FOR AGENDA

EBS/10/168
Correction 1

September 15, 2010

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To: Members of the Executive Board

From: The Secretary

Subject: **World Economic Outlook—Executive Summary and Chapters 1 and 2**

The attached corrections to EBS/10/168 (9/3/10) have been provided by the staff:

Factual Errors Not Affecting the Presentation of Staff's Analysis or Views

Page 30, para. 1: for "…pressures on public finances, which in turn could further dampen market sentiment. As the October 2010 GFSR shows, intensifying funding strains could again stress banking systems.

- Under an adverse scenario, involving a combination of macroeconomic risks, sovereign financing pressures, and intensifying funding strains, it is estimated that the European banking system would need an additional €76 billion to avoid funding stress. If unaddressed…"

read "…pressures on public finances, which in turn could further dampen market sentiment.

- As the October 2010 GFSR discusses, renewed funding strains could again stress banking systems. If unaddressed…"

Page 98, Figure 2.4: The first chart in the panel has been corrected.

Questions may be referred to Mr. Decressin (ext. 37140) and Ms. Koeva Brooks (ext. 39809) in RES.

This document will be posted on the secure page of the extranet website for Executive Directors and member country authorities. It would be appreciated if Directors could ensure that the World Economic Outlook documents are treated as **Strictly Confidential** until they are published on October 6.

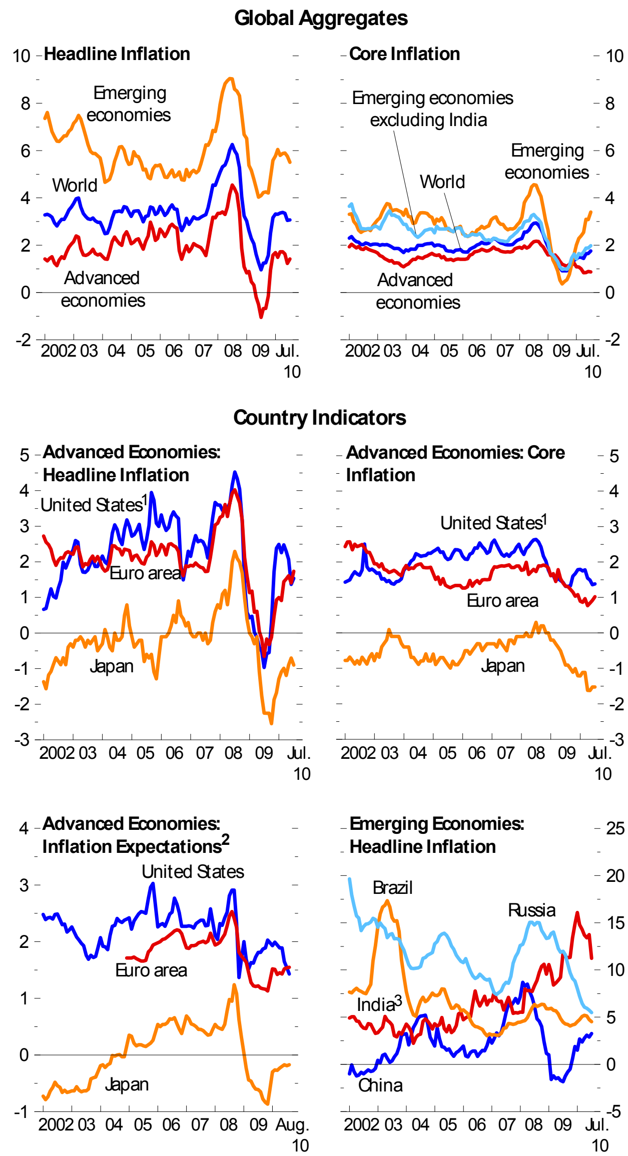
Att: (2)

Inflation is projected in general to stay low amid continued excess capacity and high unemployment (Figure 1.14). The recovery of commodity prices, however, has raised the level of consumer prices during 2010. Thus, in advanced economies, headline inflation has been running around 1¾ percent for many months but has lately begun to slow. Core inflation has been much lower, recently falling below 1 percent. In emerging economies, headline and core rates are about 6 percent and 3 percent, respectively. With market indicators suggesting that commodity prices should remain stable and with downward pressure on wages gradually diminishing, headline and core inflation in advanced economies should converge to about 1¼ percent in 2011 and in emerging economies to about 5 percent. Among some major emerging economies, capacity constraints are beginning to boost prices: Brazil, for example, has experienced gradual increases in inflation pressure, while India has seen a sharp rise in inflation.

