeated difficulty of extending temporary policy measures implies that these provisions may expire nonetheless. Furthermore, given the lengthy election season and ongoing gridlock in the U.S. Congress, there is little chance of meaningful medium-term debt reduction before 2013. Should growth disappoint, the lack of a fiscal consolidation strategy may increase the U.S. risk premium, which could have spillover effects for other major economies. Another downside risk, given ongoing problems in resolving household debt burdens and clearing the market overhang of foreclosed homes, is that the recovery in house prices will be more protracted than assumed under the baseline. On the other hand, if the job market continues to positively surprise and, thereby, provide more widespread support to consumption, growth could become more resilient and ultimately strengthen.

In Canada, the housing market is an area of potential vulnerability, with high house prices and rising household indebtedness. Strong spillovers to Canada from the United States mean it is also exposed to the risks discussed above.

Given the outlook and the ongoing problems in Europe, the first priority for U.S. authorities is to agree on and commit to a credible fiscal policy agenda

that places public debt on a sustainable track over the medium term. But reflecting lessons being learned in Europe, the U.S. authorities must make efforts to support near-term recovery. The recent agreement to extend payroll tax relief and unemployment benefits is welcome, but more effort is required toward medium-term consolidation. The Congressional Budget Office estimates that current policies will lead to a rise in federal debt held by the public to about 90 percent of GDP by 2020—an uncomfortably high burden (Figure 2.7, panel 6). Conversely, if all temporary tax reductions and stimulus measures were allowed to expire—a path that would significantly undermine the recovery and economic growth—debt would fall to just under 65 percent of GDP.

Another important policy priority is for support the housing market. A recent white paper on housing released by the Federal Reserve Board (BGFRS, 2012) and Chapter 3 of this issue of the *World Economic Outlook* highlight multiple ways that growth is constrained by the overhang of foreclosed homes and the prevalence of households with negative equity. Recent improvements to the Home Affordable Modification Program are welcome, but will likely struggle to be effective without strong participation from government-sponsored enterprises Fannie Mae and Freddie Mac. The adoption of the administration's proposals on mortgage refinancing would also be a step in the right direction,

and both Chapter 3 and the Federal Reserve Board white paper discuss a number of additional possibilities. Regardless of the approach, however, bold policy action that supports the housing market could lead to a significant boost in consumption and overall growth and is strongly recommended.

The recent change in the way the Federal Reserve communicates its decisions and policy assumptions has the potential to bolster its support for the economy. Specifically, it has announced an inflation target of 2 percent over the medium term within its dual mandate and has started publishing policy rate forecasts with a view to influencing long-term interest rates and better anchoring inflation expectations (see Figure 2.7).¹ It should also stand ready to implement uncon-

¹Explicit forecasts are more transparent, given the parsing that took place in the past over the distinctions in meaning between,

ventional support if activity threatens to disappoint, so long as inflation expectations remain subdued.

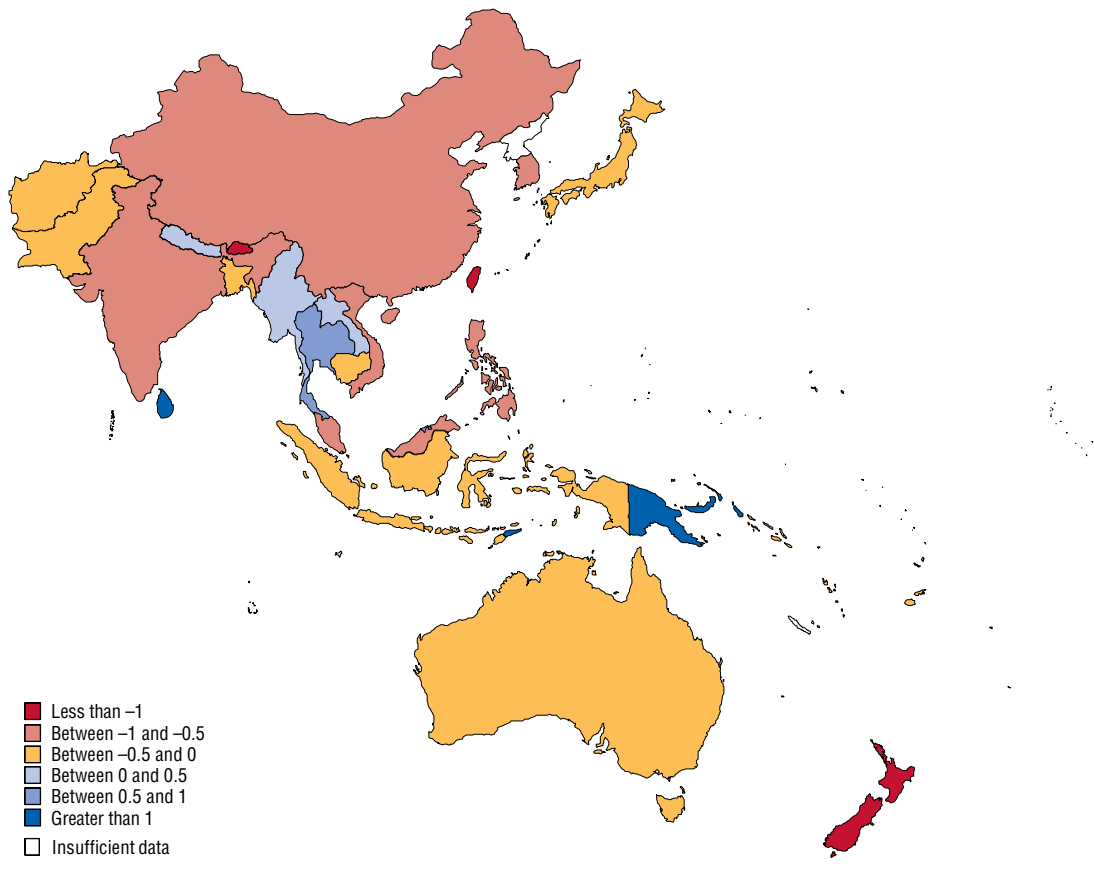
Canada is in a sounder fiscal and financial position than the United States. Ongoing fiscal tightening should continue, although there is policy room to slow the pace if downside risks to growth materialize.

Asia: Growth Is Moderating

Much weaker external demand has dimmed the outlook for Asia (Figure 2.8). But resilient domestic demand in China, limited financial spillovers, room for policy easing, and the capacity of Asian banks to step in as European banks deleverage suggest that the soft landing under way is likely to continue.

for example, “for some time,” “for an extended period,” and “at least through mid-2013.”

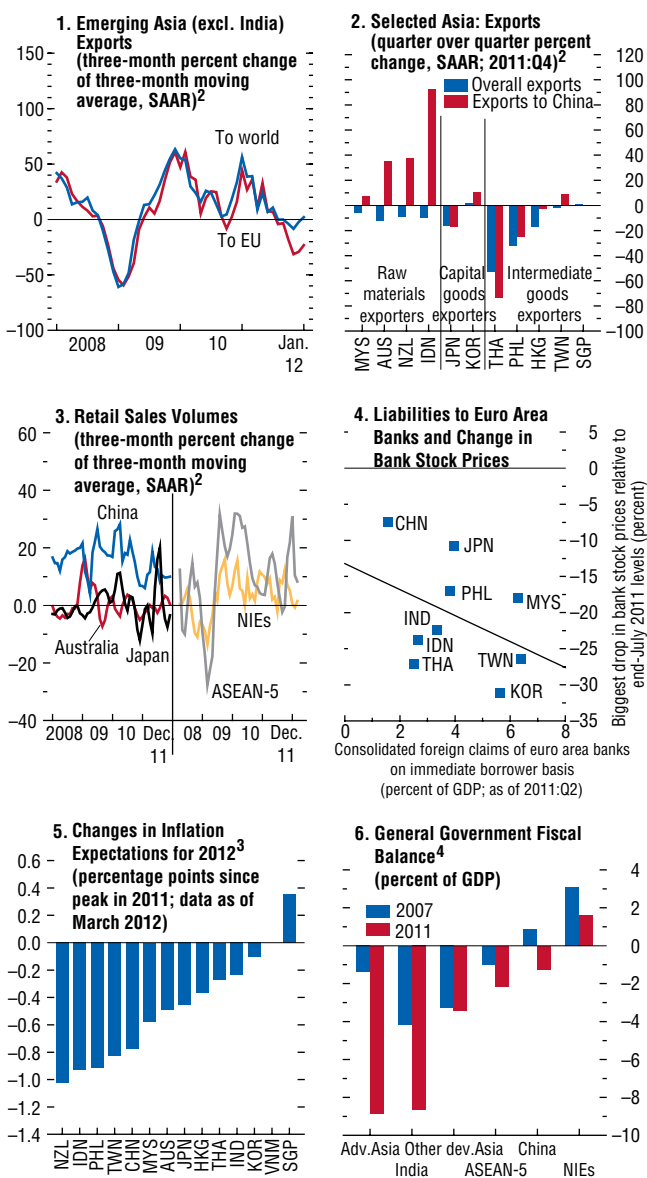
Figure 2.8. Asia: Revisions to 2012 GDP Growth Forecasts
(Change in percentage points from September 2011 WEO projections)



Source: IMF staff estimates.

Figure 2.9. Asia: Growth Is Moderating¹

Slowing exports, particularly to Europe, are dampening Asia's growth prospects. But Chinese demand provides a buffer to the region's commodity exporters, and domestic demand remains strong in some parts of developing Asia. Market turmoil in late 2011 was greater for countries with closer links to euro area banks. Inflation has moderated in many economies, but there is less fiscal room now than in 2007.



Sources: Bank for International Settlements; CEIC; Consensus Economics; IMF, *Direction of Trade Statistics*; and IMF staff calculations.

¹Advanced Asia (Adv. Asia): Australia (AUS), Japan (JPN), New Zealand (NZL); ASEAN-5: Indonesia (IDN), Malaysia (MYS), Philippines (PHL), Thailand (THA), Vietnam (VNM); CHN: China; IND: India; Newly Industrialized Asian Economies (NIEs): Hong Kong SAR (HKG), Korea (KOR), Singapore (SGP), Taiwan Province of China (TWN).

²SAAR: seasonally adjusted annual rate.

³For India, the change in expectations refers to the average annual wholesale price inflation for fiscal year ending in March 2013.

⁴Other developing Asia (Other dev. Asia): Afghanistan, Bangladesh, Bhutan, Brunei Darussalam, Cambodia, Fiji, Kiribati, Lao PDR, Maldives, Myanmar, Nepal, Pakistan, Papua New Guinea, Samoa, Solomon Islands, Sri Lanka, Timor-Leste, Vanuatu.

Activity across Asia slowed during the last quarter of 2011, reflecting both external and domestic developments. The effect of spillovers from Europe can be seen in the weakness of Asia's exports to that region (Figure 2.9, panel 1). In some economies, such as India, domestic factors also contributed to the slowdown, as a deterioration in business sentiment weakened investment and policy tightening raised borrowing costs. The historic floods that hit Thailand significantly curtailed that country's growth in the last quarter of the year, shaving 2 percentage points off annual growth in 2011, and led to negative spillovers on other economies (for example, Japan). In some other Asian economies, however, robust domestic demand helped offset the drag on growth of slowing exports. Investment and private consumption remained strong in China, buoyed by solid corporate profits and rising household income (Figure 2.9, panel 2). Moreover, the rebound from the supply-chain disruptions caused by the March 2011 Japanese earthquake and tsunami was stronger than anticipated.

While financial turmoil in the euro area spilled over to Asian markets late last year, the effects were limited. Portfolio flows turned sharply negative in late 2011, equity prices fell sharply, sovereign and bank credit default swap (CDS) spreads increased, and regional currencies depreciated. Overall, however, market movements in late 2011 were smaller than the gyrations observed during 2008–09. The movements had limited economic impact and were partially reversed in early 2012.

In emerging Asia, adverse market developments were correlated with countries' reliance on euro area banks (Figure 2.9, panel 4). As described in more detail in this chapter's Spillover Feature, euro area banks have already begun reducing their cross-border lending. Asian banks are generally in good financial health, and many large Asian banks have sufficient capacity to step up lending further.² But euro area banks handle a substantial share of trade credit in the region and often specialize in complex project financing, for which it could be difficult to find quick substitutes.

²See Chapter 3 of the April 2012 *Regional Economic Outlook: Asia and Pacific*.

Table 2.3. 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		
	2011	Projections		2011	Projections		2011	Projections		2011	Projections	
		2012	2013		2012	2013		2012	2013		2012	2013
Asia	5.9	6.0	6.5	5.0	3.9	3.6	2.0	1.4	1.7	...	...	...
Advanced Asia	1.3	2.6	2.8	1.6	1.4	1.4	2.2	1.8	2.0	4.3	4.3	4.2
Japan	-0.7	2.0	1.7	-0.3	0.0	0.0	2.0	2.2	2.7	4.5	4.5	4.4
Australia	2.0	3.0	3.5	3.4	2.7	3.0	-2.2	-4.6	-5.1	5.1	5.2	5.2
New Zealand	1.4	2.3	3.2	4.0	2.1	2.4	-4.1	-5.4	-6.3	6.5	6.0	5.4
Newly Industrialized Asian Economies	4.0	3.4	4.2	3.6	2.9	2.7	6.5	5.9	5.7	3.6	3.5	3.5
Korea	3.6	3.5	4.0	4.0	3.4	3.2	2.4	1.9	1.5	3.4	3.3	3.3
Taiwan Province of China	4.0	3.6	4.7	1.4	1.3	1.8	8.8	8.0	8.4	4.4	4.4	4.3
Hong Kong SAR	5.0	2.6	4.2	5.3	3.8	3.0	4.1	3.2	3.5	3.4	3.5	3.5
Singapore	4.9	2.7	3.9	5.2	3.5	2.3	21.9	21.8	21.3	2.0	2.1	2.1
Developing Asia	7.8	7.3	7.9	6.5	5.0	4.6	1.8	1.2	1.4	...	...	...
China	9.2	8.2	8.8	5.4	3.3	3.0	2.8	2.3	2.6	4.0	4.0	4.0
India	7.2	6.9	7.3	8.6	8.2	7.3	-2.8	-3.2	-2.9	...	...	...
ASEAN-5	4.5	5.4	6.2	5.9	5.4	4.7	2.8	1.7	1.4	...	...	...
Indonesia	6.5	6.1	6.6	5.4	6.2	6.0	0.2	-0.4	-0.9	6.6	6.4	6.3
Thailand	0.1	5.5	7.5	3.8	3.9	3.3	3.4	1.0	1.4	0.7	0.7	0.7
Malaysia	5.1	4.4	4.7	3.2	2.7	2.5	11.5	10.8	10.4	3.2	3.1	3.0
Philippines	3.7	4.2	4.7	4.8	3.4	4.1	2.7	0.9	1.0	7.0	7.0	7.0
Vietnam	5.9	5.6	6.3	18.7	12.6	6.8	-0.5	-1.6	-1.4	4.5	4.5	4.5
Other Developing Asia⁴	4.6	5.0	5.0	10.6	9.7	9.2	-0.7	-2.0	-2.0	...	...	...
<i>Memorandum</i>												
Emerging Asia ⁵	7.3	6.8	7.4	6.1	4.7	4.3	2.5	1.9	2.0	...	...	...

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

²Percent of GDP.

³Percent. National definitions of unemployment may differ.

⁴Other 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.

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

Although the external environment is challenging, a soft landing is projected under the baseline forecast, given robust domestic demand, favorable financial conditions, and room for policy easing. Growth in the region is projected at 6 percent in 2012 before gradually recovering to 6½ percent in 2013 (Table 2.3).

