

Crisis of Confidence

Outlook



Risks

Policies

WEO Growth Projections: September 2011

(percent change from a year earlier)



WORLD



U.S.



EURO AREA



JAPAN



BRAZIL



RUSSIA



INDIA



CHINA

2011
(SEP 2011)

4.0

1.5

1.6

-0.5

3.8

4.3

7.8

9.5

2011
(APR 2011)

4.4

2.8

1.6

1.4

4.5

4.8

8.2

9.6

2012
(SEP 2011)

4.0

1.8

1.1

2.3

3.6

4.1

7.5

9.0

2012
(APR 2011)

4.5

2.9

1.8

2.1

4.1

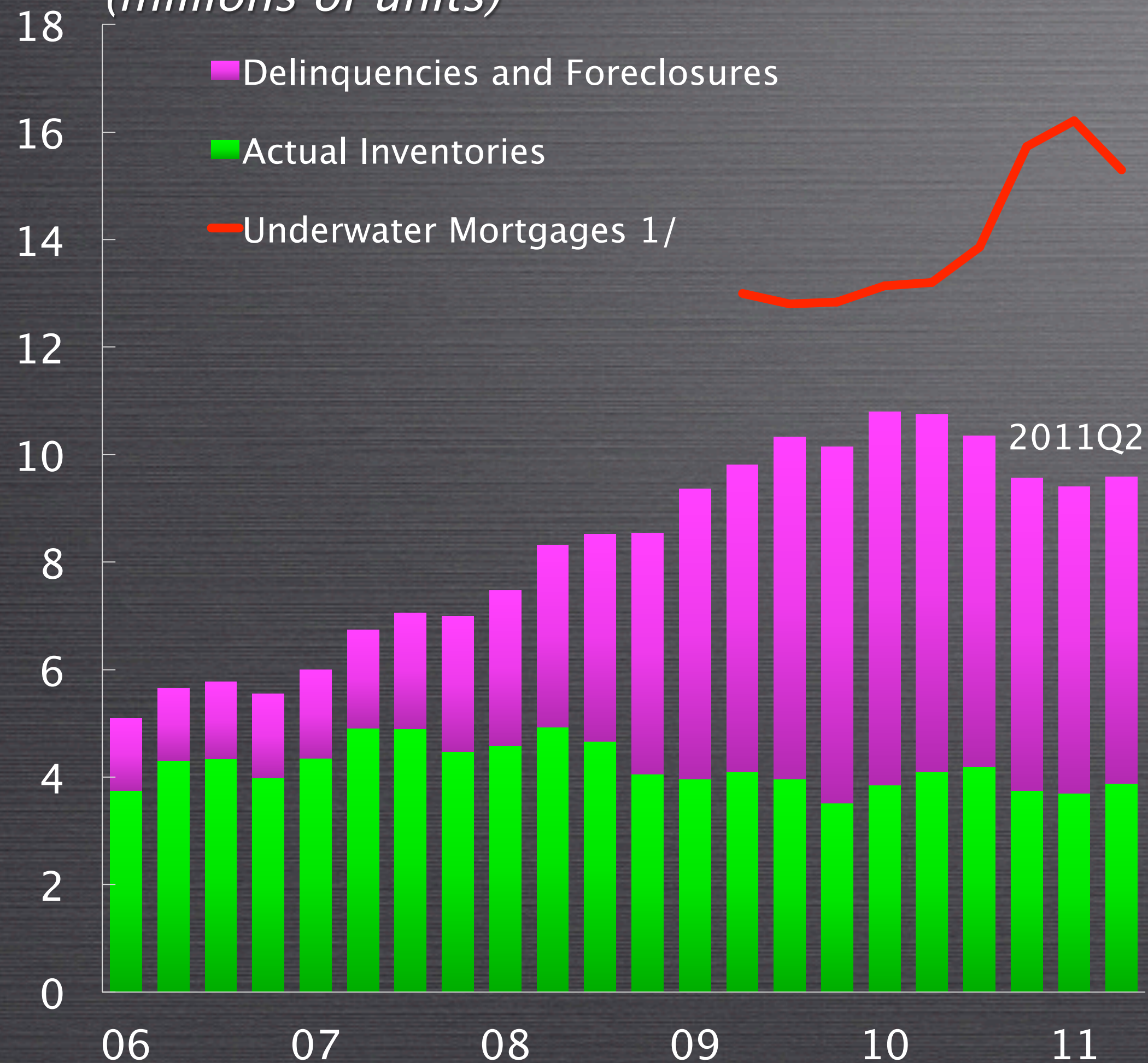
4.5

7.8

