The World Economy: How Did We Get Here and Where Are We Going?

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International Monetary Fund

Presentation at the London School of Economics
October 26, 2011
### A Sharp Decrease in Growth

#### WEO Real GDP Growth Projections
*(percent change from a year earlier)*

<table>
<thead>
<tr>
<th></th>
<th>2011 (Sep 2011)</th>
<th>2011 (Apr 2011)</th>
<th>2012 (Sep 2011)</th>
<th>2012 (Apr 2011)</th>
</tr>
</thead>
<tbody>
<tr>
<td>World</td>
<td>4.0</td>
<td>4.4</td>
<td>4.0</td>
<td>4.5</td>
</tr>
<tr>
<td>U.S.</td>
<td>1.5</td>
<td>2.8</td>
<td>1.8</td>
<td>2.9</td>
</tr>
<tr>
<td>Euro Area</td>
<td>1.6</td>
<td>1.6</td>
<td>1.1</td>
<td>1.8</td>
</tr>
<tr>
<td>Japan</td>
<td>-0.5</td>
<td>1.4</td>
<td>2.3</td>
<td>2.1</td>
</tr>
<tr>
<td>Brazil</td>
<td>3.8</td>
<td>4.5</td>
<td>3.6</td>
<td>4.1</td>
</tr>
<tr>
<td>Russia</td>
<td>4.3</td>
<td>4.8</td>
<td>4.1</td>
<td>4.5</td>
</tr>
<tr>
<td>India</td>
<td>7.8</td>
<td>8.2</td>
<td>7.5</td>
<td>7.8</td>
</tr>
<tr>
<td>China</td>
<td>9.5</td>
<td>9.6</td>
<td>9.0</td>
<td>9.5</td>
</tr>
</tbody>
</table>

Source: IMF, *World Economic Outlook.*
The Confluence of Two Factors

- Slower Underlying Growth: Balance sheet repairs.
- A Crisis of Confidence: Political uncertainty, and fiscal/financial interactions.
- Interacting in Bad Ways: This is where the risks are.
Why the Slowdown?

Crisis of Confidence

Risks

Policies
Why the Slow Down?

Failure of internal rebalancing: Balance sheet repairs at work.

- Fiscal consolidation.
- Weak domestic private demand.

External rebalancing has stalled.
Fiscal Consolidation: Proceeding, But a Long Way to Go

Change in Cyclically-Adjusted Primary Balances
(percent of GDP)

- Total required adjustment by 2020 1/

Greece
Ireland
Portugal
Spain
Italy
Japan
U.S.
U.K.
France
Canada
Germany

Source: IMF staff estimates.

1/ Total required adjustment to reduce the gross debt ratio to 60 percent by 2030 (net debt target of 80 percent for Japan). After 2020, the primary balance must be maintained constant at the prevailing level until 2030.
Fiscal Consolidation: Proceeding, But a Long Way to Go

Change in Cyclically-Adjusted Primary Balances
(percent of GDP)

- Projected adjustment (2010–15)
- Remaining adjustment until 2020 to achieve illustrative debt targets 1/

Source: IMF staff estimates.

1/ Total required adjustment to reduce the gross debt ratio to 60 percent by 2030 (net debt target of 80 percent for Japan). After 2020, the primary balance must be maintained constant at the prevailing level until 2030.
Change in Cyclically-Adjusted Primary Balances (percent of GDP)

Projected adjustment (2010–11)

Greece

Ireland

Portugal

Spain

Italy

Japan

U.S.

U.K.

France

Canada

Germany

Source: IMF staff estimates.
1/ Total required adjustment to reduce the gross debt ratio to 60 percent by 2030 (net debt target of 80 percent for Japan). After 2020, the primary balance must be maintained constant at the prevailing level until 2030.
Low Private Domestic Demand: Mechanical Brakes or Animal Spirits?

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

- Delinquencies and Foreclosures
- Actual Inventories
- Underwater Mortgages 1/

U.S. Expected Change in Income and Wages 2/ 3/
(percent; median; 3-month moving average)

Sources: University of Michigan, Survey of Consumers; New York Federal Reserve–ALP Panel; and IMF staff estimates.
1/ Data from Zillow.com (single-family homes with mortgages in negative equity).
2/ Shaded bars indicate NBER-dated recessions.
3/ Median of point forecasts for year-ahead wage growth.
External Rebalancing Has Stalled

Global Imbalances 1/
(current account; percent of world GDP)

Sources: IMF, *World Economic Outlook*; and IMF staff estimates.
1/ CEE = Central European Economies; GIPS = Greece, Italy, Portugal, and Spain; ROW = Rest of World; EMA = Emerging Asia; OIL = Oil-exporting countries.
Why the Slowdown?

Crisis of Confidence

Risks

Policies
Global Financial Stability Is Worsening

Credit Strain and Market & Liquidity Strain Indicators

Risk Appetite

Source: IMF staff estimates.
Prompting a Flight to Safe Assets

Asset Price Performance since April GFSR (percent)

- Italian
- Greek
- WESovereign
- Spanish
- Irish
- Greek
- Italian
- French
- Spanish
- US
- Oil
- Commodities
- Vix (inverted)
- Eurofirst 300
- EM Equities
- S&P 500
- Swiss Franc
- 10-year bund
- 10-year treasury
- Gold
Sovereign Spillovers to the EU Banking System

Cumulative Spillovers from High-Spread Euro Area Sovereigns, 2010 Till Now
(billions of euros)

Spillovers from . . .