Figure 1.14. Global Inflation

(Twelve-month change in the consumer price index unless noted otherwise)

Inflation is projected to stay low amid continued excess capacity and high unemployment. The recovery of commodity prices has raised the level of consumer prices. With market indicators suggesting that commodity prices should remain stable and with downward pressure on wages gradually diminishing, headline and core inflation in advanced economies should converge to about 1¼ percent in 2011, and in emerging economies to about 5 percent. Inflationary pressures are more elevated in economies that have had a history of unstable inflation or that are operating closer to capacity.



Sources: Consensus Economics; Haver Analytics; and IMF staff calculations.
[1]Personal consumption expenditure deflator.
[2]One-year-ahead *Consensus Forecasts*. The December values are the average of the surrounding November and January values.
[3]Consumer price index for industrial workers.

Risks to activity are mainly on the downside

Risks to the growth projections are mainly to the downside. Financial and macroeconomic conditions are likely to remain unsettled for as long as fundamental economic weaknesses persist and the required reforms remain a work in progress. Major risks have already been discussed. Key is that room for policy maneuver in advanced economies has fallen. Refinancing requirements during the second half of 2010 and 2011 will be enormous. For example, among the advanced economies, Belgium, France, Italy, Japan, and the United States will issue a gross volume of bonds with a value exceeding 40 percent of GDP. With such high volume passing through bond markets, small disturbances may propagate rapidly across sovereign debt markets, prompting changes in investor confidence and stalling the recovery.

Additionally, the financial sector remains very fragile. Banks face major funding requirements in a market that is still very risk averse. As recent experience has shown, funding troubles at individual institutions can have major macroeconomic ramifications. New capital shortfalls that require additional public sector financial support would add to the pressures on public finances, which in turn could further dampen market sentiment.

- As the October 2010 GFSR discusses, renewed funding strains could again stress banking systems. If unaddressed, such funding pressures could reawaken deleveraging pressures and the adverse feedback loop between the euro area banking systems and the regional economy. However, in most countries existing backstops are sufficient to cover needs under such a scenario.

  In the United States the real estate sector could well dip again, exposing pockets of vulnerability in the banking system. A stress test of the top 40 U.S. bank holding companies suggests that, under an adverse scenario where residential and commercial real estate prices fall by 6 percent and 9 percent, respectively, and real GDP growth slows to 1.2 percent in 2011, banks would require a total of $3 billion in additional capital in order to maintain a 6 percent Tier 1 ratio. While the capital of U.S. banks thus appears broadly sufficient, in the absence of GSE and other government interventions substantially more capital would be needed.

- In Japan, a near-term disruption in the government bond market remains unlikely, but the factors currently supporting the Japanese bond market are expected to gradually erode. Also, banks' ever larger holdings of government bonds and the increasing interest rate risk arising from their extension into longer-dated maturities create a potential risk to financial stability if there were a sudden increase in government bond yields.

Quantitative risk indicators

The IMF staff's quantitative indicators confirm that risks to activity are still high and to the downside in 2011 (Figure 1.15). Specifically, risks as measured by the dispersion in analysts' forecasts for real GDP growth or inflation, oil price options, and the Chicago Board Options Exchange Market Volatility Index (VIX)[8] have moved up to varying degrees lately,

[8] VIX is a popular measure of the implied volatility of S&P 500 index.

market economies—larger accumulation of reserves by one could induce further accumulation by others in the region if the level of reserves is perceived as a proxy for the credibility of a country's policy framework.[8] International coordination could alleviate challenges of this nature.

Asia should also focus on various structural reforms to accomplish its medium-term rebalancing objectives. Specific policy options include implementing health care, education, and pension reforms to enhance the social safety net (China); promoting investment by small and medium-size enterprises (Japan); improving the business climate (Philippines); increasing the productivity of the nontradables or service sector (China, Japan, Korea); facilitating further product and labor market flexibility and productivity (China, Malaysia, some NIEs, Philippines); lowering corporate savings by realigning relative prices for a range of inputs, including capital, land, water, and energy (China); and further financial sector development and capital market deepening (China, India, Philippines, Thailand).

Many economies have already embarked on such reforms. Besides the recent resumption of a managed floating exchange rate regime in China, the government has launched a number of measures to enhance the social safety net.[9] In Korea, the government recently announced plans to further develop the service industry, including through streamlined regulation and greater competition. Singapore's recent budget contains measures to enhance labor productivity. However, these measures will take time to be effective, which combined with an anticipated slower pace of adjustment in advanced economies (in light of the shorter-term economic challenges they face) suggests a protracted period over which global imbalances may eventually narrow.

The U.S. Recovery Is Moderating in the Face of Debt and Continued Uncertainty

The U.S. economy is recovering, thanks to unprecedented macroeconomic policy stimulus, emergency financial stabilization measures, and a modest cyclical upswing. But the rate of expansion is beginning to moderate. The economy grew at an annualized rate of [1.6] percent in the three months to June, a slower pace than the 3.7 percent growth rate posted in the first quarter. Moreover, high-frequency indicators suggest a weak recovery in coming quarters.