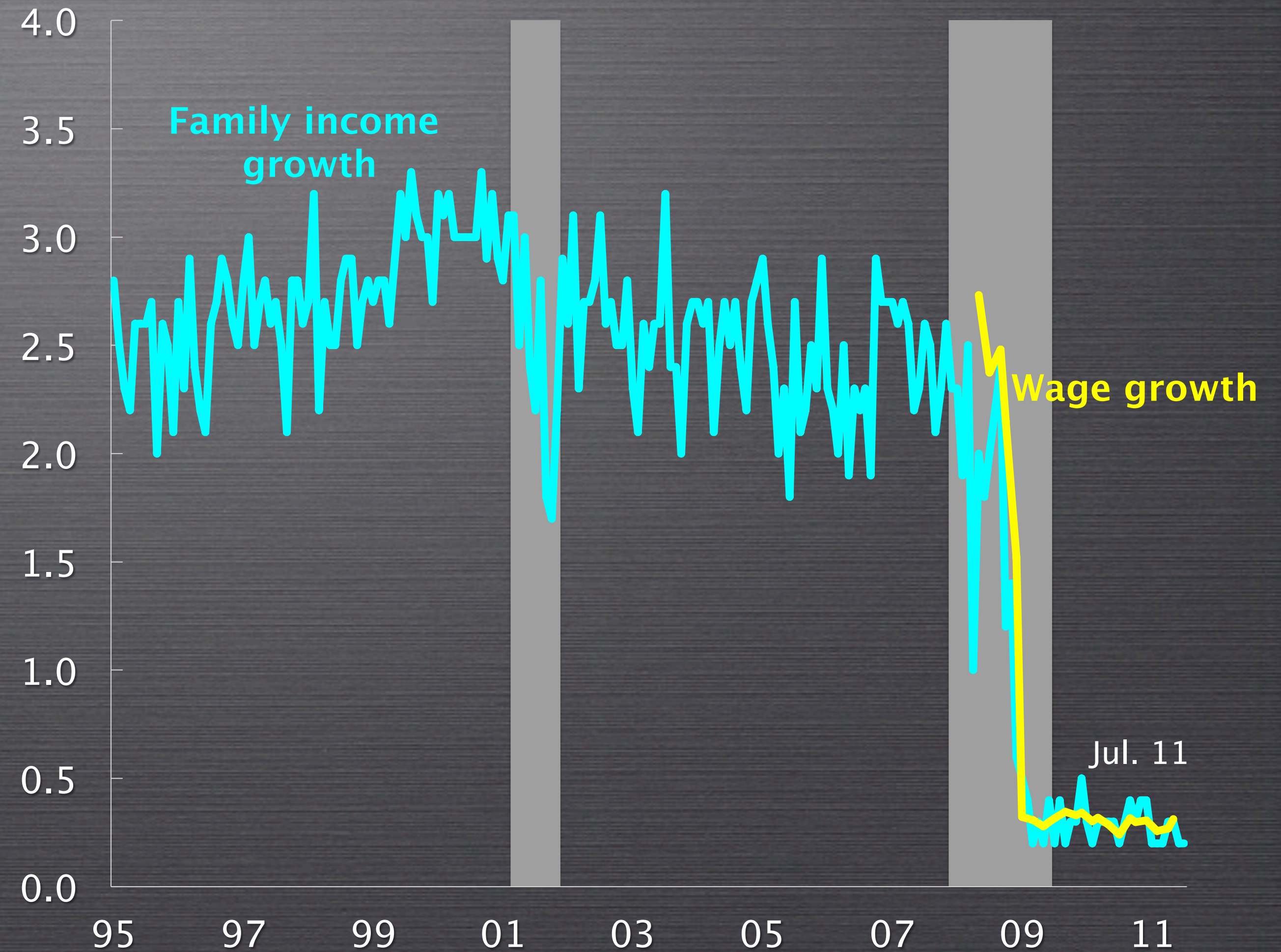
9.5

Reason 1: U.S. Economy Dealing With Crisis Legacy

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



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



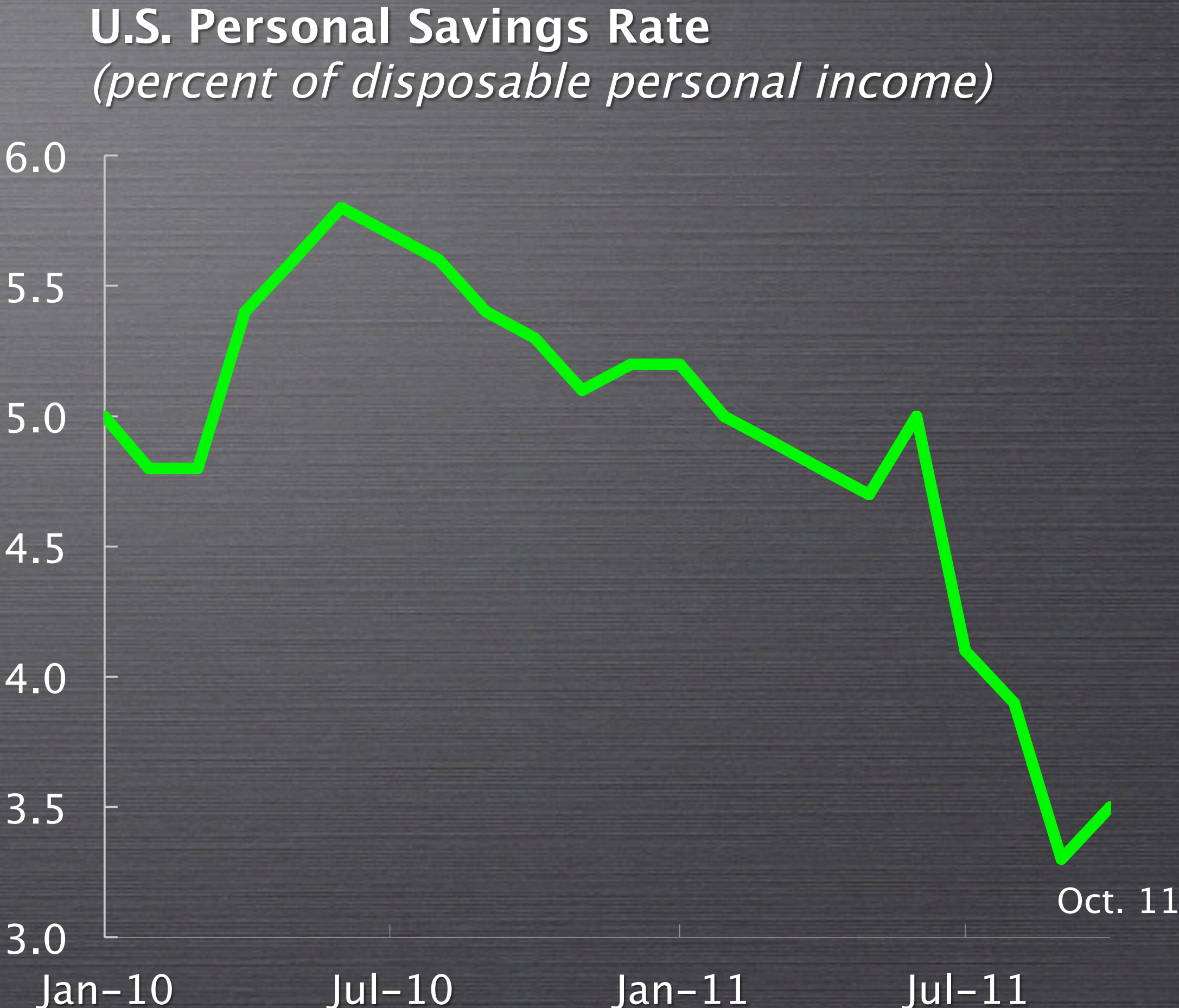
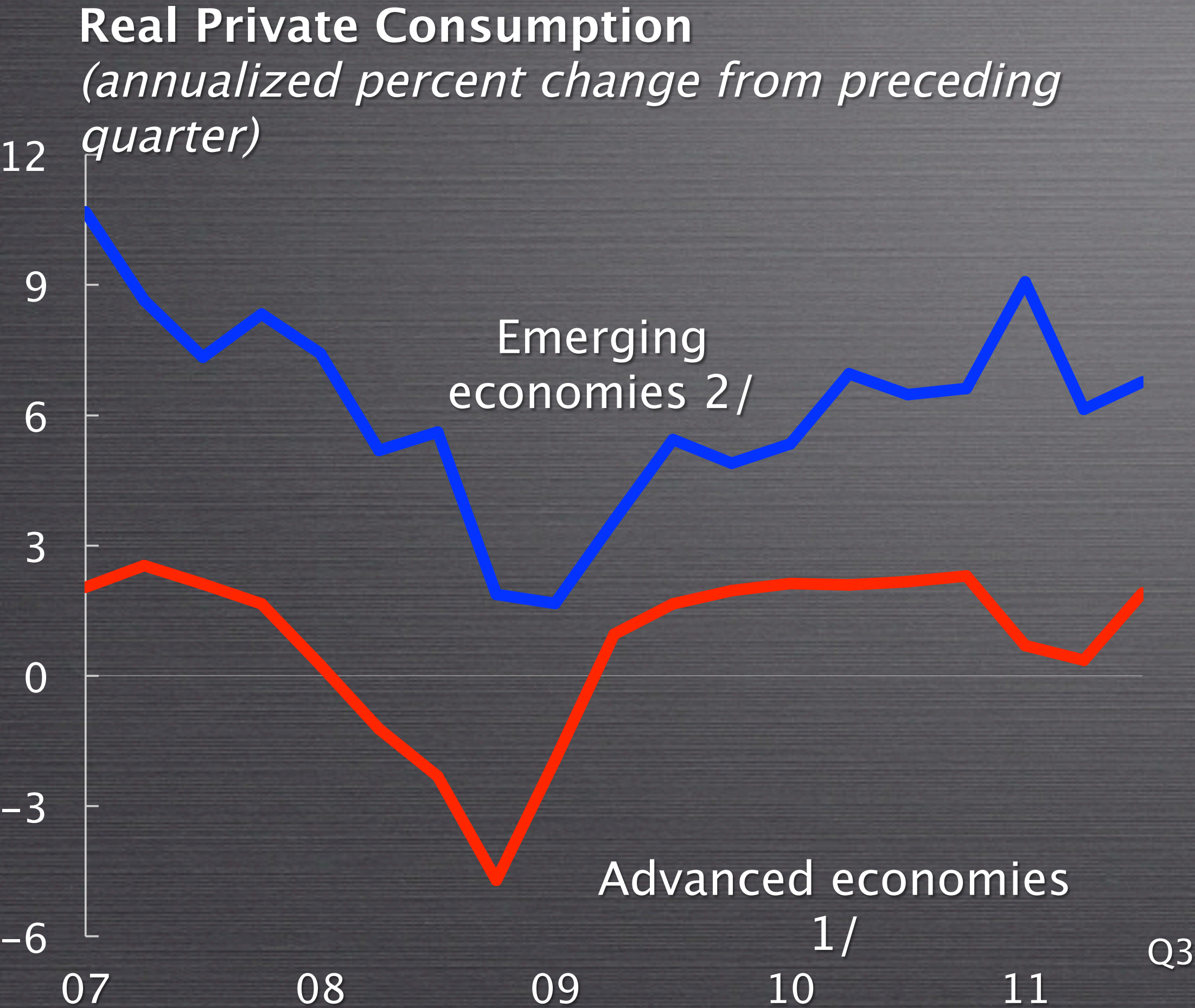
Sources: University of Michigan, Survey of Consumers; New York Federal Reserve-ALP Panel; and IMF staff estimates.

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.

U.S. Consumption Is Struggling



1/ Australia, Canada, Czech Republic, Denmark, euro area, Hong Kong SAR, Israel, Japan, Korea, New Zealand, Norway, Singapore, Sweden, Switzerland, Taiwan Province of China, United Kingdom, and United States.
2/ Argentina, Brazil, Bulgaria, Chile, China, Colombia, Hungary, India, Indonesia, Latvia, Lithuania, Malaysia, Mexico, Pakistan, Peru, Philippines, Poland, Romania, Russia, South Africa, Thailand, Turkey, Ukraine, and Venezuela.

Source: Bloomberg, L.P.

