The State of the World Economy

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November 4, 2010
Rebalancing and Recovery

- A (now) old theme: A strong recovery requires two rebalancing acts.
  - Internal: From public to private demand
  - External: From surplus to deficit countries

- Rebalancing happening slowly.
  - Private demand in Advanced Economies is weak
  - External rebalancing is slow
  - Limiting fiscal consolidation

- A weak recovery in Advanced Economies, stronger in Emerging Economies. Tensions: Capital flows, currency wars?
Limited Internal and External Rebalancing

U.S. Real GDP Growth Contributions
(percentage; qoq saar)

China Real GDP Growth Contributions
(percentage; yoy)

Sources: Haver Analytics; and IMF, World Economic Outlook.
1/ IMF staff estimates (not official data).
## WEO Real GDP Growth Projections

*(percent change from a year earlier)*

<table>
<thead>
<tr>
<th></th>
<th>U.S.</th>
<th>Euro Area</th>
<th>Japan</th>
<th>Brazil</th>
<th>Russia</th>
<th>China</th>
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</thead>
<tbody>
<tr>
<td><strong>2010 (Oct. 2010)</strong></td>
<td>2.6</td>
<td>1.7</td>
<td>2.8</td>
<td>7.5</td>
<td>4.0</td>
<td>10.5</td>
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<td><strong>2010 (Jul. 2010)</strong></td>
<td>3.3</td>
<td>1.0</td>
<td>2.4</td>
<td>7.1</td>
<td>4.3</td>
<td>10.5</td>
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<tr>
<td><strong>2010 (Jan. 2010)</strong></td>
<td>2.7</td>
<td>1.0</td>
<td>1.7</td>
<td>4.7</td>
<td>3.6</td>
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<td>2.9</td>
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<td>4.2</td>
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</tbody>
</table>

Source: IMF, World Economic Outlook.
Prospects for a Double Dip?

Prospects for GDP Growth
(annual percent change)

Sources: IMF, World Economic Outlook and staff estimates.
United States: Uncertainty

- Saving behavior of U.S. consumers.
- Poor prospects of residential investment.
- Non residential investment. Profits or sales?
Uncertainty about U.S. Saving

U.S. Household Saving Ratio
(percent of disposable income)

Prospects for U.S. Housing Investment

U.S. Housing Inventories and Foreclosures
(millions of units)

Sources: MCM staff estimates, Haver Analytics.
1/ Data from Zillow.com.
Corporate Net Cash Flows

Corporate Spreads and Rates

Average Q and Capital Stock

1. Corporate net cash flows (percent of nominal GDP)
2. NBER Recessions

Uncertainty Index

Uncertainty about U.S. Investment

Equipment and Software Investment
(percent change, yoy)


1/ Accelerator Large VAR, Accelerator WEO, VECM1, and Tobin's Q models.
2/ Minimum and maximum values across the four forecasting models.
U.S. Recovery? Output versus Employment

U.S. Nonfarm Employment during Recessions

(percent change from start of each recession; months from peak on x-axis)

U.S. Long-Term Unemployment

(percent of total)

Europe: Mixed News


- The mechanisms in place. Collateral at ECB. EFSF and Standbys for new issues if needed.

- Real: Better than forecast, in particular in Germany. A new German expansion?
Europe: Sovereign and Financial Risks

DOMESTIC

SOVEREIGN

E. Similar sovereigns come under pressure

B. Increase in bank funding costs

C. Erosion in potential for official support

A. Mark-to-market fall in value of govt bonds held by local banks

I. Increase in contingent liabilities of govt.

FOREIGN

SOVEREIGN

I. Increase in contingent liabilities of govt.

D. Mark-to-market fall in value of govt. bonds held by foreign banks

F. Contagion channels (A, B, & C as above)

G. Rise in counter-party credit risk

H. Withdrawal of funding for risky banks

BANKS
Sovereign and Financial Spreads

Change in Sovereign and Financial CDS Spreads
End-September 2009 to September 2010
(percent)

Average percent change in local senior financial CDS

Percent change in sovereign CDS

Greece
Portugal
Italy
Spain
Belgium
France
Ireland
U.K.
U.S.
Japan
Is Germany Getting Ahead?