- In China, even with the drag from external demand, growth is projected to be above 8 percent in 2012 and 2013 because consumption and investment are expected to remain robust.
- In India, while part of the expected slowdown to 7 percent in 2012 is a cyclical response to higher interest rates and lower external demand, policy uncertainty and supply bottlenecks are playing a role and will need to be tackled in the near term to ensure that potential growth does not decline.

- With a timely boost from reconstruction spending, Japan is projected to grow at 2 percent in 2012. The crisis in Europe and problems regarding energy supply are likely to dampen Japanese economic activity and exports. Growth is expected to remain subdued at 1¾ percent in 2013, reflecting the weak global environment and a decline in reconstruction spending.
- In Korea, a rebound in construction is expected to offset a muted outlook for private consumption and investment due to increased global uncertainty.
- Exports from the ASEAN-5³ were hit particularly hard, but strong domestic demand helped offset the external slowdown, especially in Indonesia. In

³The Association of Southeast Asian Nations (ASEAN) has 10 members; the ASEAN-5 are Indonesia, Malaysia, the Philippines, Thailand, and Vietnam.

Thailand, a rebound following last year's flooding is expected in the first half of 2012, supported by monetary easing and a large fiscal package in response to the floods.

As the pace of economic activity in the region has slowed and capital flows have diminished, inflation pressure has waned and credit growth has slowed. Inflation in the region is expected to recede from 5 percent last year to just under 4 percent in 2012 and to 3½ percent in 2013.

There are significant downside risks to the outlook. In particular, an escalation of the euro area crisis—the downside scenario described in Chapter 1 and illustrated in Figure 2.2—could lower emerging Asia's output by 1¼ percent relative to the baseline, and Japan's output by 1¾ percent. For Asia's open economies, trade would be the most important channel of transmission. For Japan, the simulation results suggest that the spillover effects of decreased external demand are magnified by the constraint on monetary policy of the zero nominal interest rate floor.

A sharp rise in global risk aversion and uncertainty would also produce significant spillovers, not only through its effect on financial market conditions (Figure 2.5, panel 3), but also because of its dampening effect on trade in durables. As shown in panel 2 of Figure 2.5, the region's exposure to euro area banks is smaller than that of other regions. Nevertheless, banking systems in the region that have the greatest reliance on foreign wholesale funding (the newly industrialized Asian economies—NIEs—Australia, New Zealand) remain vulnerable to deleveraging in the global financial system.

An additional external risk is that tensions in the Middle East will cause another oil price spike. Among the internal risks is balance sheet vulnerability from slowing real estate and export sectors in China. These appear manageable on their own, but a large external shock could bring these risks to the fore, precipitating a decline in investment and activity in China that would also have implications for its trading partners.

Policy in the region needs to be set with an eye toward these risks. For economies with relatively low levels of public debt (ASEAN-5, China, NIEs), the pace of fiscal consolidation could be slowed if

downside risks materialize. Many Asian economies could also advance their plans to boost social safety nets and increase investment in infrastructure if another round of fiscal stimulus is warranted—these policies have long-term positive effects on economic rebalancing and income inequality that are beneficial even in good times. However, fiscal consolidation remains a priority in India and Japan, to anchor confidence and rebuild room to meet future challenges.

Although monetary tightening has been appropriately paused in many Asian economies, and cautiously reversed in some, room for further easing is constrained in economies where underlying inflation pressures remain (India, Indonesia, Korea) and in those that are still working through previous credit expansion (China). In Japan, by contrast, further monetary easing can help strengthen growth prospects, and asset purchases under existing programs may need to be expanded to accelerate an exit from deflation.

If euro area bank deleveraging escalates, policymakers will need to ensure that the supply of credit is maintained for those vulnerable to credit rationing, such as small and medium-size firms. Programs developed precisely for this purpose during the 2008–09 crisis could be reactivated as needed. Dollar-funding pressures, which became evident during the previous crisis (notably in Korea, Malaysia, and Taiwan Province of China), remain a vulnerability. Should global liquidity dry up as a result of an intensified euro area crisis, policymakers should stand ready to backstop liquidity in the region.

The fragility of the external outlook highlights the need for the region to rebalance growth by strengthening domestic sources of demand over the coming years. In China, a continuation of recent currency appreciation and progress in implementing the policies identified in the 12th Five-Year Plan would ensure that the recent decline in the external surplus is sustained (see Box 1.3). Elsewhere in emerging Asia, including in many ASEAN economies and India, strengthening domestic demand will require improving the conditions for private investment, including by addressing infrastructure bottlenecks and enhancing governance and public service delivery.

Latin America and the Caribbean: On a Glide Path to Steady Growth

The swings in risk aversion in global markets over the past six months have had significant effects on the region. Initially a rise in risk aversion took some pressure off a number of economies in the region that were threatening to overheat. But, after this pause, capital flows are returning and exchange rates are once again under pressure. Earlier policy tightening, however, is beginning to bear fruit. This combination of policy gains and recent resilience in the face of global sentiment swings means that the outlook is promising (Figure 2.10). Nevertheless, inflation remains above the midpoint of the target band in many economies and credit growth is still elevated. At

the same time, there is continued potential for down-drafts from Europe. While risks are broadly balanced, these tensions are complicating the tasks of policymakers.

The LAC region grew strongly during 2011. External factors had a significant influence on these developments. High commodity prices supported activity in many of the region's commodity exporters despite a general slowdown in global growth and capital flows, which helped contain overheating pressures. Internally, the tightening of fiscal, monetary, and prudential policies also helped moderate the pace of expansion (Figure 2.11). In Central America and the Caribbean, while economic activity is still subdued, strong real linkages with the United States

Figure 2.10. Latin America and the Caribbean: Revisions to 2012 GDP Growth Forecasts
(Change in percentage points from September 2011 WEO projections)

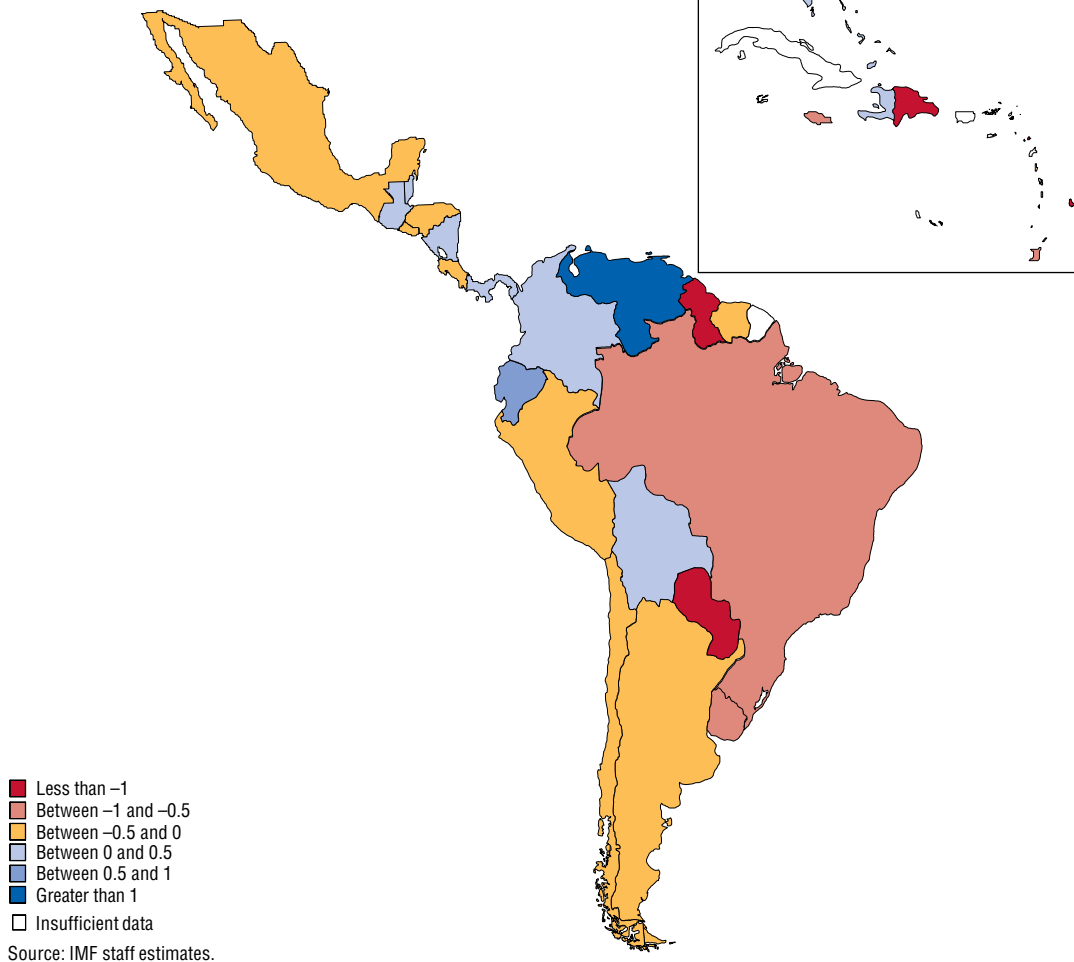
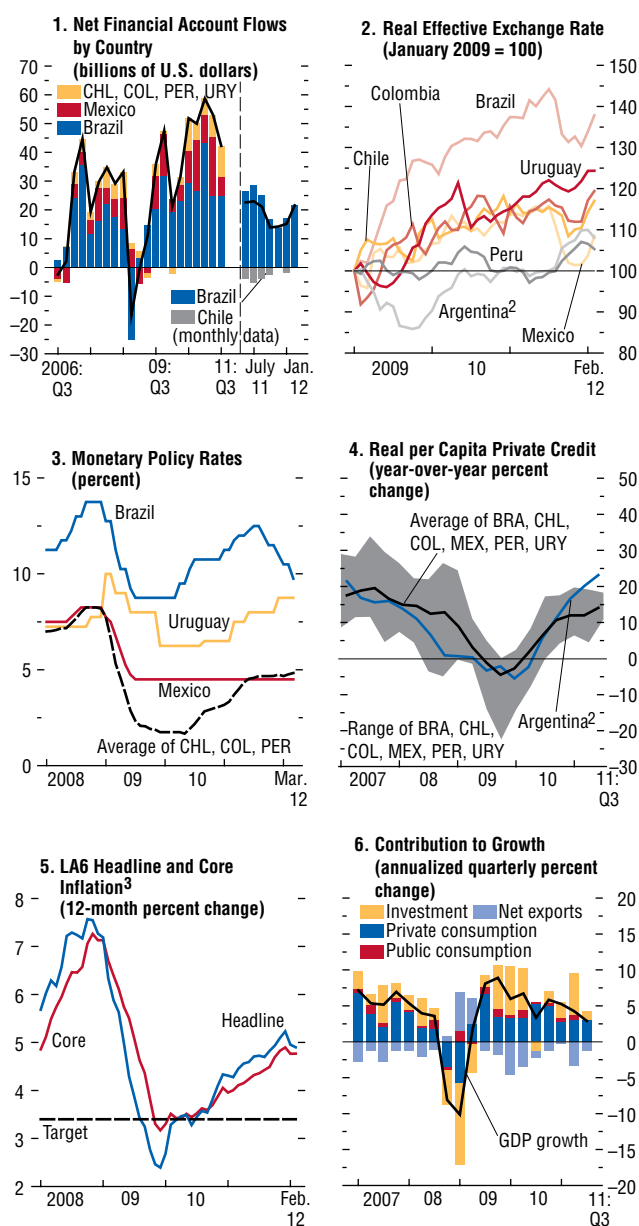


Figure 2.11. Latin America: Watch Out for Downdrafts¹

Swings in risk aversion over the past six months led at first to a moderation of capital flows and exchange rates but, more recently, to a renewal of capital flows and pressure on exchange rates. Policy tightening began to bear fruit, leading to stabilization of real credit growth—albeit at high levels. Nonetheless, inflation is still above the midpoint of the target in many countries. Policymakers need to remain vigilant to possible downdrafts from Europe and updrafts from capital flows.



Sources: Haver Analytics; IMF, *International Financial Statistics*; and IMF staff calculations.
¹BRA: Brazil; CHL: Chile; COL: Colombia; MEX: Mexico; PER: Peru; URY: Uruguay.
²Nominal variables for Argentina are deflated using IMF staff estimates of average provincial inflation.
³LA6: Brazil, Chile, Colombia, Mexico, Peru, and Uruguay.

offer some upside prospects as the United States slowly recovers.

Spillovers to the region through trade, financial, and banking channels were active during recent months but with only limited effects on activity. As implied above, trade spillovers are predominantly commodity related and, as such, linked to Asian growth. Financial spillovers have been more closely related to European developments—a rise in risk aversion stemming from concerns about developments in Europe led to a temporary reduction in capital flows to the region. There was not, however, a reversal of flows and, as such, this development has been a net positive for the region. Nevertheless, the region has had difficulty absorbing hot money in the past and this remains an ongoing source of vulnerability. Spillovers to the region from Europe, however, are channeled most directly through the region’s exposure to the operations of European banks. There is a relatively large European bank presence in the region, particularly of Spanish banks (see Figure 2.5, panel 2). The sale by Santander of shares in its local subsidiaries in late 2011 caused a temporary fall in regional bank stock indices, which points to the possibility that weakness in the European parent banks could cause problems for regional financial markets and for the supply of credit. However, the regional operations of these banks are predominantly conducted by subsidiaries and funded by local deposits, so it is likely that future financial spillovers will be small.

Growth in the LAC region is projected to moderate to 3¾ percent in 2012, before returning to about 4 percent in 2013 (Table 2.4). Among the commodity exporters, strong domestic demand growth moderated, as tighter macroeconomic policies began to bear fruit and the external environment weakened. This is most apparent in Brazil, where growth for 2011 was 2¾ percent and monetary policy has already been loosened. In combination, these forces mean that overheating risks have receded (see Figure 1.18). However, elevated credit and import growth suggests that overheating risks are not completely under control and could reemerge if capital flows return to previous levels. In Mexico, growth was strong in 2011 and, as in the United States, surprised to the upside. Growth is forecast at between 3½ and 3¾ percent

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

	Real GDP			Consumer Prices ¹			Current Account Balance ²			Unemployment ³		
	2011	Projections		2011	Projections		2011	Projections		2011	Projections	
		2012	2013	2011	2012	2013	2011	2012	2013	2011	2012	2013
North America	2.0	2.2	2.5	3.1	2.3	2.0	-3.0	-3.1	-2.9	...	...	...
United States	1.7	2.1	2.4	3.1	2.1	1.9	-3.1	-3.3	-3.1	9.0	8.2	7.9
Canada	2.5	2.1	2.2	2.9	2.2	2.0	-2.8	-2.7	-2.7	7.5	7.4	7.3
Mexico	4.0	3.6	3.7	3.4	3.9	3.0	-0.8	-0.8	-0.9	5.2	4.8	4.6
South America⁴	4.8	3.8	4.3	7.8	7.4	7.0	-1.0	-1.9	-2.0	...	...	...
Brazil	2.7	3.0	4.1	6.6	5.2	5.0	-2.1	-3.2	-3.2	6.0	6.0	6.5
Argentina ⁵	8.9	4.2	4.0	9.8	9.9	9.9	-0.5	-0.7	-1.1	7.2	6.7	6.3
Colombia	5.9	4.7	4.4	3.4	3.5	3.1	-2.8	-2.7	-2.4	10.8	11.0	10.5
Venezuela	4.2	4.7	3.2	26.1	31.6	28.8	8.6	7.4	5.6	8.1	8.0	8.1
Peru	6.9	5.5	6.0	3.4	3.3	2.6	-1.3	-2.0	-1.9	7.5	7.5	7.5
Chile	5.9	4.3	4.5	3.3	3.8	3.0	-1.3	-2.4	-2.4	7.1	6.6	6.9
Ecuador	7.8	4.5	3.9	4.5	5.7	4.8	-0.3	0.5	0.6	6.0	5.8	6.2
Uruguay	5.7	3.5	4.0	8.1	7.4	6.6	-2.2	-3.6	-3.2	6.1	6.0	6.0
Bolivia	5.1	5.0	5.0	9.9	4.9	4.5	2.2	1.6	1.1	...	...	...
Paraguay	3.8	-1.5	8.5	6.6	5.0	5.0	-1.2	-3.5	-1.4	5.6	5.8	5.5
Central America⁶	4.7	4.0	4.0	5.6	5.3	5.2	-6.9	-6.9	-6.7	...	...	...
Caribbean⁷	2.8	3.5	3.6	7.2	5.5	5.2	-3.5	-3.6	-3.7	...	...	...
<i>Memorandum</i>												
Latin America and the Caribbean ⁸	4.5	3.7	4.1	6.6	6.4	5.9	-1.2	-1.8	-2.0	...	...	...
Eastern Caribbean Currency Union ⁹	-0.2	1.5	2.2	3.4	3.5	2.4	-19.9	-21.4	-20.5	...	...	...