Reason 2: Growing Confidence Crisis in Europe

**Private
Debt**

Subprime crisis originates in U.S. banks

Banking

Banking crisis spreads from U.S. to Europe

Sovereign

Sovereign debt problems spread to larger euro members

Role of Confidence in Fiscal Sustainability

1. Fiscal sustainability forecasts depend on:

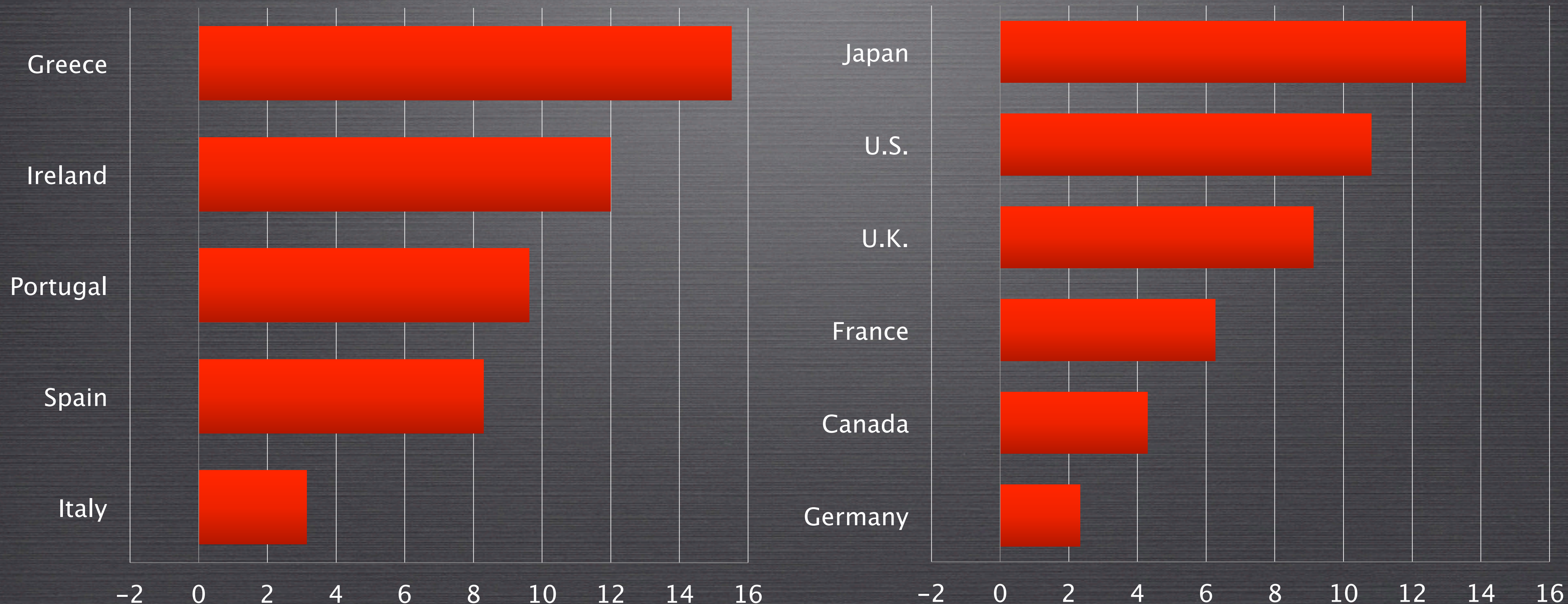
- Level of debt/GDP ratio
- Expected primary surplus
- Expected growth rate
- Interest rate

2. Most of these factors depend on sentiment about the outlook

Fiscal Consolidation: A Long Way to Go

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

■ Total required adjustment by 2020 1/

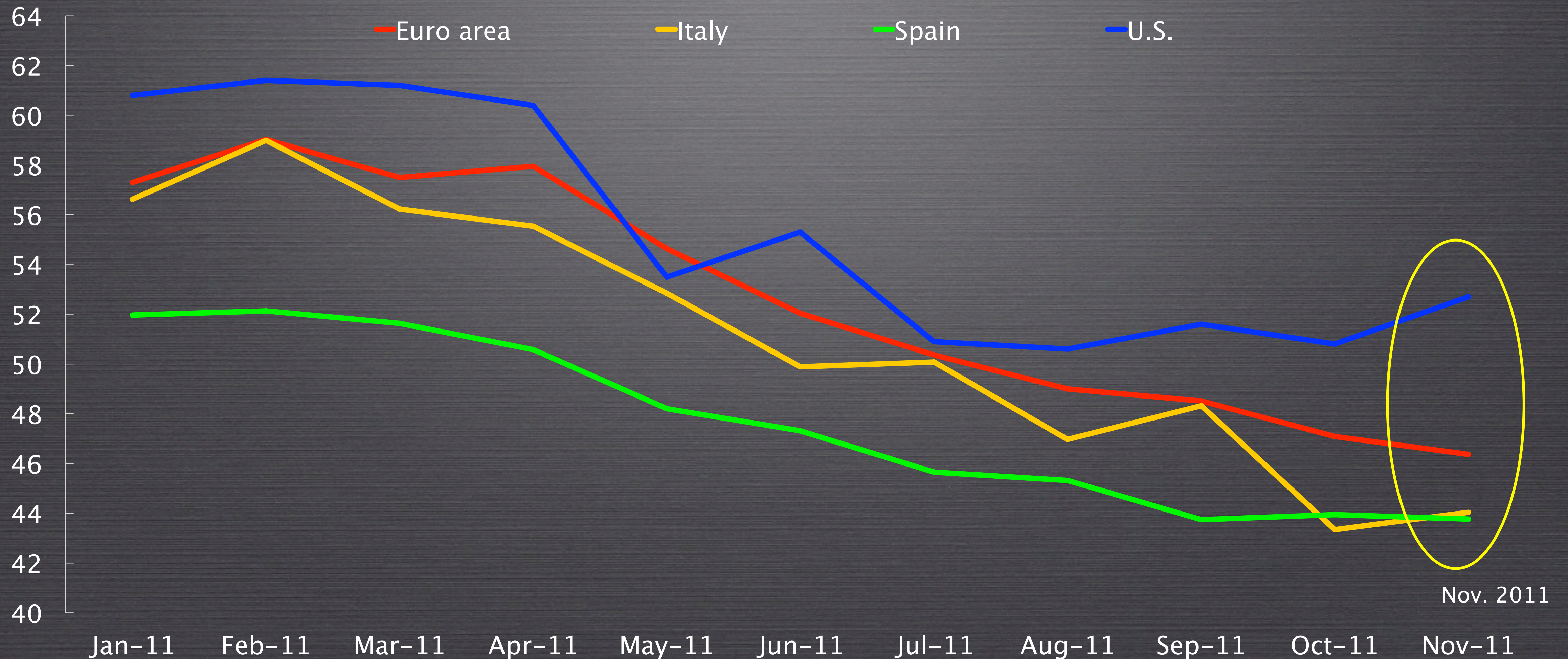


Source: IMF staff estimates.