Euro Area Real GDP Growth Contributions
(percent; qoq saar)

Germany Real GDP Growth Contributions
(percent; qoq saar)

Source: IMF, World Economic Outlook.
Fiscal Consolidation: At What Pace?

Fund line:

- Medium-term credible plan for debt stabilization. Use rules, increased age of retirement, replacement rules...
- Then, have more room for profile of adjustment. Variation across countries.
- Current plans broadly appropriate given forecasts. Adjustment if things turn out worse.
- Actual state of play. Not enough on MT anchoring.
The Pace of Fiscal Consolidation

Projected Change in Cyclically Adjusted Primary Balances
(percent of potential GDP)

Source: IMF staff estimates based on 2010 October WEO.
1/ In percent of GDP; distance from yellow bar reflects required additional fiscal adjustment relative to 2010-13; adjustment to be sustained between 2020-30 to reduce public debt to prudent levels.
2/ Structural primary balance.
3/ Excluding financial sector support recorded above the line.
Emerging Market Economies

- Need to rebalance towards domestic demand.
  - Short term: To compensate for lower exports.
  - Medium term: To increase consumption and investment.

- Face large capital flows (with volatility). Largely fundamentals. Partly interest rate/carry trade.

- Not yet at 2007 levels. More portfolio rather than bank flows. Likely to increase over time.

The Decrease in China’s Trade Surplus

China Trade Balance with Deficit and Surplus Partner Countries 1/
(billions of U.S. dollars)

Exports
Imports

Surplus Partner Countries, Asia
Surplus Partner Countries, non-Asia
Deficit Partner Countries
Merchandise Trade Balance

Source: IMF, Direction of Trade Statistics (DOTS).
1/ Designation of surplus or deficit partner countries based on average current account balance between 2001 and 2008 applied to DOTS partner groups.
Increasing Capital Flows

Net Monthly Flows to Emerging Market Equity Funds (billions of U.S. dollars)

Net Monthly Flows to Emerging Market Bond Funds (billions of U.S. dollars)
Appreciation versus Reserve accumulation

Foreign Reserves and Real Effective Exchange Rate
*(change from end-June 2009 until end-June 2010)*

Change in Real Effective Exchange Rate (percent)

The size of the bubble corresponds to total reserves minus gold

Change in Reserves (percent of GDP)

23 Foreign Reserves and Real Effective Exchange Rate (change from end-June 2009 until end-June 2010)
Not Only EMs. Risk Aversion, Appreciation, and Reserve Accumulation in Switzerland.
International Reserves
(billions of U.S. dollars)

Source: IMF staff estimates.
Currency Wars?

- External rebalancing is needed. Simulation.

- Capital flows and appreciation are part of the adjustment process.

- Capital flows/appreciation can be excessive. Irrational investors, disruptions from fast adjustments in e, inability of domestic financial system to absorb large flows.

- Slow adjustment of e, carry trade and capital flows.

- What if one country pegs?

- Policy implications
  - Use of macro prudential tools/capital controls
  - Limits on quantitative easing.
How Much Can External Rebalancing Help?

Real GDP
(percent deviation from baseline)

- Increase in US Saving Rate 1/
- Increase in US Saving Rate and Decrease in Emerging Asia Saving Rate 1/
- Increase in US Saving Rate and Real Exchange Rate in Emerging Asia 2/

1/ Limited exchange rate flexibility (crawling peg) in Emerging Asia.
2/ Floating exchange rate in Emerging Asia, following large initial appreciation.
Policy Challenges

Key directions:

- Financial repairs and reforms (to sustain private domestic demand in Advanced Economies, and reduce downside risks).

- Fiscal consolidation in Advanced Economies (to reduce fiscal stimulus as private demand increases).

- Rebalancing towards domestic demand in Emerging Economies. Managing the "currency wars."
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