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

²Percent of GDP.

³Percent. National definitions of unemployment may differ.

⁴Also includes also Guyana and Suriname.

⁵Figures are based on Argentina's official GDP and consumer price index (CPI-GBA) data. The IMF has called on Argentina to adopt remedial measures to address the quality of the official GDP and CPI-GBA data. The IMF staff is also using alternative measures of GDP growth and inflation for macroeconomic surveillance, including data produced by private analysts, which have shown significantly lower real GDP growth than the official data since 2008, and data produced by provincial statistical offices and private analysts, which have shown considerably higher inflation figures than the official data since 2007.

⁶Central America comprises Belize, Costa Rica, El Salvador, Guatemala, Honduras, Nicaragua, and Panama.

⁷The Caribbean comprises Antigua and Barbuda, The Bahamas, Barbados, Dominica, Dominican Republic, Grenada, Haiti, Jamaica, St. Kitts and Nevis, St. Lucia, St. Vincent and the Grenadines, and Trinidad and Tobago.

⁸Latin America and the Caribbean comprises Mexico and economies from the Caribbean, Central America, and South America.

⁹Eastern Caribbean Currency Union comprises Antigua and Barbuda, Dominica, Grenada, St. Kitts and Nevis, St. Lucia, and St. Vincent and the Grenadines as well as Anguilla and Montserrat, which are not IMF members.

for 2012 and 2013, a slight slowdown but still above potential. In Central America, growth is expected to be about 4 percent and in the Caribbean, about 3½ percent. High public debt and weak tourism and remittance flows continue to constrain the outlook for the Caribbean. The outlook for Central America, like that for Mexico, is closely tied to developments in the United States.

Spillovers to the region, both real and financial, from renewed crisis in Europe are likely to be limited. It is estimated that a reemergence of crisis in Europe, one of the downside scenarios described in Chapter 1 and presented in Figure 2.2, could lower

regional output by about ¾ percent relative to the baseline. This is toward the lower end of estimated effects, reflecting the relatively low level of trade with Europe (which accounts for only about 10 percent of the region's goods exports) and limited financial spillovers (see Figure 2.5). As discussed above, despite the relatively large presence of European banks in the region, spillovers through European banking operations are expected to be moderate. Conversely, the region, and particularly the Southern Cone, is very dependent on commodity prices. In this respect, it could be affected if a crisis in Europe spills over into a more general slowdown, particu-

larly if it affects China and emerging Asia. Counterbalancing this external vulnerability is the sway of the Brazilian economy, which is driven predominantly by internal factors.

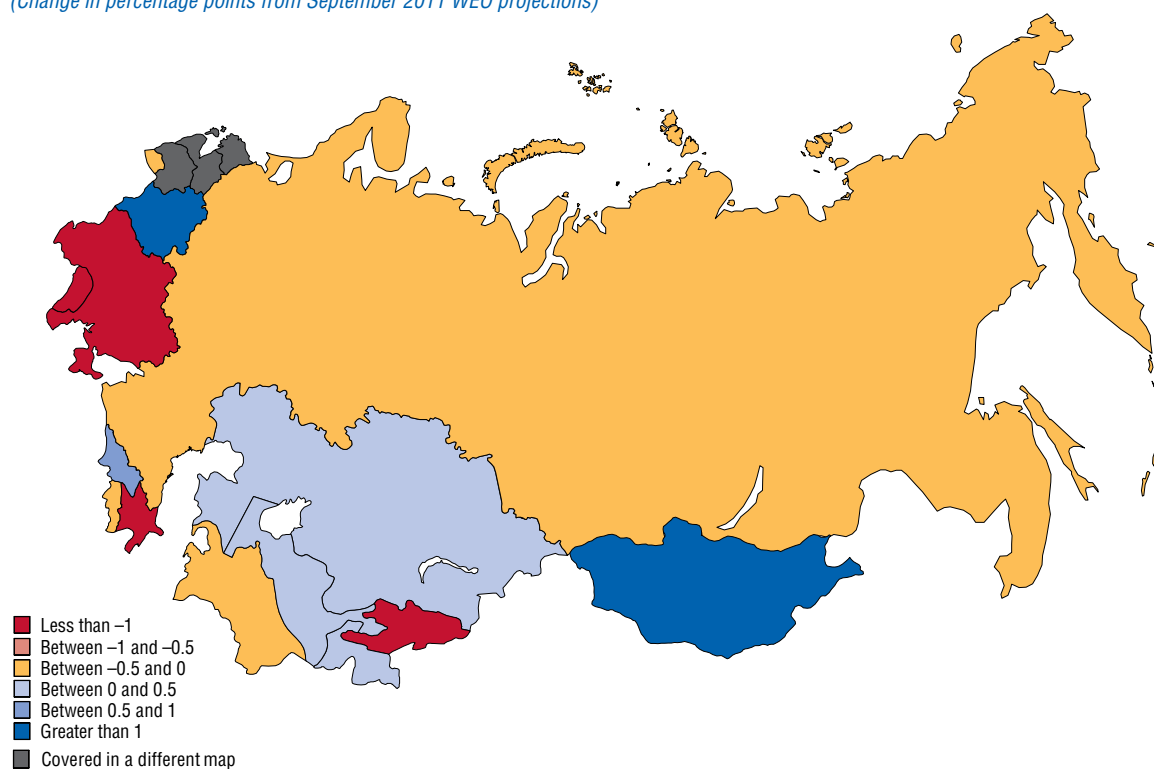
Against this backdrop, policies must be alert to domestic overheating and must build on a strong foundation of prudential measures developed during the most recent periods of robust capital flows. While external pressures abated briefly, they are returning—it would be premature to relax policy settings while inflation is still above the midpoint of target bands and risks tend to the upside. These concerns are particularly acute in Venezuela, where policy has not tightened noticeably and inflation continues at high levels. Similarly, in Argentina, although it is not affected by international credit flows in the same way, high credit growth and high inflation are worrisome. Recent swings in capital flows provide a strong argument for regional governments to continue strengthening their prudential

frameworks to ensure that they are prepared for any future booms or busts in these flows. In Mexico, given firmly anchored inflation expectations and continuing softness in the United States, monetary policy can remain accommodative as long as inflation pressure and expectations remain at bay.

Fiscal consolidation should continue (especially where it is needed to maintain debt sustainability), but social and infrastructure spending should be protected too. Fiscal policy in commodity exporters should focus on saving any windfall revenue gains while commodity prices are still strong, to build room for supportive action in case downside risks to the outlook begin to materialize (see Chapter 4). In Central America, policies should shift toward rebuilding the policy buffers used during the crisis and adopting structural reforms aimed at boosting medium-term growth. Greater resolve is required in reducing debt overhang in the Caribbean while addressing weak competitiveness.

Figure 2.12. Commonwealth of Independent States: Revisions to 2012 GDP Growth Forecasts

(Change in percentage points from September 2011 WEO projections)



Source: IMF staff estimates.

Note: Includes Georgia and Mongolia.

Commonwealth of Independent States: Commodity Prices Are the Main Spillover Channel

Weaker exports to Europe along with policy tightening in some economies will moderate growth in the CIS this year (Figure 2.12), even though commodity prices are expected to remain high. If the euro area crisis intensifies, the fall in global demand together with the associated decline in commodity prices will be a significant constraint on the region's growth.

The CIS continued to grow strongly during the second half of 2011, supported by still-strong oil and commodity prices, a rebound in agricultural output in a number of economies (Armenia, Belarus, Kazakhstan, Russia) following the drought in 2010, and strong domestic demand (Figure 2.13).

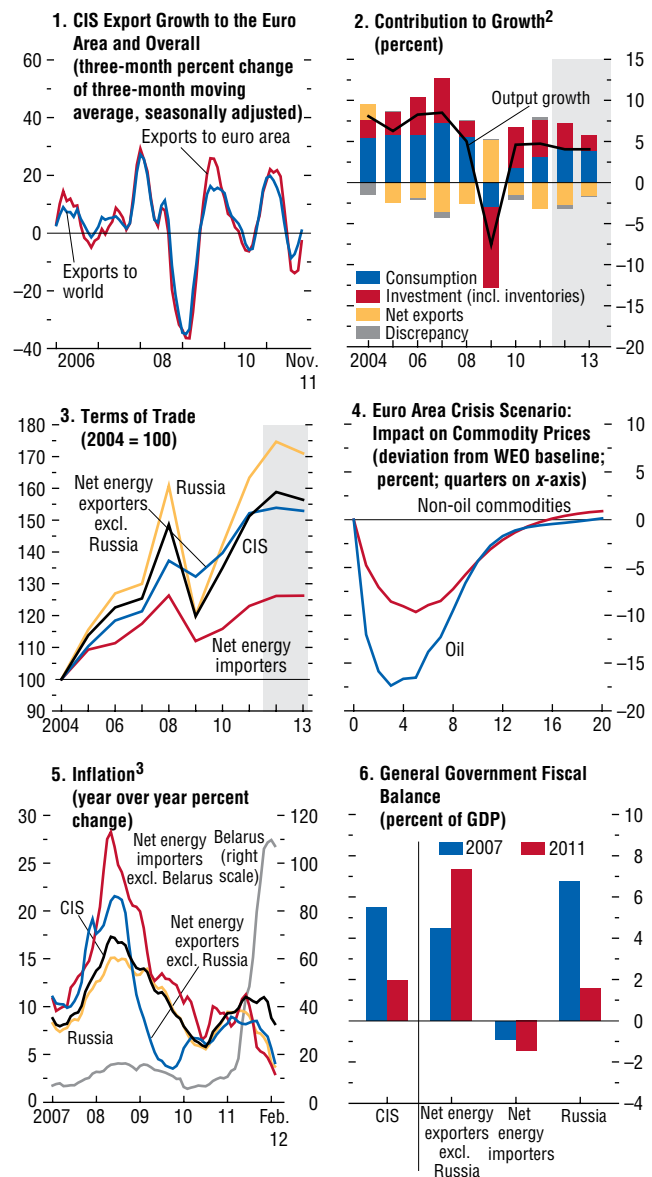
The region, however, has been affected by spillovers from the euro area. The rise in global financial turmoil in late 2011 and the resulting flight to safety contributed to significant capital outflows from Russia, a rise in CDS spreads (particularly for Ukraine), and depreciation of a number of regional currencies, including the Russian ruble. The onset of recession in the euro area is reflected in weaker exports and a slowdown in industrial production in the region's larger economies.

Reflecting the much weaker external outlook, growth in the CIS is expected to slow to 4¼ percent in 2012, from 5 percent in 2011 (Table 2.5). This slowdown is expected to occur even with oil prices remaining relatively high.

- Growth in Russia will benefit from high oil prices. Current projections of 4 percent growth this year are only slightly below the forecasts in the September 2011 *World Economic Outlook*. Growth in 2013 has also been revised down to just below 4 percent because oil prices are expected to weaken somewhat.
- In the region's other energy-exporting economies, growth is also projected to moderate slightly, to 5¾ percent in 2012 and 5½ percent in 2013. Despite weaker external conditions, growth in these economies will be supported by strong terms of trade, as well as investment in oil and mining (Kazakhstan) and infrastructure (Kazakhstan, Uzbekistan). Following a sharp fall in oil output

Figure 2.13. Commonwealth of Independent States: Buoyed by Commodity Prices, Buffeted by Euro Area Headwinds¹

Weaker external demand, especially from Europe, has been a drag on growth in the CIS. The region has benefited from still-high commodity prices, but an escalation of the euro area crisis would cause a big terms-of-trade shock for the region. Inflation has eased, but fiscal room has not yet been rebuilt to precrisis levels.



Sources: Haver Analytics; IMF, *Direction of Trade Statistics*; and IMF staff estimates.
¹Net energy exporters: Azerbaijan, Kazakhstan, Russia, Turkmenistan, Uzbekistan. Net energy importers: Armenia, Belarus, Georgia, Kyrgyz Republic, Moldova, Mongolia, Tajikistan, Ukraine.
²Azerbaijan, Georgia, Tajikistan, Turkmenistan, and Uzbekistan are excluded due to data limitations.
³Due to data limitations, Turkmenistan and Uzbekistan are excluded from the group of net energy exporters excluding Russia; Kyrgyz Republic, Mongolia, and Tajikistan are excluded from the group of net energy importers excluding Belarus.

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

	Real GDP			Consumer Prices ¹			Current Account Balance ²			Unemployment ³		
	2011	Projections		2011	Projections		2011	Projections		2011	Projections	
		2012	2013		2012	2013		2012	2013		2012	2013
Commonwealth of Independent States (CIS)⁴	4.9	4.2	4.1	10.1	7.1	7.7	4.6	4.0	1.7	...	...	...
Net Energy Exporters	4.7	4.3	4.2	8.5	5.1	6.6	6.2	5.4	2.6	...	...	...
Russia	4.3	4.0	3.9	8.4	4.8	6.4	5.5	4.8	1.9	6.5	6.0	6.0
Kazakhstan	7.5	5.9	6.0	8.3	5.5	7.0	7.6	6.6	5.6	5.4	5.4	5.3
Uzbekistan	8.3	7.0	6.5	12.8	12.7	10.9	5.8	2.8	3.0	0.2	0.2	0.2
Azerbaijan	0.1	3.1	1.9	7.9	5.6	6.1	26.3	21.8	16.4	6.0	6.0	6.0
Turkmenistan	14.7	7.0	6.7	5.8	6.2	7.0	1.8	2.1	1.3	...	...	...
Net Energy Importers	5.7	3.7	3.9	18.2	17.4	13.3	-8.0	-7.1	-5.8	...	...	...
Ukraine	5.2	3.0	3.5	8.0	4.5	6.7	-5.6	-5.9	-5.2	8.2	8.2	7.9
Belarus	5.3	3.0	3.3	53.2	66.0	35.8	-10.4	-6.2	-6.5	0.6	0.6	0.6
Georgia	7.0	6.0	5.5	8.5	1.7	5.5	-12.7	-10.3	-9.3	14.9	14.1	13.5
Armenia	4.4	3.8	4.0	7.7	4.0	4.2	-12.3	-11.0	-9.5	19.0	19.0	18.5
Tajikistan	7.4	6.0	6.0	12.4	7.9	8.4	-2.3	-3.6	-5.0	...	...	...
Mongolia	17.3	17.2	11.8	9.5	13.6	12.5	-30.4	-24.4	-1.8	3.0	3.0	3.0
Kyrgyz Republic	5.7	5.0	5.5	16.6	4.1	8.1	-3.1	-4.8	-4.2	7.9	7.7	7.6
Moldova	6.4	3.5	4.5	7.6	5.5	5.0	-10.6	-9.7	-9.9	6.7	6.6	6.4
<i>Memorandum</i>												
Low-Income CIS Economies ⁵	7.3	6.1	5.9	11.7	8.7	8.7	-1.7	-2.6	-2.2	...	...	...
Net Energy Exporters Excluding Russia	6.8	5.7	5.4	8.9	7.1	7.7	10.6	8.8	7.1	...	...	...