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.

Why Europe? Look At Growth

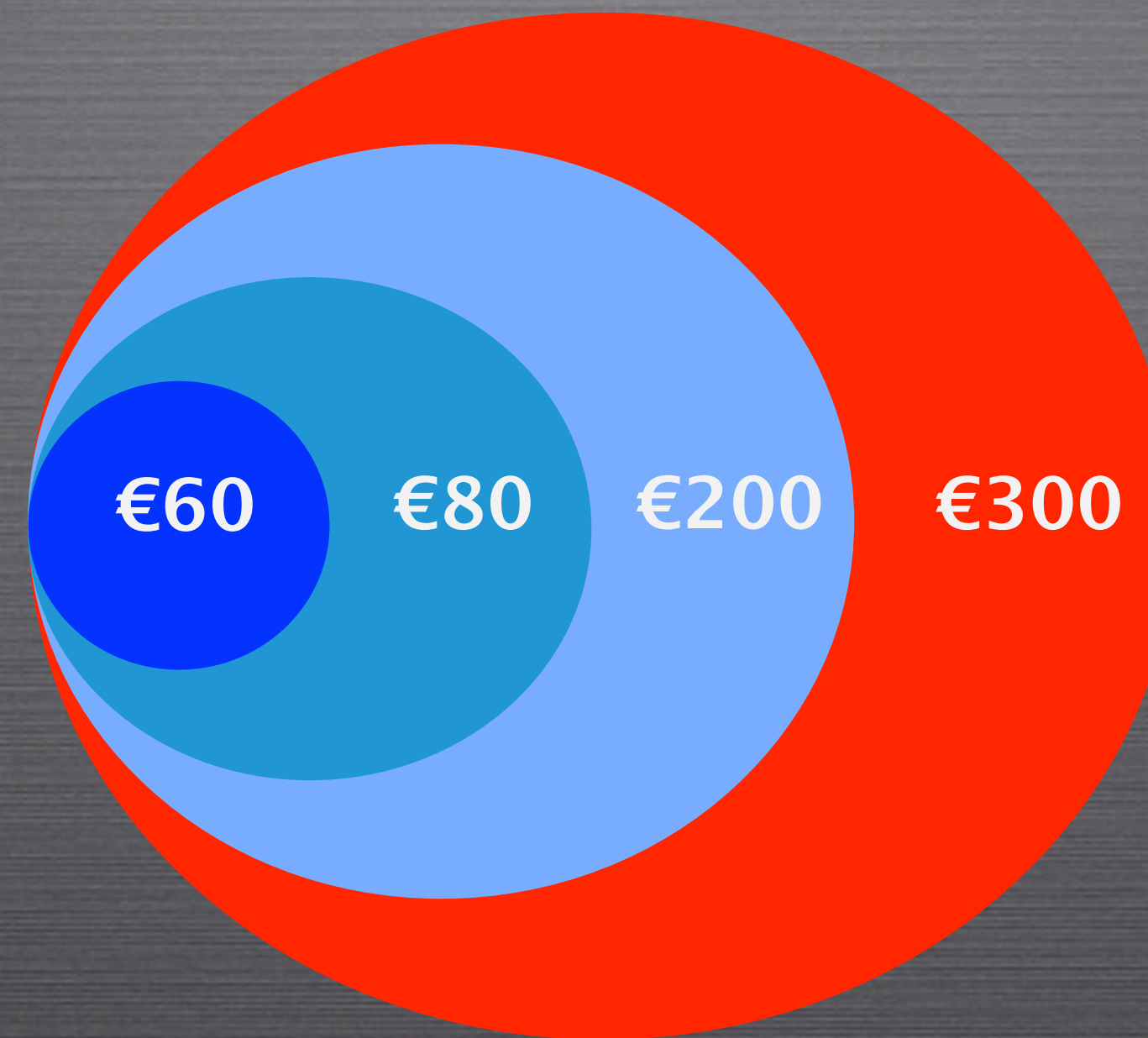
Euro area Manufacturing PMI's
(index; >50=expansion; sa)



Source: Haver Analytics.

Sovereign Spillovers to the EU Banking System

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



Spillovers from ...

- Greek sovereign
- Irish & Portuguese sovereign
- Belgian, Spanish & Italian sovereign
- High-spread euro area banking sector

Crisis of Confidence

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September WEO Key Assumptions: Problems Are Contained