- €60: Greek sovereign
- €80: Irish & Portuguese sovereign
- €200: Belgian, Spanish & Italian sovereign
- €300: High-spread euro area banking sector
EU Bank Capital: Current Situation

Core Tier 1 Ratios
(percent of risk-weighted assets)

Sources: European Banking Authority; and IMF staff estimates.
Note: Includes core Tier 1 capital at end-2010, actual equity raising from January to April 2011, and commitments made by April 2011 for equity raisings and government support.
EU Bank Capital: Current Situation

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Capital Flows to EMs: Volatility Dominates
(billions of U.S. dollars; weekly flows)

Bond Funds

- QE2 (Nov. 3)
- S&P downgrade (Aug. 5)

Equity Funds

- QE2 (Nov. 3)
- S&P downgrade (Aug. 5)

Source: EPFR Global.
Rapid Credit Growth Can Lead to Rising Nonperforming Loans in EMs

Credit and GDP Growth (cumulative percent change; 2005 – 2010)

Predicted NPL Ratios in 2011 and 2012 (percent, no shock)

Sources: IMF, Global Data Source; IMF, International Financial Statistics; and IMF staff estimates.
Why the Slowdown?

Risks

Crisis of Confidence

Policies
Risks – Adverse Feedback Loops

Lower growth

Fiscal
- Automatic stabilizers held back
- Worsen fiscal balance
- Higher guarantees
- Sovereign risks increase

Financial
- Lower bank asset quality
- Less bank lending

Sovereign risks increase

Worsen fiscal balance

Lower bank asset quality

Less bank lending

Automatic stabilizers held back

Higher guarantees

Sovereign risks increase
Risks – Adverse Feedback Loops

Lower growth

Automatic stabilizers held back

Worsen fiscal balance

Lower bank asset quality

Less bank lending

Fiscal Too Loose

Higher guarantees

Sovereign risks increase

Financial
World Economy Facing Severe Downside Risks

A Global “Paradox of Thrift”

- Households, firms, and governments reduce demand, with many advanced economies unable to lower policy rates further.

Household and Public Debt Sustainability in the U.S.

- Continued low growth without fiscal consolidation could raise risk premia and U.S. bond yields, with adverse effects on public debt sustainability.

Sovereign Debt and Funding Pressures in Euro area

- Funding costs and low growth risk undermining fiscal sustainability and raise already high pressure on banks. Wholesale funding markets and deleveraging could trigger further large spillovers to real economy.
High unemployment with Limited Policy Space

Unemployment Rate
(percent; weighted by labor force)

Source: IMF, Global Data Source.
Declining Share of Labor in Income likely to Persist

Source: OECD.

Note: Left-hand panel reports mean and inter-quartile range for all advanced economies. Right-hand panel shows country-specific data for seven selected economies.
Against a Backdrop of High Income Inequality in Many Countries


1 GINI coefficient is a measure of income inequality, with a lower value associated with higher income equality.
2 Most recent data available.
Why the Slowdown?  Crisis of Confidence

Risks  Policies
Need for Collective Action

To Preserve Stability and Sustainable Global Growth

Restoring Confidence
- Global economy entering a danger zone
- Decisive action needed to safeguard stability and prevent a crisis from deepening

Sustainable and Balanced Growth
- Path to recovery has narrowed but still within reach
- Medium-term consolidation, structural reform, and rebalancing are necessary complements to short-term action

Urgent and Collaborative Action Required
## Sovereign Balance Sheet Repair

### Principles
- Credible medium-term plans and frameworks
- No one-size-fits-all: size and speed of adjustment varies

### Achieving Credibility
- Entitlement reforms necessary, not sufficient
- Well-designed rules and institutions key
- But no substitute for political will

### Concretely
- For most, plans and frameworks help afford greater flexibility through more “back-loaded” timing
- For most, let automatic stabilizers operate
### Monetary Policy

<table>
<thead>
<tr>
<th>Advanced Economies</th>
<th>Emerging Market Economies</th>
</tr>
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<tbody>
<tr>
<td>• Keep policy rates low (or lower if room allows and risks warrant)</td>
<td>• Tighten if needed, but be ready to shift</td>
</tr>
<tr>
<td>• Deal with undesirable side effects through macro-prudential policies</td>
<td>• Complement with macro-prudential/capital flow measures where needed</td>
</tr>
<tr>
<td>• Be ready to use unconventional measures (e.g., QE, SMP)</td>
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## Better Target Financial and Structural Policies

<table>
<thead>
<tr>
<th>Advanced Economies</th>
<th>Private Sector Balance Sheet Repair</th>
<th>U.S. Households</th>
<th>European Banks</th>
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<tbody>
<tr>
<td></td>
<td></td>
<td>• Mortgage debt</td>
<td>• Adequate capital buffers; sources: private/national/EFSF</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>• Restructure/resolve where necessary</td>
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<th>Advanced Economies</th>
<th>Better target structural reforms for growth</th>
<th>U.S. and Europe</th>
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<tr>
<td></td>
<td></td>
<td>• Tackle high unemployment</td>
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<tr>
<td></td>
<td></td>
<td>• Better align reform plans with OECD's priorities for growth</td>
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<tr>
<td></td>
<td></td>
<td>• Enhance supply potential</td>
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Emerging Market Economies: Contain Vulnerabilities and Enhance Resilience

Beyond Fiscal and Monetary Policies
- Prudential (macro and micro)
- Structural financial reform

Low-Income Countries: Remain resilient and supportive of sustainable growth

Macro and structural policies
- Continue advancing structural reforms, medium-term public investment frameworks
- Rebuild policy buffers mostly exhausted in previous crisis
Tackling Global Imbalances

Global Growth and Stability

External Rebalancing

- In U.S., more external demand to sustain growth
- In EM Asia, shift towards internal demand, assisted by structural adjustments, large gaps in social safety net, financial restrictions, and undervalued exchange rates. These take time, movement is essential
- Beneficial from domestic and multilateral perspective
Thank You