¹Movements in consumer prices are shown as annual averages. December–December changes can be found in Table A7 in the Statistical Appendix.²Percent of GDP.³Percent. National definitions of unemployment may differ.⁴Georgia 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.⁵Low-income CIS economies comprise Armenia, Georgia, Kyrgyz Republic, Moldova, Tajikistan, and Uzbekistan.

in 2011, Azerbaijan's hydrocarbon output is expected to remain broadly stable this year, and continued strong growth in the nonhydrocarbon sector is expected to help the economy expand by 3 percent in 2012.

- In the energy-importing economies of the CIS, both external and domestic factors are contributing to the slowdown in growth this year. Waning export demand and tighter monetary and financial conditions will contribute to a slowdown in Ukraine's growth from 5¼ percent last year to 3 percent this year. Growth in Belarus is also expected to slow to 3 percent this year from 5¼ percent in 2011, as a result of last year's currency crisis and the monetary and fiscal tightening that was required to bring inflation down from triple digits.

After rising in mid-2011 due to high food and fuel prices (as well as to excess demand pressures in

a number of economies), headline inflation began to moderate in many CIS economies in the second half of last year and early this year. Contributing to the decline are good harvests that reduced food price inflation, a moderation in economic activity, and monetary tightening in a number of economies. As a result, inflation is projected to moderate this year in almost all economies in the region, with depreciation-driven inflation in Belarus a notable exception.

The most important risk to the region is the possible escalation of the crisis in the euro area. Direct spillovers will come through trade linkages—the euro area accounts for about a third of the region's exports, the most for any region outside Europe (Figure 2.5, panel 1). Even CIS economies with less direct trade exposure to the euro area will be affected via Russia, which is the largest trade partner (and a source of remittances and foreign direct investment)

for many economies in the region. An indirect but potentially more important channel is the effect a euro area crisis and global downturn would have on commodity prices.

In the euro area crisis scenario described in Chapter 1, oil and commodity prices would be lower by 17 and 10 percent, respectively, relative to the baseline, resulting in a significant terms-of-trade shock for the region (Figure 2.13, panel 4). And as was demonstrated late last year, increased capital outflows would put pressure on the region's currencies and exacerbate funding pressure for economies with large external financing needs, such as Ukraine. While the region's financial linkages with euro area banks are relatively limited (see Figure 2.5, panel 2), distress in a systemically important euro area bank could cause an abrupt withdrawal of funding and raise the likelihood of banking sector distress in Russia.⁴ An upside risk for CIS energy exporters is a further rise in oil prices as a result of renewed tensions in the Middle East.

Fortifying the region against such risks calls for rebuilding policy room in most CIS economies, notably through fiscal consolidation. Fiscal balances are much lower than they were before the 2008–09 crisis. In Russia, the non-oil deficit has more than tripled since the crisis, and the oil reserve fund has been drawn down; in Ukraine, public finances remain vulnerable to pressures from higher wage, pension, and capital spending; and in Belarus, tight wage policy in the budget sector will be crucial to the reduction of inflation expectations.

The moderation of inflation in the region gives policymakers some room for monetary maneuvering. Nevertheless, monetary policy should continue to focus on reducing inflation under the baseline scenario, because inflation remains high in a number of economies (Belarus, Russia, Uzbekistan). Should downside risks materialize, monetary and fiscal authorities should stand ready to adjust their policies. Greater exchange rate flexibility, which was a welcome development in Russia last year but is still lacking in other economies in the region, would also help these economies adjust to adverse shocks.

⁴See IMF (2011).

Middle East and North Africa: Growth Stalled, Outlook Uncertain

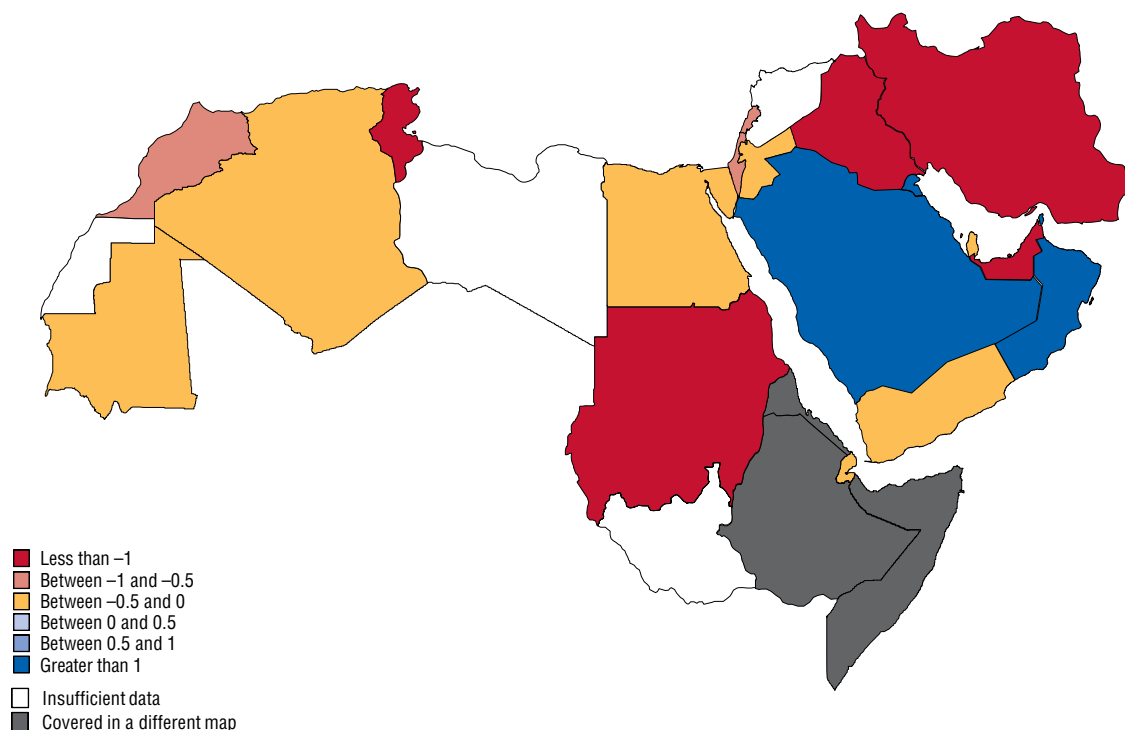
In addition to significant internal challenges in several economies in the region and geopolitical risks associated with the Islamic Republic of Iran, there are large potential spillovers to the region from Europe. Internal challenges, exemplified by ongoing social unrest, have spurred an increase in social transfers. Key policy priorities will be preserving or rebuilding macroeconomic stability in the face of the ongoing unrest while evolving toward a model for inclusive growth that does not depend so heavily on government transfers. External challenges come from two main sources—oil prices and trade linkages with Europe. For oil exporters, a renewal of crisis in Europe could depress oil prices and undermine the recent increases in government spending on social support. In North Africa, trade, remittance, and tourism links with Europe are historically important and currently depressed.

Growth in the MENA region was below trend in 2011, primarily because of country-specific factors.⁵ Among oil exporters, strong oil prices contributed to growth of 4 percent in 2011, which was held down by lower outcomes in the Islamic Republic of Iran related to a poor harvest and the effect of the subsidy reform. Among oil importers, growth was 2 percent even after the exclusion of data from the Syrian Arab Republic. This low growth is a direct reflection of the effects of social unrest. Other than through their effects on oil prices, global factors and European developments have had a relatively minor effect on the region to date—revisions primarily reflect regional developments (Figure 2.14).

Regional spillovers from the social unrest have been large, particularly on tourism and capital flows, which have declined throughout the region (Figure 2.15). Given the size of economy-specific shocks and their strong regional spillovers, it is difficult to isolate a Europe-specific effect, except the weakening of remittances. Even so, the potential spillovers from a reemergence of crisis in Europe, as modeled in the first downside scenario of Chapter 1 and illustrated

⁵The Syrian Arab Republic has been excluded from the data and projections due to the uncertain political situation. Growth in Libya, which is included, is strongly affected by the civil war and projected bounce back in 2012.

Figure 2.14. Middle East and North Africa: Revisions to 2012 GDP Growth Forecasts
(Change in percentage points from September 2011 WEO projections)



Source: IMF staff estimates.

in Figure 2.2, could lower regional output by about 3¼ percent relative to the baseline—the largest spillover effect for any region outside Europe. Of this, most is attributable to weaker oil prices. The remaining effect reflects strong spillovers from weaker trading partner demand on the region—predominantly through effects on foreign financing flows, trade, tourism, and remittances. These links are best seen in the pattern of trade for the region (see Figure 2.5, panel 1). Goods exports to Europe account for approximately 20 percent of exports, or 7 percent of GDP—higher than for Asia, Canada, Latin America, the SSA region, or the United States. Figure 2.5 also shows that, although current financial linkages appear weak, spillovers to the MENA region were among the strongest in the year immediately following the collapse of Lehman Brothers in 2008.

These strong spillovers from Europe shape the risks to the outlook, but the baseline is predominantly determined by regional factors. The base-

line forecast is for growth of 4¼ percent in 2012 and 3¾ percent in 2013 (Table 2.6). Among oil importers, strong oil prices, anemic tourism associated with social unrest in the region, and lower trade and remittance flows reflecting ongoing problems in Europe are the major constraints. Among oil exporters, negative developments in the Islamic Republic of Iran are projected to be offset by increased oil production in Iraq and Saudi Arabia and a bounce back in Libya. Given the relatively subdued growth outlook and receding non-oil commodity prices, inflation in the region is projected to fall slightly over the forecast horizon from 9½ percent in 2011 to 8¾ percent in 2013.

As mentioned above, external risks revolve around developments in Europe. Internal risks are dominated by political developments. Domestic instability caused a significant decline in tourism for the region, which has yet to recover to earlier levels (Figure 2.15, panel 2). A more intense recession in

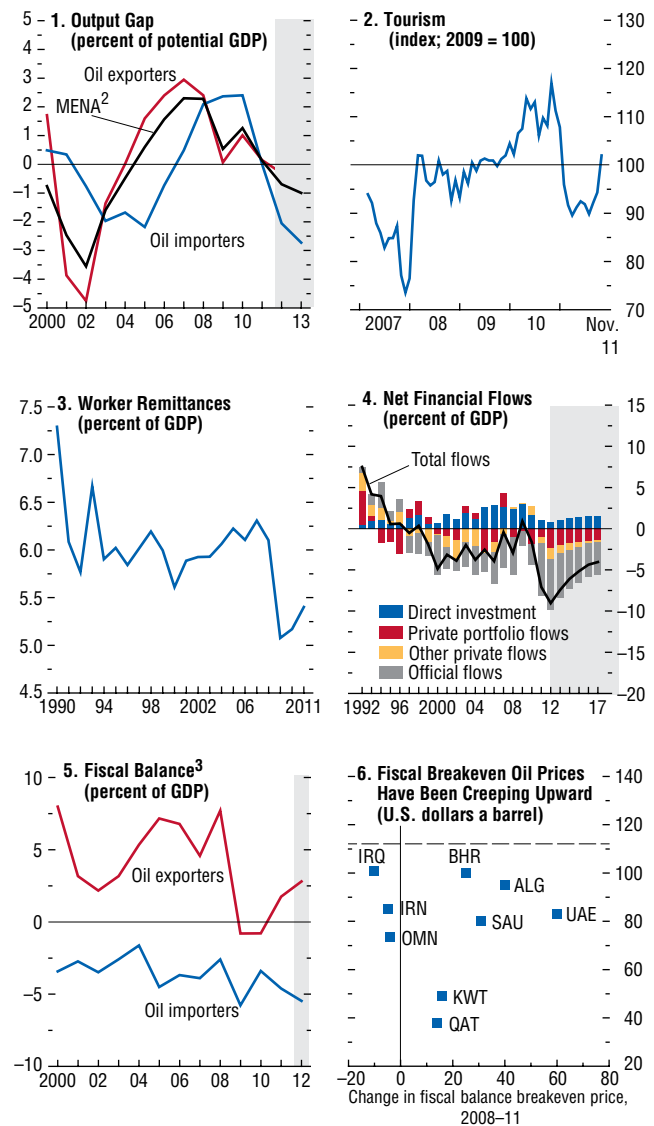
Europe could further undermine the already shaky tourism sector with follow-on effects to the rest of the economy. For oil exporters, risks revolve around the price of oil—which, on the downside, is predominantly tied to the possibility of an intensified crisis in Europe that spills over into slower growth in the rest of the world. Government expenditures have risen to such a degree that a relatively modest fall in the price of oil can lead to budget deficits. Conversely, despite being already elevated because of regional political uncertainty, oil prices could rise further on the back of intensified concerns about an Iran-related oil supply shock, unrest in the region, or an actual disruption in oil supplies. Such effects could be dramatic given limited inventory and spare capacity buffers, as well as the still-tight physical market conditions expected throughout 2012.

Given these risks and outlook, the region faces serious policy challenges. The primary challenge is to secure economic and social stability, but there is also a short-term need to place public finances on a sustainable footing. For oil exporters, governments need to seize the opportunity presented by high oil prices to move toward sustainable and more diversified economies. In addition, the social disruption highlights the need for an inclusive medium-term growth agenda that establishes strong institutions to stimulate private sector activity, opens up greater access to economic opportunities, and addresses chronically high unemployment, particularly among the young.

A key medium-term fiscal policy objective is the reorientation of fiscal policies toward poverty reduction and the promotion of productive investment. However, increased spending on fuel and food subsidies (with the Islamic Republic of Iran an important exception), along with pressures to raise civil service wages and pensions, is straining public finances (particularly for oil-importing economies), which will not be sustainable over the medium term. Increased targeting of subsidies, and fuel subsidy reforms in particular, will help ease the strain.⁶

Figure 2.15. Middle East and North Africa: A Sea of Troubles¹

The uncertain political environment in many economies in the region is undermining growth prospects. The legacy of social unrest and of weakness in Europe can be seen in weak tourism and remittance numbers and capital outflows. An increase in social transfer expenditures means that, for oil exporters, government budgets are increasingly dependent on continued high oil prices.



Sources: Haver Analytics; national authorities; and IMF staff estimates.

¹Oil exporters: Algeria (ALG), Bahrain (BHR), Islamic Republic of Iran (IRN), Iraq (IRQ), Kuwait (KWT), Libya, Oman (OMN), Qatar (QAT), Saudi Arabia (SAU), Sudan, United Arab Emirates (UAE), Republic of Yemen. Oil importers: Djibouti, Egypt, Jordan, Lebanon, Mauritania, Morocco, Syrian Arab Republic, Tunisia. Data exclude Syrian Arab Republic for 2011 onward and South Sudan after July 9, 2011.

²MENA: Middle East and North Africa.

³Data exclude Libya.

⁶See Annex 3.2 of the April 2011 *Regional Economic Outlook: Middle East and Central Asia*, and Coady and others (2010) for discussion of these issues.