I

Euro area sovereign crisis does not worsen

II

Strains on European banks do not intensify

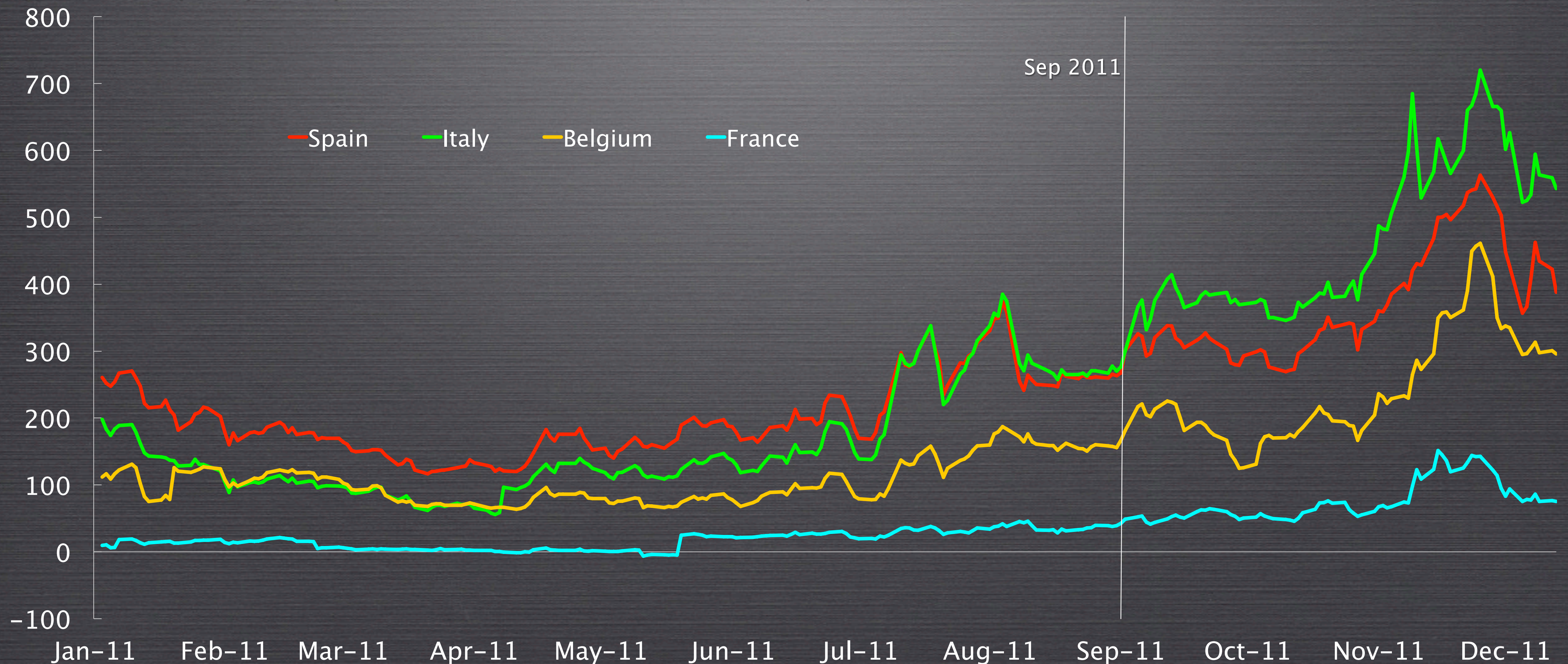
III

Global risk aversion does not escalate

But...European Sovereign Crisis Has Deepened

Government Bond Spreads

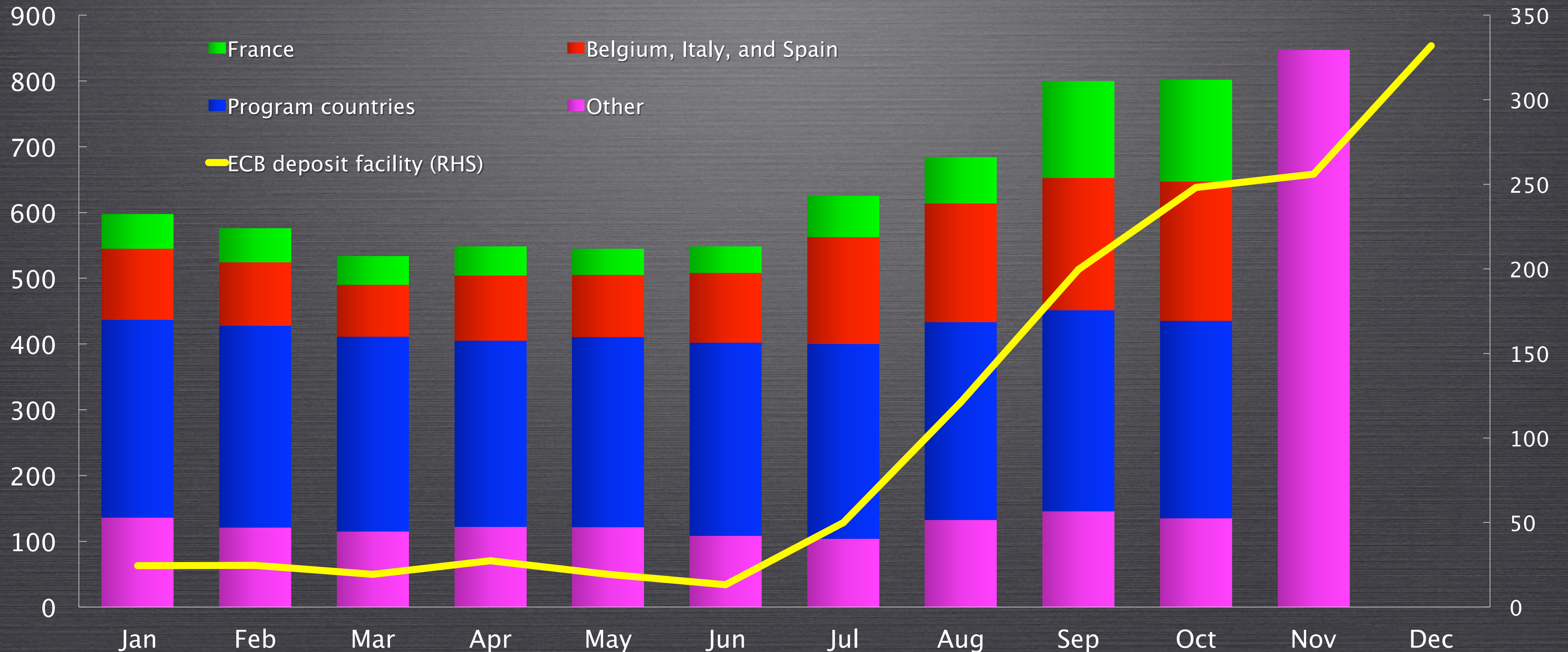
(two-year yield spreads over German bunds; basis points)