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[8]See Cheung, Yin-Wong, and Xingwang Qian, 2009, "Hoarding of International Reserves: Mrs. Machlup's Wardrobe and the Joneses," *Review of International Economics,* Vol. 17, No. 4, pp. 824–43.

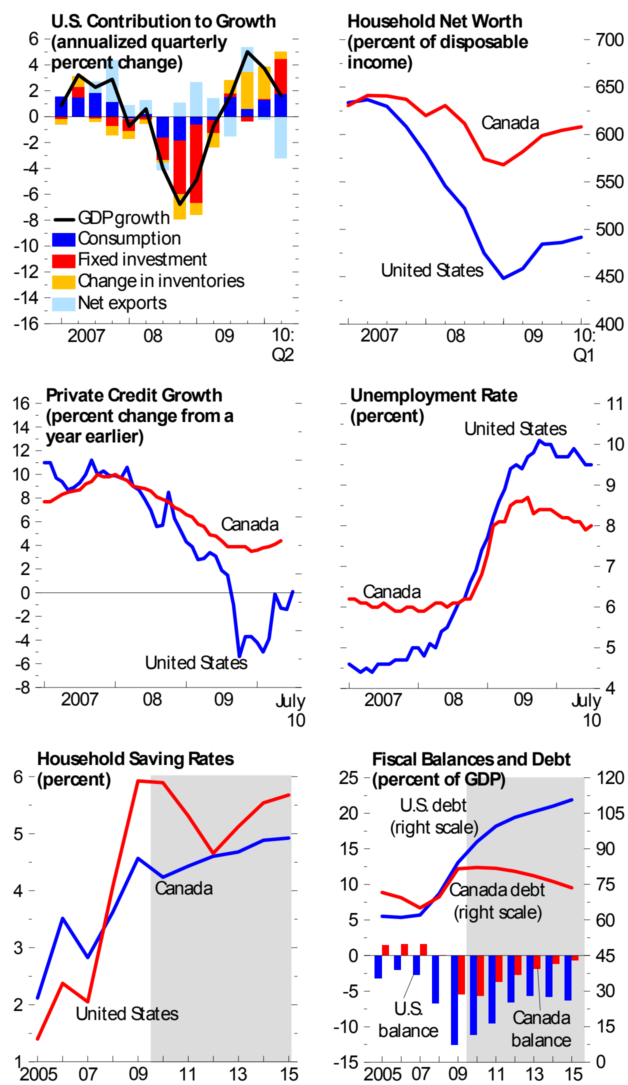
[9]See *People's Republic of China—2010 Article IV Consultation*, www.imf.org/external/pubs/ft/scr/2010/cr10238.pdf.

Much of the weakness of this recovery is due to sluggish personal consumption—by far the biggest component of U.S. GDP. After accelerating to an annualized growth rate of [2] percent in the third quarter of 2009, personal consumption expenditure has since limped along at an average rate of [1½] percent. There are several reasons for this weakness. First, household net worth has deteriorated sharply (Figure 2.4). House prices have fallen by [25-30] percent (depending on which index is used) over three years, with the brunt of the adjustment falling on households that have the highest marginal propensity to consume. Second, unemployment is high: it is currently 9½ percent of the workforce; a broader measure of unemployment (which takes into account those seeking full-time jobs but only finding part-time work) is 16.5 percent; the median duration of unemployment, 22 weeks, is nearly twice the peak level of the previous 40 years. A weak labor market hits incomes and the ability to obtain credit, and it raises job uncertainty for those currently employed. Third, banks are still reluctant to lend to consumers, restricting credit for larger purchases, as they struggle to reduce leverage and restore balance sheets. Overall, given the unusually low savings levels before the crisis and the steep decline in personal net worth since then, the desire to save is more likely to stay elevated relative to precrisis levels. The personal saving rate since the beginning of 2009 has averaged [6] percent—a level last seen in [1995]—and is projected to remain at about 5 to 6 percent through 2015.

In contrast to private consumption, private investment in software and equipment has rebounded strongly. Firms have also increased productivity, and unit labor costs have declined sharply. In the near term, fixed investment is likely to be the principal driver of domestic demand,

Figure 2.4. United States and Canada: Differing Fortunes

The pace of recovery in the United States has moderated. Consumers face headwinds of high debt and fallen asset values; weak credit growth, despite extraordinarily loose monetary conditions; and persistently high unemployment. Personal saving rates will remain higher than precrisis levels for a sustained period, and public balances are projected to deteriorate further. By contrast, the Canadian economy is less hampered by the same factors and is set to recover more strongly.



Sources: Haver Analytics; and IMF staff estimates.