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

	Real GDP			Consumer Prices ¹			Current Account Balance ²			Unemployment ³		
	2011	Projections		2011	Projections		2011	Projections		2011	Projections	
		2012	2013		2012	2013		2012	2013		2012	2013
Middle East and North Africa	3.5	4.2	3.7	9.6	9.5	8.7	13.2	14.5	12.7	...	...	...
Oil Exporters⁴	4.0	4.8	3.7	10.3	10.3	8.8	16.9	18.2	16.0	...	...	...
Islamic Republic of Iran	2.0	0.4	1.3	21.3	21.8	18.2	10.7	6.6	5.1	15.1	16.7	18.1
Saudi Arabia	6.8	6.0	4.1	5.0	4.8	4.4	24.4	27.9	22.7	...	...	...
Algeria	2.5	3.1	3.4	4.5	5.5	4.5	10.3	10.0	7.9	10.0	9.7	9.3
United Arab Emirates	4.9	2.3	2.8	0.9	1.5	1.7	9.2	10.3	10.4	...	...	...
Qatar	18.8	6.0	4.6	2.0	4.0	4.0	28.4	31.5	29.0	...	...	...
Kuwait	8.2	6.6	1.8	4.7	3.5	4.0	41.8	46.2	41.9	2.1	2.1	2.1
Iraq	9.9	11.1	13.5	6.0	7.0	6.0	7.9	9.1	10.8	...	...	...
Sudan ⁵	-3.9	-7.3	-1.5	18.1	23.2	26.0	2.1	-4.6	-4.0	12.0	10.8	9.6
Oil Importers⁶	2.0	2.2	3.6	7.5	6.9	8.4	-5.3	-5.3	-4.9	...	...	...
Egypt	1.8	1.5	3.3	11.1	9.5	12.1	-2.0	-2.6	-2.1	10.4	11.5	11.3
Morocco	4.3	3.7	4.3	0.9	2.0	2.5	-7.4	-5.9	-6.0	9.0	8.9	8.8
Tunisia	-0.8	2.2	3.5	3.5	5.0	4.0	-7.4	-7.1	-7.1	18.9	17.0	16.0
Lebanon	1.5	3.0	4.0	5.0	4.0	3.3	-14.4	-14.2	-13.4	...	...	...
Jordan	2.5	2.8	3.0	4.4	4.9	5.6	-9.5	-8.3	-6.8	12.9	12.9	12.9
<i>Memorandum</i>												
Israel	4.7	2.7	3.8	3.4	2.0	2.0	0.1	-0.9	0.0	5.6	6.0	5.8
Maghreb ⁷	-1.7	11.0	5.9	3.9	4.0	3.0	2.7	5.3	6.2	...	...	...
Mashreq ⁸	1.8	1.8	3.4	10.0	8.6	10.8	-4.3	-4.7	-4.1	...	...	...

¹Movements in consumer prices are shown as annual averages. December–December changes can be found in Tables A6 and A7 in the Statistical Appendix.²Percent of GDP.³Percent. National definitions of unemployment may differ.⁴Also includes Bahrain, Libya, Oman, and Republic of Yemen.⁵Data for 2011 exclude South Sudan after July 9. Data for 2012 onward pertain to the current Sudan.⁶Also includes Djibouti and Mauritania. Excludes Syrian Arab Republic for 2011 onward.⁷The Maghreb comprises Algeria, Libya, Mauritania, Morocco, and Tunisia.⁸The Mashreq comprises Egypt, Jordan, Lebanon, and Syrian Arab Republic. Excludes Syrian Arab Republic for 2011 onward.

Sub-Saharan Africa: Resilience Should Not Breed Complacency

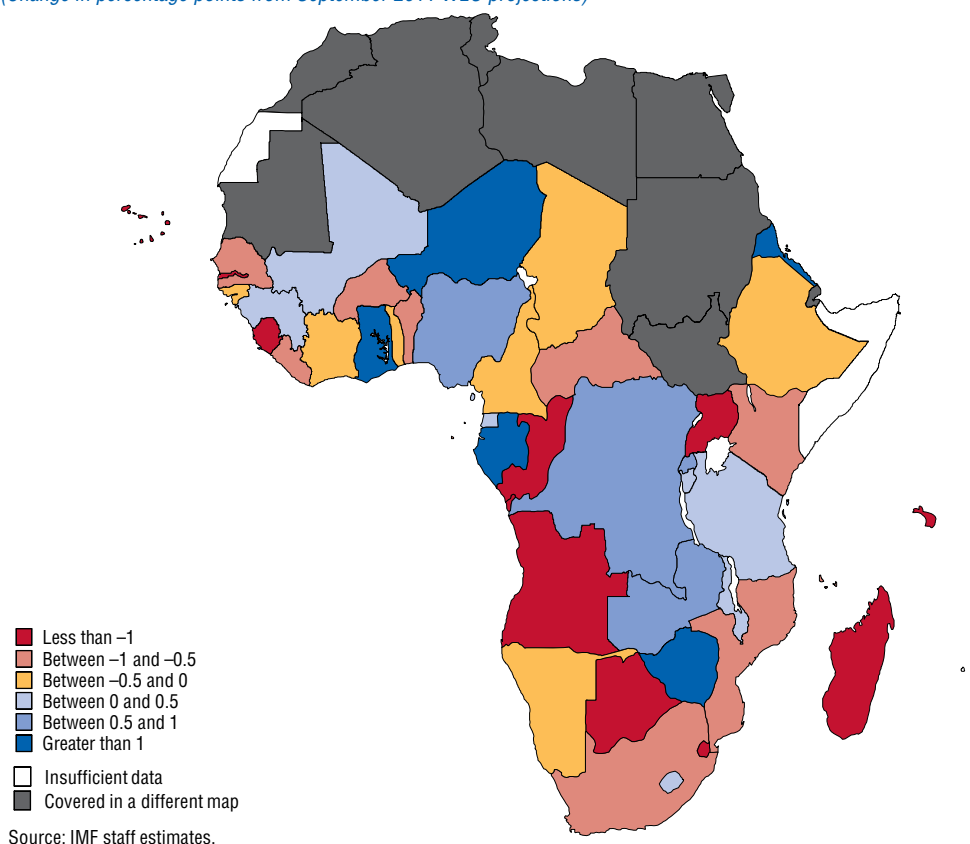
Sub-Saharan Africa has recorded another year of strong growth and was one of the regions least affected by recent financial turmoil and deterioration in the global outlook (Figure 2.16). Rebuilding policy buffers remains a priority in most economies, but sluggish growth in South Africa may require some policy support. Containing the surge in inflation is a policy priority in east Africa.

The SSA region turned in another solid performance in 2011, expanding by about 5 percent. This occurred despite a slowdown in South Africa (due in part to the slowdown in the euro area), adverse supply shocks from drought in both eastern and western Africa, and civil conflict in Côte d'Ivoire.

The region's resilience reflects a number of factors, including its relative insulation from financial spillovers emanating from the euro area. The region's limited financial linkages with Europe (see Figure 2.5, panels 2 and 3) helped protect it from the turmoil in late 2011, with South Africa a notable exception—there it led to rand depreciation and stock price volatility. Furthermore, the diversification of exports toward fast-growing emerging markets has reduced the region's trade exposure to Europe.⁷ Exports to the euro area now account for only one-fifth of the region's exports, down from two-fifths in the early 1990s (Figure 2.5, panel 1; Figure 2.17, panel 4). High commodity prices also benefited the region's commodity exporters and

⁷See Chapter 3 of the October 2011 *Regional Economic Outlook: Sub-Saharan Africa*.

Figure 2.16. Sub-Saharan Africa: Revisions to 2012 GDP Growth Forecasts
(Change in percentage points from September 2011 WEO projections)



boosted investment in natural resource extraction. And policy stances remain relatively accommodative in many economies in the region.

Reflecting this resilience, the downward revision to the SSA outlook was small (Figure 2.1, panel 1; Figure 2.17, panel 1). SSA growth is expected to pick up somewhat in 2012 to 5½ percent, from 5 percent in 2011 (Table 2.7), helped by the coming onstream of new mineral and oil production and the reversal of the adverse supply shocks experienced in 2011. That said, several economies will experience a significant slowdown:

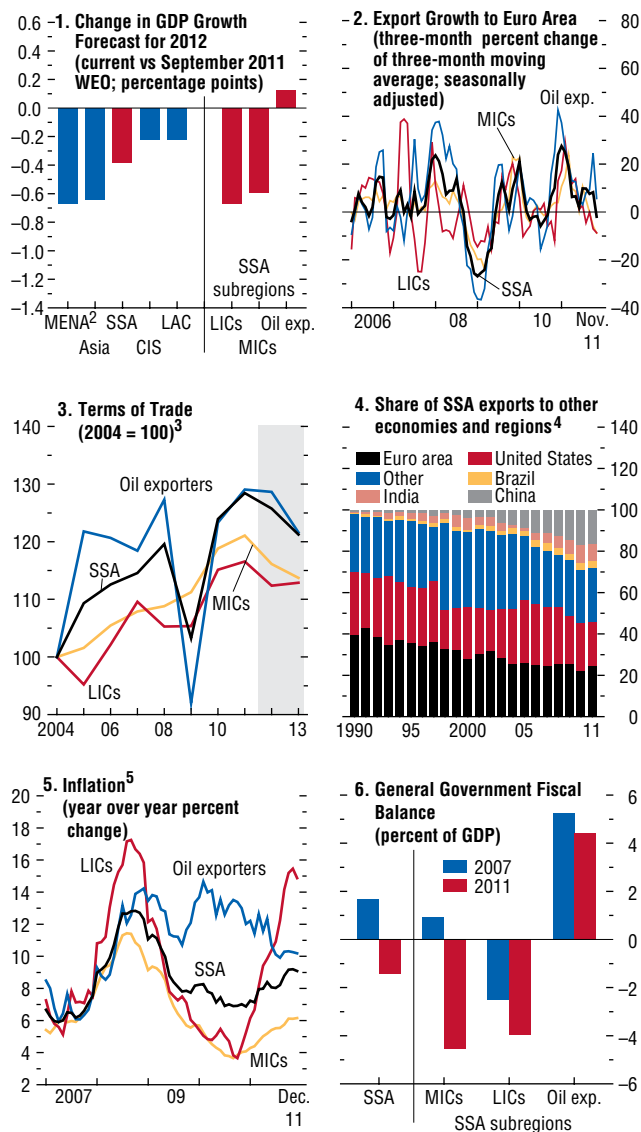
- The region's middle-income economies, which are growing the least rapidly, saw large downward revisions to their growth, reflecting their stronger trade and financial ties with slowing Europe. South Africa is projected to expand by only 2¾ percent this year, 1 percentage point less than projected in the September 2011 *World Economic Outlook*. This reflects deterioration in the external environment,

weaker terms of trade, and a general loss of business confidence. Growth is also expected to slow in Botswana to 3¼ percent this year due in large part to weaker global demand for diamonds. After the one-time boost from the start of oil production last year, Ghana's growth is set to moderate to a still-robust 8¾ percent this year.

- Growth in the oil-exporting economies is expected to accelerate to 7¼ percent in 2012 from 6¼ percent last year, largely because new oil fields coming onstream in Angola are expected to boost GDP growth there to 9¾ percent this year. In Nigeria, non-oil GDP growth is projected to ease somewhat this year, reflecting tighter fiscal and monetary policies, although with some rebound in oil output, overall GDP growth should remain about 7 percent.
- Among the low-income economies, a rebound in agricultural output and in hydroelectricity generation following last year's drought is expected to support

Figure 2.17. Sub-Saharan Africa: Continued Resilience¹

Sub-Saharan Africa has seen only small downward revisions to its growth projections. Exports to Europe have slowed, especially for middle-income economies, but strong terms of trade and increased diversification toward fast-growing emerging markets have helped support the region. Inflation pressure and reduced fiscal room give policymakers less ability to maneuver if downside risks materialize.



Sources: Haver Analytics; IMF, *Direction of Trade Statistics*; and IMF staff estimates.
¹CIS: Commonwealth of Independent States; LAC: Latin America and the Caribbean; LIC: low-income country (SSA); MENA: Middle East and North Africa; MIC: middle-income country (SSA); Oil exp.: oil exporters; SSA: sub-Saharan Africa.
²Excludes Libya and Syrian Arab Republic. Excludes South Sudan after July 9, 2011.
³Excludes Liberia and Zimbabwe due to data limitations.
⁴The value for 2011 is based on the data from January to November.
⁵Due to data limitations, the following are excluded: Chad, Republic of Congo, and Equatorial Guinea from oil exporters; Zambia from MICs; Benin, Central African Republic, Comoros, Democratic Republic of Congo, Eritrea, Ethiopia, Guinea, Liberia, Malawi, São Tomé and Príncipe, Sierra Leone, and Zimbabwe from LICs.

growth in Kenya, which is projected to grow by 5¼ percent in 2012 and by 5¾ percent in 2013. But power shortages and macroeconomic tightening to stem inflation pressure are expected to temper growth in Uganda and, to a lesser extent, Tanzania.

The SSA region is relatively less exposed to the global slowdown, but it is not immune to spillovers. In the euro area crisis scenario described in Chapter 1 and presented in Figure 2.2, SSA output would be reduced by 1 percent relative to the baseline. The euro area crisis would negatively affect the region through its effect on exports, remittances, official aid, and private capital flows. It would also result in a sharp drop in oil and non-oil commodity prices relative to the baseline forecasts, by 17 and 10 percent, respectively. As a result, commodity exporters and middle-income economies that are more integrated into global markets would be the most affected by an escalation of the euro area crisis.

South Africa may also transmit global shocks to the rest of the region. It is more exposed to weaknesses in the world economy—particularly to Europe, which remains a major market for its high-value-added exports. Adverse shocks affecting South Africa can quickly spread to neighboring economies, through their effect on migrant workers' incomes, trade, regional investment, and finance.

For now, policymakers should focus on rebuilding policy buffers. Many economies in the region have already begun to reduce fiscal deficits and tighten monetary policy, particularly where inflation spiked last year. Indeed, inflation pressure has already begun to abate in much of the region, mostly on account of lower food prices. Budgetary discipline will also help generate the room needed to refocus spending on priority areas such as infrastructure, health, and education. If downside risks materialize, economies without significant financing constraints should be prepared to loosen policy levers. The challenge is different in South Africa, which is struggling with subpar growth and very high unemployment. Support for activity remains an important policy objective, and in the event of a protracted slowdown, further monetary easing could be a potential source of stimulus as long as inflation expectations and the core inflation rate remain well contained.