European Banks Are Facing Increasing Funding Strains

Central Bank Lending and Deposits

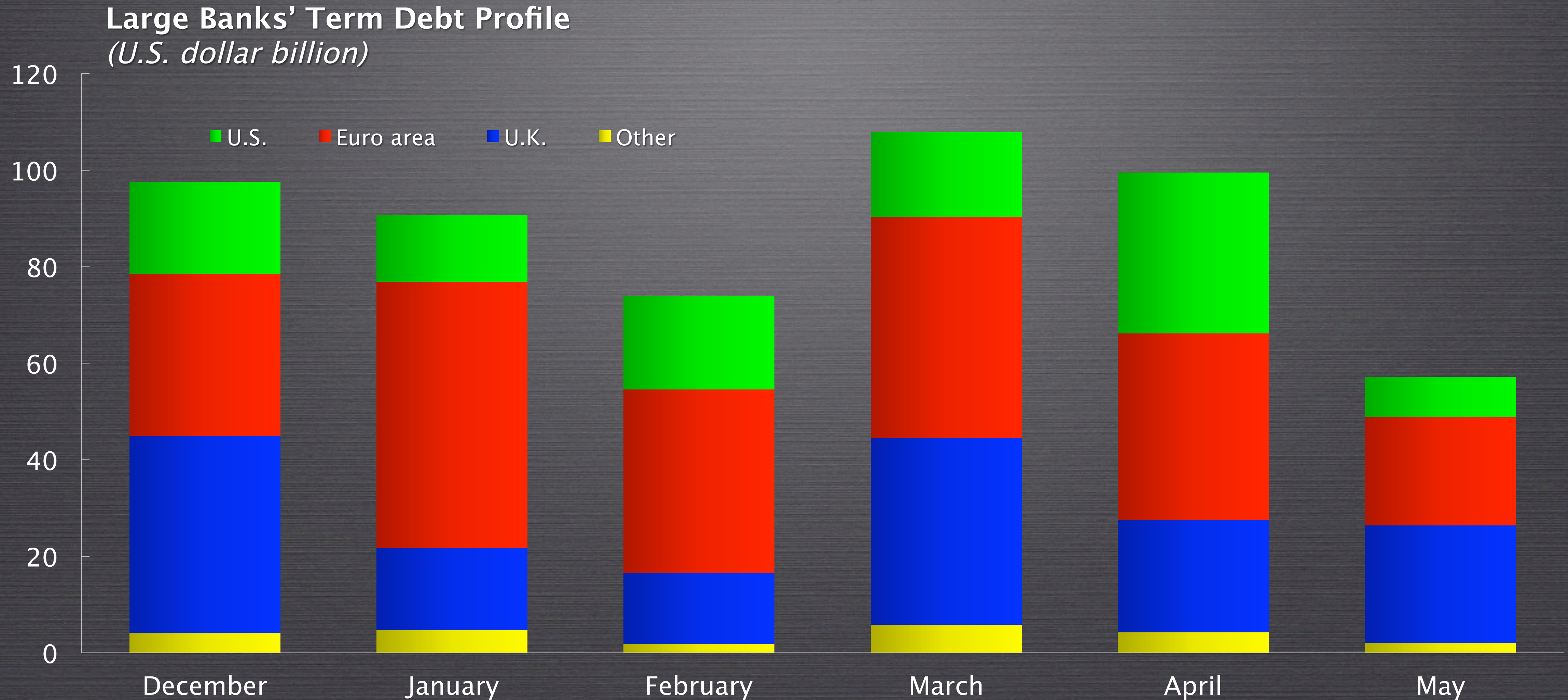
(billions of euro)



Sources: ECB; and Haver.

Note: Chart includes estimates of Greek and Irish ELA.