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

	Real GDP			Consumer Prices ¹			Current Account Balance ²			Unemployment ³		
	2011	Projections		2011	Projections		2011	Projections		2011	Projections	
		2012	2013		2012	2013		2012	2013		2012	2013
Sub-Saharan Africa	5.1	5.4	5.3	8.2	9.6	7.5	-1.8	-2.0	-2.6	...	...	...
Oil Exporters	6.2	7.3	6.2	10.2	10.2	8.7	5.6	6.9	4.9	...	...	...
Nigeria	7.2	7.1	6.6	10.8	11.2	9.7	6.2	7.3	5.3	23.9	...	...
Angola	3.4	9.7	6.8	13.5	11.1	8.3	8.1	9.7	6.2	...	...	...
Equatorial Guinea	7.1	4.0	6.8	7.3	7.0	7.0	-9.7	-9.0	-6.6	...	...	...
Gabon	5.8	5.6	2.3	1.3	2.3	2.6	12.0	11.7	7.5	...	...	...
Chad	1.6	6.9	0.1	1.9	5.5	3.0	-17.7	-10.0	3.3	...	...	...
Republic of Congo	4.5	3.1	5.4	1.9	2.7	2.9	6.2	4.3	3.8	...	...	...
Middle-Income⁴	3.9	3.8	4.2	5.4	5.8	5.4	-3.8	-4.9	-5.2	...	...	...
South Africa	3.1	2.7	3.4	5.0	5.7	5.3	-3.3	-4.8	-5.5	24.5	23.8	23.6
Ghana	13.6	8.8	7.4	8.7	9.6	8.9	-10.0	-6.9	-6.0	...	...	...
Cameroon	4.1	4.1	4.5	2.9	3.0	3.0	-3.5	-4.8	-3.3	...	...	...
Côte d'Ivoire	-4.7	8.1	6.2	4.9	2.0	2.5	6.7	-2.8	-3.0	...	...	...
Botswana	4.6	3.3	4.6	8.5	7.8	6.7	-6.8	-4.1	-1.4	...	...	...
Senegal	2.6	3.8	4.5	3.4	3.0	2.2	-8.3	-10.0	-10.7	...	...	...
Low-Income⁵	5.8	5.9	5.9	10.6	15.5	9.6	-9.7	-11.1	-9.9	...	...	...
Ethiopia	7.5	5.0	5.5	18.1	33.9	23.1	-0.2	-8.4	-7.6	...	...	...
Kenya	5.0	5.2	5.7	14.0	10.6	5.2	-11.8	-9.6	-8.4	...	...	...
Tanzania	6.7	6.4	6.7	7.0	17.4	9.5	-9.7	-12.3	-11.2	...	...	...
Uganda	6.7	4.2	5.4	6.5	23.4	7.6	-11.1	-12.5	-10.7	...	...	...
Democratic Republic of Congo	6.9	6.5	6.7	15.5	12.7	9.4	-8.7	-7.8	-6.5	...	...	...
Mozambique	7.1	6.7	7.2	10.4	7.2	5.6	-13.0	-12.7	-12.4	...	...	...

¹Movements in consumer prices are shown as annual averages. December–December changes can be found in Table A7 in the Statistical Appendix.²Percent of GDP.³Percent. National definitions of unemployment may differ.⁴Also includes Cape Verde, Lesotho, Mauritius, Namibia, Seychelles, Swaziland, and Zambia.⁵Also includes Benin, Burkina Faso, Burundi, Central African Republic, Comoros, Eritrea, The Gambia, Guinea, Guinea-Bissau, Liberia, Madagascar, Malawi, Mali, Niger, Rwanda, São Tomé and Príncipe, Sierra Leone, Togo, and Zimbabwe.

Spillover Feature: Cross-Border Spillovers from Euro Area Bank Deleveraging

Euro area banks have been reducing assets, which has raised concern about the possibility of a credit crunch and the effects on real GDP growth and financial stability, not only in the euro area but also in other regions of the world. This Spillover Feature analyzes the potential spillovers of euro area bank deleveraging on other economies.

Concerns about global spillovers from euro area bank deleveraging stem from the major role these banks play in all sectors of global lending. This includes interbank funding, nonbank private credit (including trade finance), and, to a more moderate extent, public sector lending. The recent three-year longer-term refinancing operations (LTROs) of the European Central Bank (ECB) have likely been a key element in smoothing deleveraging pressure on euro area banks, but, as explained in the April 2012 *Global Financial Stability Report*, fundamental deleveraging dynamics are likely to persist. The most exposed regions are emerging Europe and a region designated “other advanced Europe.”⁸ The decline in total banks’ foreign claims in the third quarter of 2011 has been relatively modest so far compared with the period following the collapse of Lehman Brothers in 2008. But the effects on several emerging markets and on the region designated “other advanced Asia” (Australia, Hong Kong SAR, Korea, New Zealand, Singapore, Taiwan Province of China) were sizable, and risk aversion, which has been declining from recent highs since early 2012, is not expected to return to precrisis levels soon, given continued downside risks to global growth. Simulations of euro area bank deleveraging suggest that it could have a moderate impact on growth in some regions. Although current WEO baseline projections already incorporate some deleveraging, even moderate additional growth effects from greater-than-expected deleveraging would be worrisome in the context of

the current fragile global recovery and ongoing fiscal consolidation.⁹ While there could be some offset from other sources of funding, the risk of stronger financial tensions and effects on economic activity remain, especially if deleveraging by European banks triggers a broad and sharp increase in risk aversion.

Deleveraging Pressures on Euro Area Banks and Spillover Channels

Several factors have put pressure on euro area banks to reduce their assets. First, market funding has become costly and scarce, reflecting adverse feedback loops between the sovereign crisis and bank balance sheets and a general lack of confidence between counterparties in the financial system. Although ECB operations are helping ease funding pressures, fundamental deleveraging dynamics appear to be at work. Markets are challenging a bank business model that relies heavily on wholesale funding to increase leverage. Second, some banks remain undercapitalized, and the decline in banks’ equity prices has made it difficult and costly to raise private capital. Finally, in response to these developments, the European authorities asked banks in fall 2011 to raise core Tier 1 capital ratios to 9 percent and build an exceptional capital buffer for sovereign debt exposures by June 30, 2012, with a view to restoring stability and confidence and maintaining lending to the real economy. However, the banks’ deleveraging plans submitted to the European Banking Authority suggest that in aggregate, the shortfalls are expected to be supported by capital measures, which would limit the negative impact on lending to the real economy.

Bank deleveraging can have undesirable consequences for economic activity and financial stability. A reduction in bank credit leads to tighter financing conditions and lower economic growth. Regarding real activity, this is because banks play a spe-

The main author is Florence Jaumotte, with support from Min Kyu Song and David Reichsfeld. Model simulations used in this focus were prepared by Keiko Honjo and Stephen Snudden.

⁸For this analysis, Israel is included in this region, along with Czech Republic, Denmark, Iceland, Norway, Sweden, Switzerland, and the United Kingdom.

⁹The growth effects of deleveraging mentioned in this Spillover Feature (and in the April 2012 *Global Financial Stability Report*) are not relative to the WEO baseline, which since September 2011 already incorporates some deleveraging.

cial role in the intermediation between savers and borrowers (Adrian, Colla, and Shin, 2012). When a bank reduces assets and liabilities, investors who previously lent to banks can channel funds to the real economy through other means (for example, through purchases of corporate bonds). But investors typically demand higher yields because they are less able to solve asymmetric information problems, are more risk averse, and do not use leverage as banks do to provide cheaper credit.¹⁰ As for financial stability, a reduction in bank funding to other financial institutions can generate funding distress. Fire sales of assets can spread across banks, potentially leading to a vicious circle of selling and price declines. Large divestiture by foreign affiliates can substantially weaken financial institutions' equity prices, as was the case recently in Latin America. Finally, sales of sovereign bonds could intensify the funding distress of sovereigns, with adverse feedback effects for banks and the real economy.

Euro area bank deleveraging could affect other regions of the world, especially if banks initially concentrate their deleveraging on foreign locations, as suggested by market intelligence (see the April 2012 *Global Financial Stability Report*).¹¹ The first direct channel of cross-border spillover is the withdrawal of claims of euro area banks on foreign countries. But second-round effects could follow if foreign banks'—especially internationally active U.K. and U.S. banks'—loss of euro area funding forces them to deleverage as well. Depending on the extent of funding withdrawal, deleveraging could undermine global confidence, with broader effects. With a rise in global risk aversion, emerging markets would likely suffer generalized capital outflows, whereas economies with an international reserve currency or deep domestic financial markets (Japan, United States) could face capital inflows from

¹⁰Moreover, small and medium-size firms are heavily dependent on bank credit and have little access to bond or equity financing.

¹¹There may be several reasons for this. First, these assets may not be part of their core activity. Second, the risk of negative feedback to a bank's performance because of a reduction in its profits and an increase in nonperforming loans as a result of deteriorating economic conditions abroad is smaller. Finally, the recent European Banking Authority guidelines encourage maintaining the flow of credit to EU economies. Some banking groups may, however, prefer not to deleverage in strategic emerging markets that are highly profitable.

safe haven effects, accompanied by currency appreciation. In this case, the relevant measure of exposure is not just euro area claims on an economy, but total foreign claims. Finally, foreign countries' exports could suffer if the domestic deleveraging of euro area banks lowers growth in the euro area.¹²

Pattern of Exposure and Vulnerability

The major role played by euro area banks in global lending is good reason to be concerned about deleveraging by these entities and the effects elsewhere. Based on Bank for International Settlements (BIS) data, euro area banks are major players in global foreign claims of banks in general and in each sector of lending, with shares between 25 and 40 percent (even after excluding lending to other euro area countries—Figure 2.SF.1). Moreover, a substantial share of euro area banks' foreign claims have maturities of less than one year, which makes them easy to unwind. Trade credit might be particularly vulnerable: maturities for this kind of credit are typically short, and euro area banks are major players in this market in all regions.¹³

The regions most exposed to foreign claims from euro area banks are other advanced Europe and emerging Europe (Figure 2.SF.2).^{14,15} Financial centers across the world are also very exposed. Japan and developing Asia are the least exposed regions. Emerging Europe and other advanced Europe

¹²The distress in euro area banks will also affect other regions through those regions' claims on the euro area; however, this channel is beyond the topic of deleveraging.

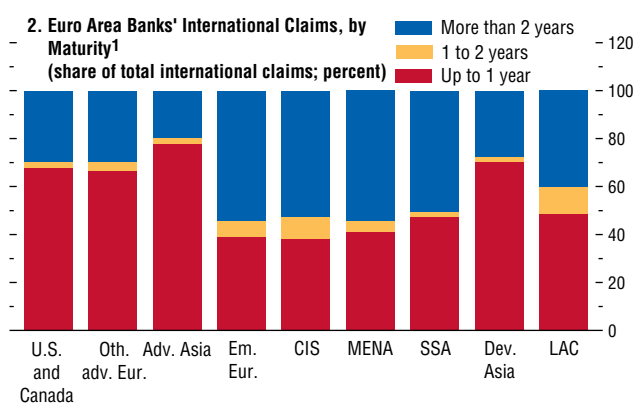
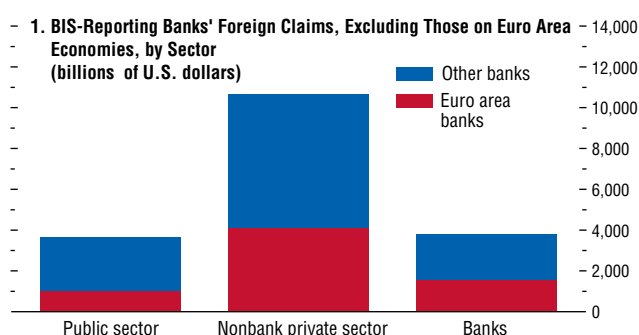
¹³Bank-intermediated trade finance is about 35 to 40 percent of total trade finance. Another niche market that could be affected is project finance.

¹⁴The regions considered in the analysis are as follows: North America comprises Canada and the United States; other advanced Europe comprises Czech Republic, Denmark, Iceland, Israel, Norway, Sweden, Switzerland, United Kingdom; other Advanced Asia comprises Australia, Hong Kong SAR, Korea, New Zealand, Singapore, Taiwan Province of China. Emerging Europe, the Commonwealth of Independent States (CIS), Developing Asia, Latin America and the Caribbean (LAC), the Middle East and North Africa (MENA), and sub-Saharan Africa (SSA) are defined according to the classification in the Statistical Appendix. Financial centers are included in the aggregates for their respective regions because they are often hubs of regional financing and may thus have spillover effects on the rest of the region.

¹⁵This is the case in all sectors (private, public, banks). North America and other advanced Asia are also relatively exposed in the banking sector, as is LAC in the public sector.

Figure 2.SF.1. Euro Area Bank Participation in Global Lending, September 2011

The major role played by euro area banks in global lending and the short-term nature of a substantial share of their foreign claims are good reasons to be concerned about their deleveraging.



Sources: Bank for International Settlements (BIS); and IMF staff calculations.
¹Advanced Asia (Adv. Asia): Australia, Hong Kong SAR, Japan, Korea, New Zealand, Singapore, Taiwan Province of China; CIS: Commonwealth of Independent States; Dev. Asia: developing Asia; Em. Eur.: emerging Europe; LAC: Latin America and the Caribbean; MENA: Middle East and North Africa; Other advanced Europe (Oth. adv. Eur.): Czech Republic, Denmark, Iceland, Israel, Norway, Sweden, Switzerland, United Kingdom; SSA: sub-Saharan Africa.

remain the most exposed regions, even considering that a portion of the foreign claims is funded by local deposits in affiliates and hence is less likely to be withdrawn (Cerutti, Claessens, and McGuire, 2011) or taking into account differences in financial deepening across regions.¹⁶ Regions that are directly exposed to banks from euro area countries that have been under market pressure, such as Greece, Ireland, Italy, Portugal, Spain, and Belgium, as opposed to the rest of the euro area, might be more vulnerable. For most regions, the bulk of exposures are to banks from the core of the euro area. But banks in the economies under market pressure have significant claims in other parts of advanced Europe (Ireland), emerging Europe, and Latin America (Spain).

Were global risk aversion to rise significantly, broader vulnerability would play a crucial role in determining the extent to which countries are affected. When total foreign exposure to banks—not just to euro area banks—is taken into account, the potential for broader vulnerability is much higher, especially in other advanced Europe, but also in advanced Asia and North America. When broader indicators are considered, emerging Europe and the CIS appear especially vulnerable (Figure 2.SF.3). Despite sharp declines in current account deficits, these economies have large external financing needs and low reserve coverage of short-term debt and the current account deficit. A significant share of public debt is financed externally, and fiscal financing requirements are large in a number of these economies. Finally, they have a high share of foreign-currency-denominated loans, which could imply large negative balance sheet effects on the private sector in the event of exchange rate pressure and could expose banks to indirect foreign currency risk. The MENA region also exhibits some vulnerability, with high public domestic rollover needs in some economies, which could be problematic if domestic sources of public financing, such as banks, are affected by the euro area crisis. Although external rollover needs are

¹⁶The adjusted measure proposed by Cerutti, Claessens, and McGuire (2011) has two partially offsetting corrections. On the one hand, subtracting foreign claims funded by local deposits reduces the size of the exposure. On the other hand, the measure adds off-balance-sheet commitments (such as unused credit lines and trade credit guarantees) to capture the maximum exposure.

also very large, most economies in the region hold ample international reserves.

More generally, risk is higher because policy room is much more limited than during the post-Lehman deleveraging, when massive injections of liquidity and recapitalization programs were made possible by ample fiscal room and greater scope for central bank intervention.

How Much Deleveraging So Far?

According to consolidated BIS data, which capture banks' cross-border deleveraging, euro area banks reduced their (adjusted) foreign claims by 3 percent during the third quarter of 2011 (the most recent data point available). Overall, global bank foreign claims declined only ½ percent thanks to some offsets by banks from North America and Japan (Figure 2.SF.4).¹⁷ The overall retrenchment so far is small in comparison with the 2008 crisis, when global foreign claims fell by about 20 percent (although that retrenchment took place over several quarters). But since June 2011 the reduction in foreign claims has affected more regions outside the euro area, especially emerging Europe, LAC, SSA, and advanced Asia.¹⁸ In addition to fewer euro area bank claims, several emerging markets have suffered outflows of funding from non-euro-area banks, while advanced economies have seen inflows of such funding, which may signal a rise in global risk aversion.¹⁹ Total foreign bank claims were lower by 2 percentage points of GDP in emerging Europe and by 0.6 percentage point of GDP in Latin America and the Caribbean and advanced Asia.²⁰ In addition, euro

¹⁷Based on BIS consolidated foreign claims at ultimate risk, adjusted for the exchange rate and breaks in series (Cerutti, 2012).

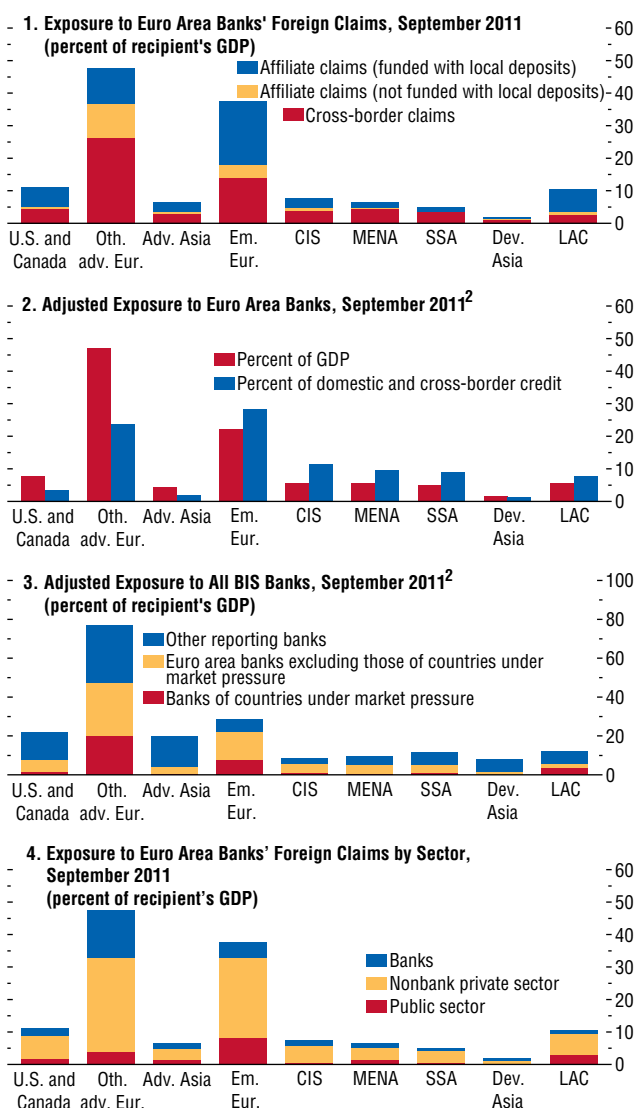
¹⁸While the discussion focuses on broad regions, the impact of deleveraging has been heterogeneous in some regions. Country-specific factors have been, and will continue to be, crucial.

¹⁹More recent data on fund flows to emerging markets, however, suggest that global risk aversion has declined again.

²⁰Claims on the nonbank private sector have fallen the most. However, because the data are consolidated by banking group, they may reflect a fall in loans to affiliates that were used for lending to the nonbank sector. Claims on (nonaffiliated) banks have so far fallen mostly in Europe, but not much in other regions. Claims on the public sector have fallen significantly in emerging Europe and Latin America.

Figure 2.SF.2. Regional Exposure to Banks' Foreign Claims¹

The regions most exposed to foreign claims from euro area banks are other advanced Europe and emerging Europe. This is true even if affiliates' claims funded with local deposits (which are less likely to be withdrawn) are ignored or if differences in financial deepening across regions are taken into account. Total foreign exposures show a much higher potential for broader vulnerability, especially in other advanced Europe, advanced Asia, and North America.



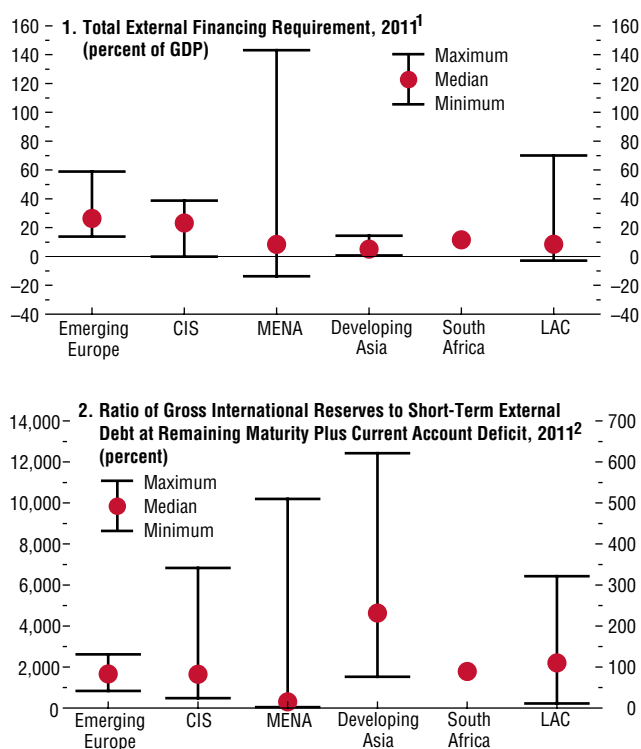
Sources: Bank for International Settlements (BIS); Cerutti, Claessens, and McGuire (2011); and IMF staff estimates.

¹Advanced Asia (Adv. Asia): Australia, Hong Kong SAR, Japan, Korea, New Zealand, Singapore, Taiwan Province of China; CIS: Commonwealth of Independent States; Dev. Asia: developing Asia; Em. Eur.: emerging Europe; LAC: Latin America and the Caribbean; MENA: Middle East and North Africa; Other advanced Europe (Oth. adv. Eur.): Czech Republic, Denmark, Iceland, Israel, Norway, Sweden, Switzerland, United Kingdom; SSA: sub-Saharan Africa.

²Adjusted borrowers' exposure to BIS-reporting banks is defined as the sum of cross-border claims, off-balance-sheet credit commitments, and affiliate claims not funded through local deposits. See Cerutti, Claessens, and McGuire (2011). Countries under market pressure: Belgium, Greece, Ireland, Italy, Portugal, Spain.

Figure 2.SF.3. Regional Vulnerabilities

Emerging Europe and the Commonwealth of Independent States (CIS) also have broader external vulnerabilities, which could make them more vulnerable should global risk aversion rise significantly.



Source: IMF staff calculations.

¹ CIS: Commonwealth of Independent States. MENA: Middle East and North Africa. LAC: Latin America and the Caribbean.

² MENA on left scale; others on right scale.

area banks tightened lending standards strongly during the third and fourth quarters of 2011, reflecting difficult access to market funding as well as weaker economic activity. And expectations are for further tightening in early 2012.

General lending conditions in the various regions (including domestic banks' deleveraging) deteriorated significantly in emerging markets during the third and fourth quarters of 2011. The strongest declines were in emerging Europe, Africa, and the Middle East. Data on growth of real credit to the private sector do not yet show a significant change in trend, but there is a lag in recording these data.²¹ The deterioration in international market funding conditions was a major reason for the tightening, and a majority of respondents in all regions attributed the tightening at least in part to financial strains in the euro area.²² Some tightening was also observed in the major advanced economies (Japan, United Kingdom, United States). U.S. dollar funding pressures had been building since the summer, but when six major central banks decided in November to lower the interest rate on dollar swap lines and extend the swap facilities until February 1, 2013, it provided some relief. In the wake of events in the euro area, credit default swap (CDS) spreads of banks around the world also rose in fall 2011, though they have eased somewhat recently.

There were also indications of pressure in trade finance, though it appears manageable so far. Trade finance surveys indicate deterioration in supply conditions as a result of financial constraints (less credit or liquidity available at counterparty banks and less credit from international financial institutions), reflecting at least in part euro area bank deleveraging.²³ But so far the impact has been more on pricing than on volume because other banks have stepped in to fill the gap.²⁴

²¹Credit growth remains high in most emerging markets (with the exception of the MENA and SSA regions) and weak or negative in most advanced regions (with the exception of other advanced Asia).

²²Institute of International Finance Survey of Emerging Markets Bank Lending Conditions.

²³Institute of International Finance Survey of Emerging Markets Bank Lending Conditions and ICC-IMF Market Snapshot, January 2012.

²⁴There is also more concern about long-term trade and project financing, for which the syndication market has shut down. It is

Finally, issuances in bond and equity markets—an alternative to bank credit—had been weakening across the board, but the most recent data on fund flows to emerging markets show strong inflows of late, signaling that global risk aversion may have decreased (see Chapter 1).

How Much Impact on Growth?

The impact of bank credit reduction on growth depends on several factors: (1) the extent to which other sources of funding can replace bank credit, (2) the evolution of the demand for credit, and (3) various regions' policy room to react to funding tightening. As for substitution of bank credit with other funding, although a full offset is unlikely (see above), other sources of funding could substantially close the gap. In many countries, domestic financial systems appear on average well capitalized and may have the potential to fill gaps.²⁵ In general, countries with strong domestic growth may be in a better position to substitute funding thanks to healthy banking and corporate sectors. Bond and equity markets could substitute for bank loans in advanced economies, but in emerging markets, these are still small relative to the size of the economy. The offsetting potential will depend greatly on global risk aversion. If euro area bank deleveraging were to cause a substantial rise in global risk aversion, a broader retrenchment of all sources of funding is likely.

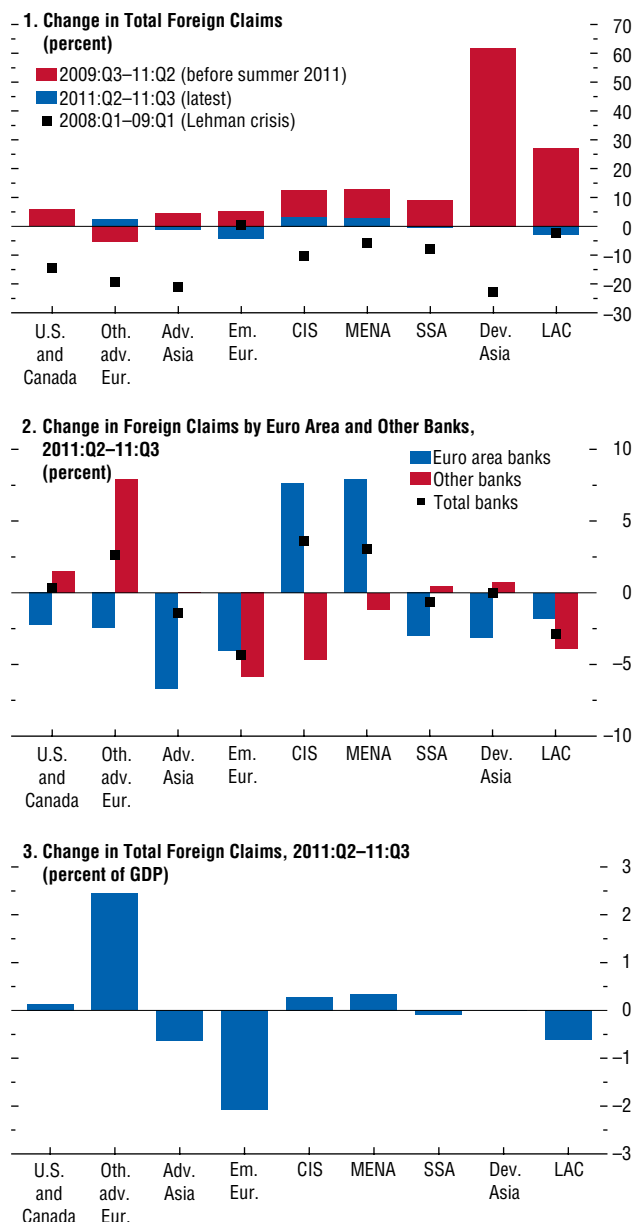
The growth impact of bank deleveraging also depends on credit demand. For instance, if overly indebted households or firms are trying to repair their balance sheets, bank deleveraging will not be as binding and may not add to deterioration in growth beyond what is reflected in falling credit demand. Weakening credit demand in some of the

hard for new entrants to step in owing to the complex nature of the contracts.

²⁵Banks appear well capitalized on average in most regions, with regulatory Tier 1 capital to risk-weighted assets well above 9 percent, a high return to equity (except in the United States and the United Kingdom), and low numbers of nonperforming loans (except in emerging Europe and some CIS economies). This does not preclude risks of financial instability, however. As we have learned from the crisis, a handful of financial institutions can bring down the whole financial system, even if the financial system is sound and healthy on average.

Figure 2.SF.4. Evolution of Banks' Adjusted Foreign Claims over Time¹

Since June 2011, there has been a retrenchment of global foreign claims affecting several emerging markets but also advanced Asia. In addition to reductions in euro area bank claims, several emerging markets have suffered outflows of funding from non-euro-area banks, while advanced economies have seen inflows of non-euro-area funding.



Sources: Bank for International Settlements (BIS); and IMF staff estimates.
¹Based on BIS consolidated foreign claims at ultimate risk basis, adjusted for the exchange rate and breaks in series (Cerutti, 2012). Advanced Asia (Adv. Asia): Australia, Hong Kong SAR, Japan, Korea, New Zealand, Singapore, Taiwan Province of China; CIS: Commonwealth of Independent States; Dev. Asia: developing Asia; Em. Eur.: emerging Europe; LAC: Latin America and the Caribbean; MENA: Middle East and North Africa; Other advanced Europe (Oth. adv. Eur.): Czech Republic, Denmark, Iceland, Israel, Norway, Sweden, Switzerland, United Kingdom; SSA: sub-Saharan Africa.

most exposed regions, such as emerging Europe and some advanced economies (euro area, Japan, United Kingdom, United States) may thus mitigate harm to growth caused by a reduction in credit. In other emerging markets, especially Asia and Latin America, credit demand is holding up well, but strong economic growth may generate additional sources of financing that can substitute for bank lending.

Finally, in countries where there is enough policy room, policymakers may be able to offset some of the impact of deleveraging by relaxing fiscal or monetary policy. Compared with 2007, the fiscal position of most regions, measured by the fiscal balance and public debt, has deteriorated substantially, especially in advanced economies. Debt levels and deficits remain more moderate in emerging markets on average, but some economies (for example, in emerging Europe and the CIS) lack fiscal room and may actually have to tighten fiscal policy in case of a renewed downturn due to fiscal financing pressures. Advanced economies (euro area, Japan, United Kingdom, United States) already have very low interest rates and are close to or have hit the zero-bound constraint to easing monetary policy. Room for monetary easing could also be constrained in some emerging market economies facing inflation pressure (India, Indonesia, Korea) or still working through the previous credit expansion is still being worked through (China). However, in these economies less credit would help reduce overheating pressures.

Simulations of Deleveraging Effects

To illustrate the potential impact of bank deleveraging on growth in the various regions of the world, we use the baseline European bank deleveraging scenario explained in the *Global Financial Stability Report*. This scenario features (1) funding pressures partly offset by the ECB's two LTROs; (2) a 9 percent core Tier 1 ratio by June 2012; (3) announced deleveraging plans; (4) progress toward the net stable funding ratio imposed by Basel III; and (5) a home bias—that is, banks deleverage first outside the European Union, next in the European Union but not in the home country, and finally in the home country. In this scenario, more than 50 percent of the reduction in the amount of credit by euro area

banks takes place outside the euro area, and outside the euro area the largest declines in percent of GDP are in the group that includes emerging Europe, the CIS, and other developing economies (specifically, the MENA and SSA regions) (Figure 2.SF.5). These amounts of deleveraging are relative to a scenario without deleveraging. Some deleveraging was likely already planned by banks before September 2011, consistent with the IMF staff's sluggish growth projections; some was likely triggered by developments since September.

The impact of deleveraging is simulated using the IMF's Global Economy Model, a quarterly, multiregion dynamic stochastic general equilibrium model. In this simulation, the reduction in regional bank credit calculated in the *Global Financial Stability Report* scenario is calibrated through an increase in the region's corporate spread.²⁶ It should be noted that there are some limitations to the model simulations, which suggests that the estimates probably represent upper bounds of the likely effects on economic growth of the change in credit supply: (1) The model does not incorporate offsets from other sources of funding, including domestic banks. (2) The simulations cannot distinguish credit supply from credit demand; hence, they may be overestimating the impact of the change in credit supply in some regions. (3) The response of monetary policy in the euro area, Japan, and the United States is constrained by the zero bound on nominal interest rates and does not take into account the possibility of further quantitative easing under a downside scenario. The largest effect of deleveraging is in the euro area, with growth reductions of 0.9 and 0.6 percentage point, respectively, in 2012 and 2013. Outside the euro area, the United States, Japan, emerging Asia, and Latin America are only slightly affected, largely through

²⁶The model is calibrated to reflect existing estimates, suggesting that a 1 percent reduction in credit reduces growth by about 0.35 percentage point. Estimates are for the euro area, emerging Europe, and the United States, but a similar coefficient is used for all the regions. An important assumption behind the simulations is that the response of monetary policy to the slowdown in the euro area, Japan, and the United States is constrained by the zero bound on nominal interest rates. The zero-bound constraint on nominal interest rates is particularly damaging for growth in the United States (relative to Japan or the euro area) because of high price flexibility: the decline in prices from lower activity pushes real interest rates higher, further dampening activity.

lower exports as a result of reduced euro area growth. Growth in other economies (which includes emerging Europe, CIS, and the MENA and SSA regions) is more affected, especially in 2012 (by about 0.8 percentage point). The model does not provide separate estimates for emerging Europe, but regression estimates suggest that the growth effect of deleveraging could also be 0.7 percentage point.²⁷ Thus, overall, the growth impact of euro area bank deleveraging would be relatively moderate, except in Europe.

Policy Implications

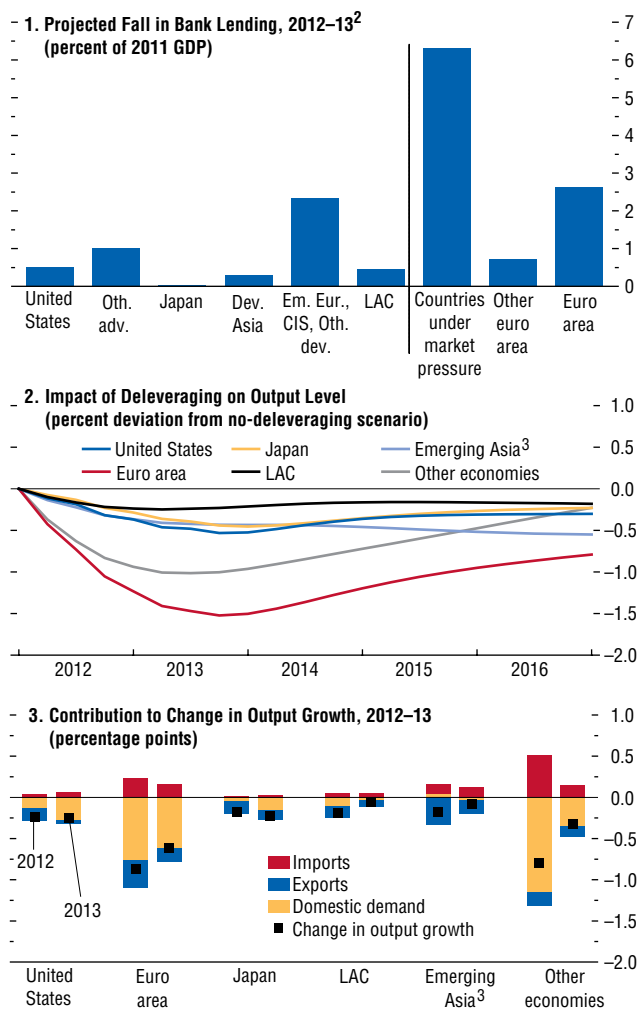
Policymakers are taking action to mitigate the expected impact of deleveraging by euro area banks and should be prepared to do more if needed, both in the euro area and in the rest of the world. For the euro area, continued provision by the ECB of ample liquidity at short and longer maturities is the key to smooth deleveraging. Given the currently very unfavorable market conditions for raising private capital, increased public funding to inject capital into banks would reduce the risk of a credit crunch. Making the European Financial Stability Facility more attractive and effective for bank recapitalization and ensuring that it is adequately funded would be especially helpful for economies subject to market pressures, but could also give other economies a leg up (reflecting highly linked financial systems and real economies in the euro area). If the 9 percent core Tier 1 capital ratio appears to be triggering swift deleveraging, it may be necessary to give banks more flexibility to reconstitute their capital buffers.

Policymakers in the rest of the world should be prepared to mitigate the impact of euro area bank deleveraging on growth through fiscal and monetary easing—provided there is enough policy room. Policymakers should also be ready to back-stop liquidity in their banking systems should the need arise. Options range from swap lines with the Federal Reserve to alleviate dollar shortages for countries that currently do not have them to regional pooling arrangements, drawing down the

²⁷The estimated regressions are from Chapter 4 of the October 2011 *Regional Economic Outlook: Europe*.

Figure 2.SF.5. Potential Impact of European Bank Deleveraging on Growth¹

The impact of deleveraging on growth absent any significant rise in global risk aversion is very moderate, except in the euro area countries under market pressure and in the group of other economies (which includes CIS, emerging Europe, MENA, and SSA). Some of this deleveraging was already planned and ongoing before the fall of 2011. These are upper-bound estimates. Indeed, the model does not account for the fact that other sources of funding, including domestic banks in some non-euro-area countries, are providing some offset; it does not distinguish credit supply from credit demand; and advanced economies could engage in further unconventional monetary easing if growth weakens.



Source: IMF staff estimates.

¹Based on the *GFSR* baseline scenario of European bank deleveraging.

²The projected fall in bank lending supply is from the 58 EU banks in the *GFSR* bank deleveraging exercise (baseline scenario). For the euro area, and for four of the economies included in the other advanced group (Czech Republic, Denmark, Sweden, United Kingdom), it also includes the projected fall in bank lending supply from other domestic banks in the economy. CIS: Commonwealth of Independent States; Countries under market pressure: Greece, Ireland, Italy, Portugal, Spain; Dev. Asia: developing Asia; Em. Eur.: emerging Europe; LAC: Latin America and the Caribbean; Other advanced (Oth. adv.): Australia, Canada, Czech Republic, Denmark, Hong Kong SAR, Iceland, Israel, Korea, New Zealand, Norway, Singapore, Sweden, Switzerland, Taiwan Province of China, United Kingdom; Other developing (Oth. dev.): Middle East and North Africa and sub-Saharan Africa; Other euro area: Austria, Belgium, Cyprus, Estonia, Finland, France, Germany, Luxembourg, Malta, Netherlands, Slovak Republic, Slovenia.

³Emerging Asia: developing Asia and Hong Kong SAR, Korea, Singapore, and Taiwan Province of China.

large stock of foreign reserves (in some economies), and enhanced deposit guarantees. Thinly capitalized banks should be directed to increase their capital buffers. Finally, policymakers should ensure that the supply of credit is maintained for credit-

rationed agents (small and medium-size firms, households) and for trade financing, possibly stepping in through government programs if needed, without creating distortions in the allocation of credit.

Box 2.1. East-West Linkages and Spillovers in Europe

Regional economic and financial integration between western and eastern Europe has advanced rapidly since the fall of the Iron Curtain.¹ As a result, regional spillovers have also increased. They were prominent during the 2008–09 crisis and again in fall 2011, when the euro area crisis escalated. This box reviews recent developments in integration and analyzes spillovers between western and eastern Europe.

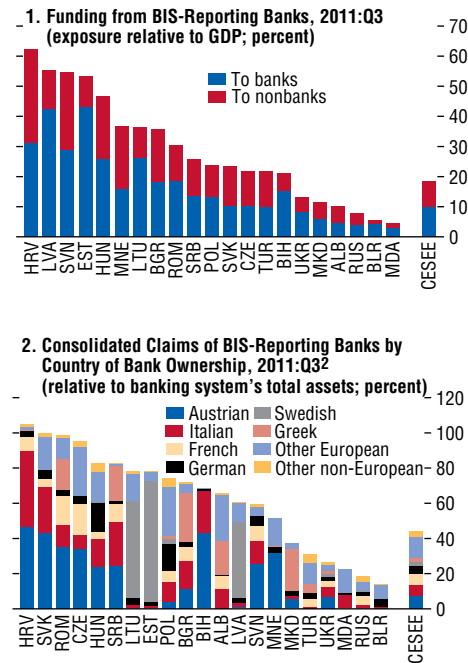
Regional economic and financial integration between western and eastern Europe has increased in many areas. Two prominent features are banking sector integration and the buildup of production chains within the context of greater general trade integration.

- The financial sector in eastern Europe has become closely integrated with the banking sector in western Europe through both ownership and financing. Much of the banking system in the region is now owned by banks in western Europe, particularly parent banks headquartered in Austria, France, and Italy. During the precrisis boom years, parent banks increased both financing to their subsidiaries and direct cross-border lending to nonbanks. As a result, banks reporting to the Bank for International Settlements (BIS), most of which are headquartered in western Europe, now have a significant market share in eastern Europe. Their assets account for more than half of total assets in the banking system in a number of economies (Figure 2.1.1).
- Trade integration has grown rapidly. For western Europe, eastern Europe is the most dynamic export market, with exports increasing from slightly less than 1 percent of GDP in 1995 to about 3¼ percent in 2010. They are now higher than those to Asia or the Western Hemisphere. Conversely, western Europe is eastern Europe's largest export market, with exports to that destination accounting for about 15 percent of the region's GDP.

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¹In this box “eastern Europe” refers to countries in central, eastern, and southeastern Europe (CESEE); “western Europe” refers to the euro area, Denmark, Iceland, Norway, Sweden, Switzerland, and the United Kingdom.

Figure 2.1.1. Eastern Europe: Financial Linkages with Western Europe¹



Sources: Bank for International Settlements (BIS) Locational and Consolidated Banking Statistics (Tables 6A, 6B, 9B); and IMF staff calculations.

¹ALB: Albania; BGR: Bulgaria; BLR: Belarus; BIH: Bosnia and Herzegovina; CESEE: Central, eastern, and southeastern Europe; CZE: Czech Republic; EST: Estonia; HRV: Croatia; HUN: Hungary; LTU: Lithuania; LVA: Latvia; MDA: Moldova; MKD: former Yugoslav Republic of Macedonia; MNE: Montenegro; POL: Poland; ROM: Romania; RUS: Russia; SRB: Serbia; SVK: Slovak Republic; SVN: Slovenia; TUR: Turkey; UKR: Ukraine.

²The bottom figure is constructed using BIS consolidated banking statistics, which show the stock of gross assets owned by BIS-reporting banks in each CESEE country. These assets may be funded domestically (for example, through domestic deposits), through parent banks, or through the international wholesale market. Although in many CESEE countries financial integration with western Europe is also visible through the high volume of funding from parent banks, in some other countries (for example, Czech Republic, Slovak Republic) domestic banking systems are mostly domestically financed even though they are owned mostly by western European banking groups.

- Cross-border production chains have multiplied, especially in the automobile sector. German firms in particular have relocated some of their production to the region. Within these produc-

Box 2.1. (continued)

tion chains, eastern European economies have specialized in final assembly, while core components are produced in western Europe. The stock of foreign direct investment in the region is about 42 percent of GDP on average, most of it owned by firms in western Europe.

Within these broad trends, the degree of integration varies across countries. Central Europe and the Baltics are the most intertwined with western Europe. Southeastern Europe is less integrated. It has fewer cross-border production chains and less trade with western Europe.

Growth, Trade, and Financial Spillovers

Given the tight linkages, it has long been recognized that shocks originating in western Europe can affect eastern Europe's economies. But reverse spillovers can also be important. Germany's export growth during the precrisis years was boosted by strong demand from eastern Europe, while the sharp contraction in eastern Europe in 2009 exacerbated the German downturn.² In financial markets, increases in credit default swap (CDS) spreads of Austrian parent banks in early 2009 partly reflected their exposure to the crisis in some eastern European countries.

A variety of empirical models confirms that growth and trade spillovers are quantitatively important, with a shock in western Europe affecting eastern Europe as much as one for one.³ In particular, a vector autoregression model, which implicitly involves spillovers through many channels of transmission, suggests even larger spillover effects. A shock to growth in western Europe has a one-for-one effect on growth in eastern Europe. In contrast, a growth shock in eastern Europe has no significant effect on growth in western Europe. However, the effects of a shock emanating from central Europe on

growth in western Europe are statistically significant, with spillover magnitudes of about one-third.

Models also confirm that financial spillovers matter, with funding from western European parent banks strongly affecting credit and domestic demand growth in eastern Europe. The financing provided by western European banks added 1½ percentage points to eastern Europe's annual GDP growth during 2003–08, when annual average growth was 6½ percent. Financial and trade spillovers also interact because shocks to financial flows from western Europe to eastern Europe are soon felt in trade flows. An estimated 57 cents of each euro of bank financing from western Europe ended up being spent on imports from that region.

Spillovers from the Euro Area Crisis

Until early fall 2011, there had been little impact of the euro area crisis on eastern Europe. While CDS spreads in the euro area periphery rose steadily, those in eastern Europe remained flat or declined, as the region recovered from the deep recession of 2008–09.

The picture changed when the euro area crisis intensified late last year. East-West banking linkages proved to be an important channel of transmission. CDS spreads widened for large western European banks, reflecting their significant funding pressure. These, in turn, triggered sizable balance sheet deleveraging, including of assets in eastern Europe. BIS locational statistics show that western European banks' exposure to the region declined by almost 5 percent in the third quarter of 2011, the biggest quarterly decline since the 2008–09 crisis. Financial market spillovers also mattered. Sovereign CDS spreads in the region increased—the magnitude of the increases varied with underlying vulnerability, with those on Hungarian bonds particularly large—and currencies came under pressure.

Reflecting these spillovers, and notwithstanding improved euro area sentiment, growth in eastern Europe is expected to slow sharply this year, and downside risks are significant. This outlook highlights how greater economic and financial integration and the potential for greater cross-border spillovers have raised new policy challenges

²During 2003–08, German exports to central, eastern, and southeastern Europe grew by 16 percent annually in real terms, raising total export growth 6½ percent to 8¼ percent; in 2009, they dropped by 26 percent, which worsened the contraction of Germany's exports from 12¼ to 16¼ percent.

³The models are described in Chapter 4 of the October 2011 *Regional Economic Outlook: Europe*.

Box 2.1. (continued)

for eastern European economies. A key concern is that funding from foreign parent banks could be constrained for some time. Measures to support bank financing from domestic sources, including the domestic deposit base, could help to enable appropriate business and consumer credit expansion. Adequate liquidity and solvency of the domestic banking sector will play an important role in supporting depositors' confidence, as will policies geared toward lowering macroeconomic imbalances

and vulnerability. Compared with 2008, some areas of vulnerability are lower. High current account deficits are no longer an issue in most economies. But in other areas vulnerability is still high—external debt in many economies is still large, and foreign currency balance sheet exposure remains a problem. In addition, a number of new weaknesses have emerged—including a high number of nonperforming loans and large fiscal deficits—which have only been partially addressed.

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