....And Face Large Rollover Needs Going Forward



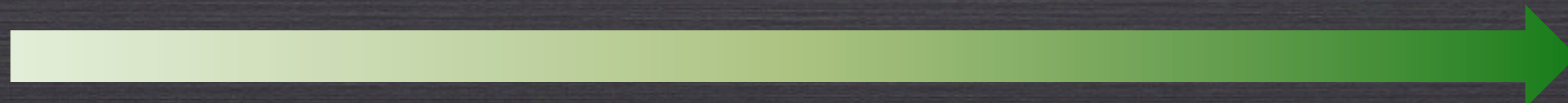
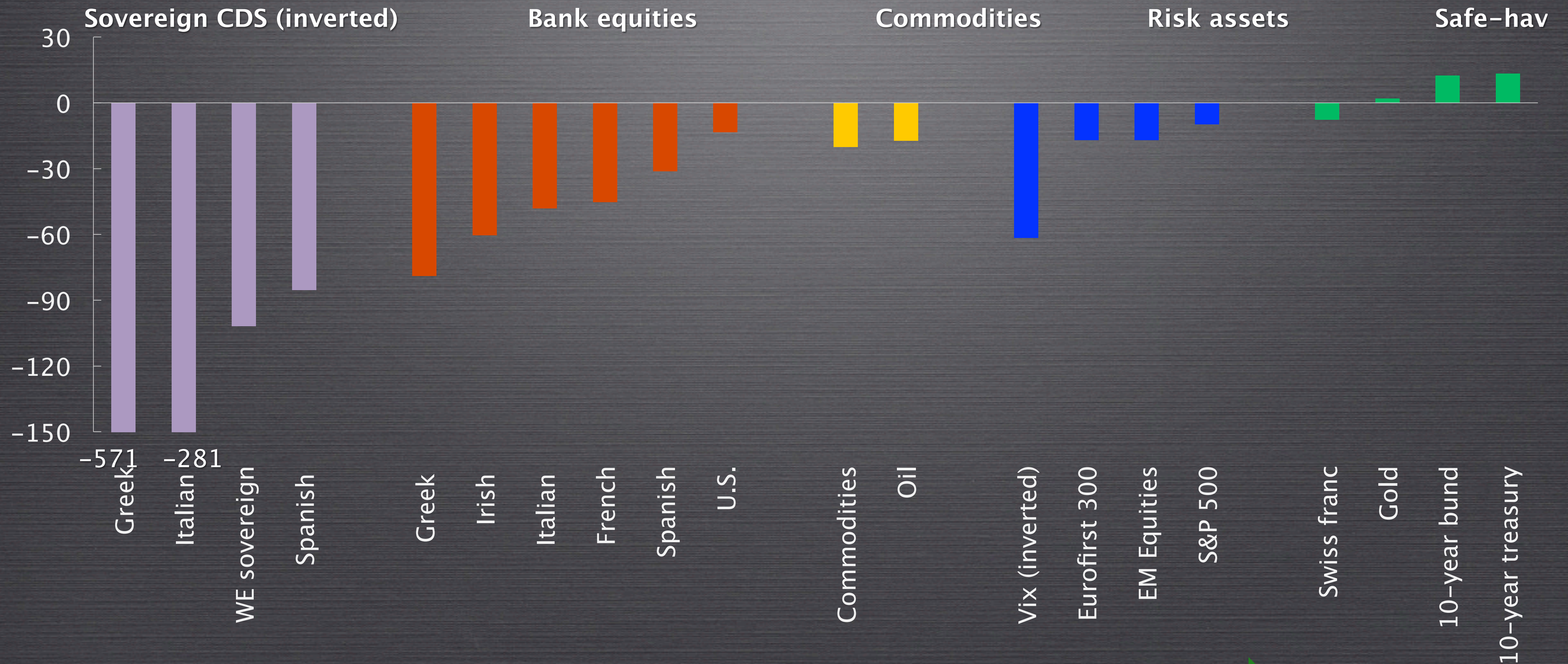
Sources: SNL Financial; and staff estimates.

Note: Chart shows debt for the BIS-FSB systemically important banks, where data are available.

And...There's Been a Flight to Safety

Asset Price Change from **April 2011** to mid-December

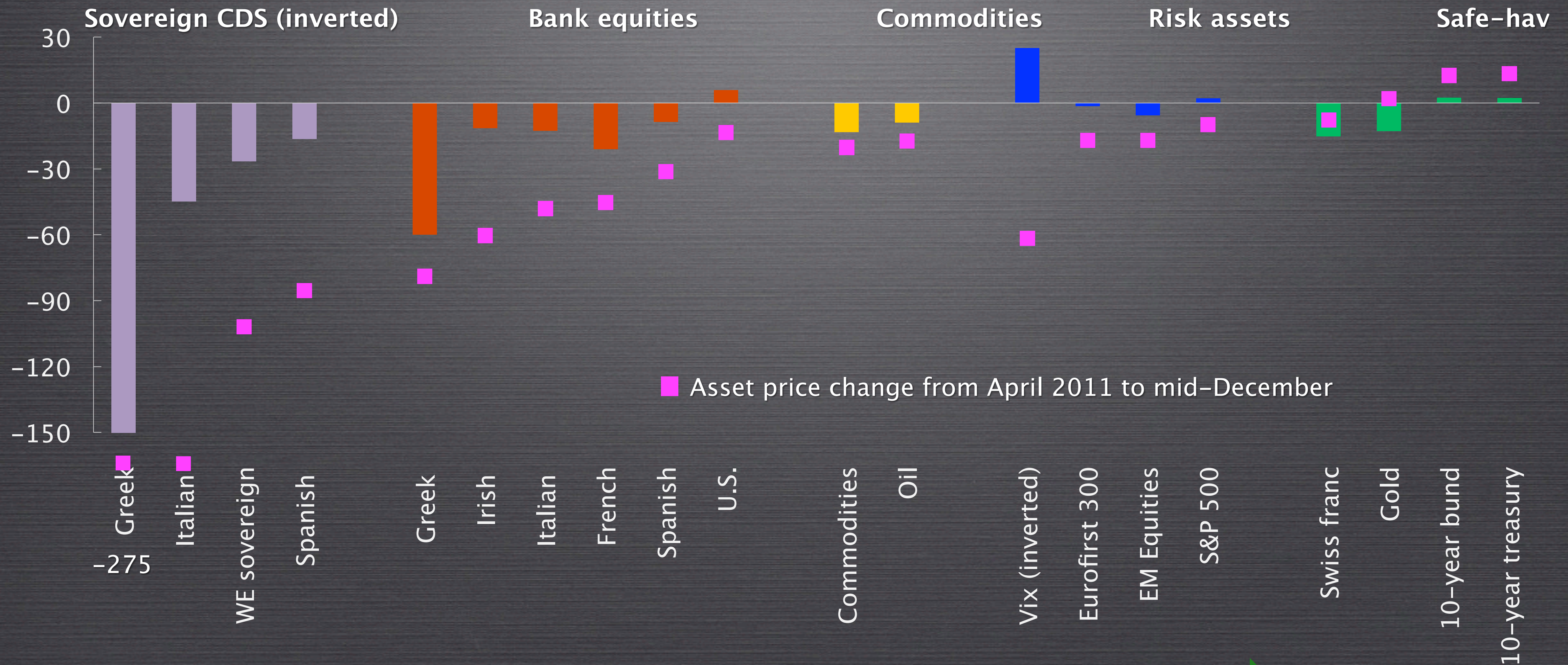
(percent change; VIX in percentage points; VIX and WE sovereign CDS inverted)



And...There's Been a Flight to Safety

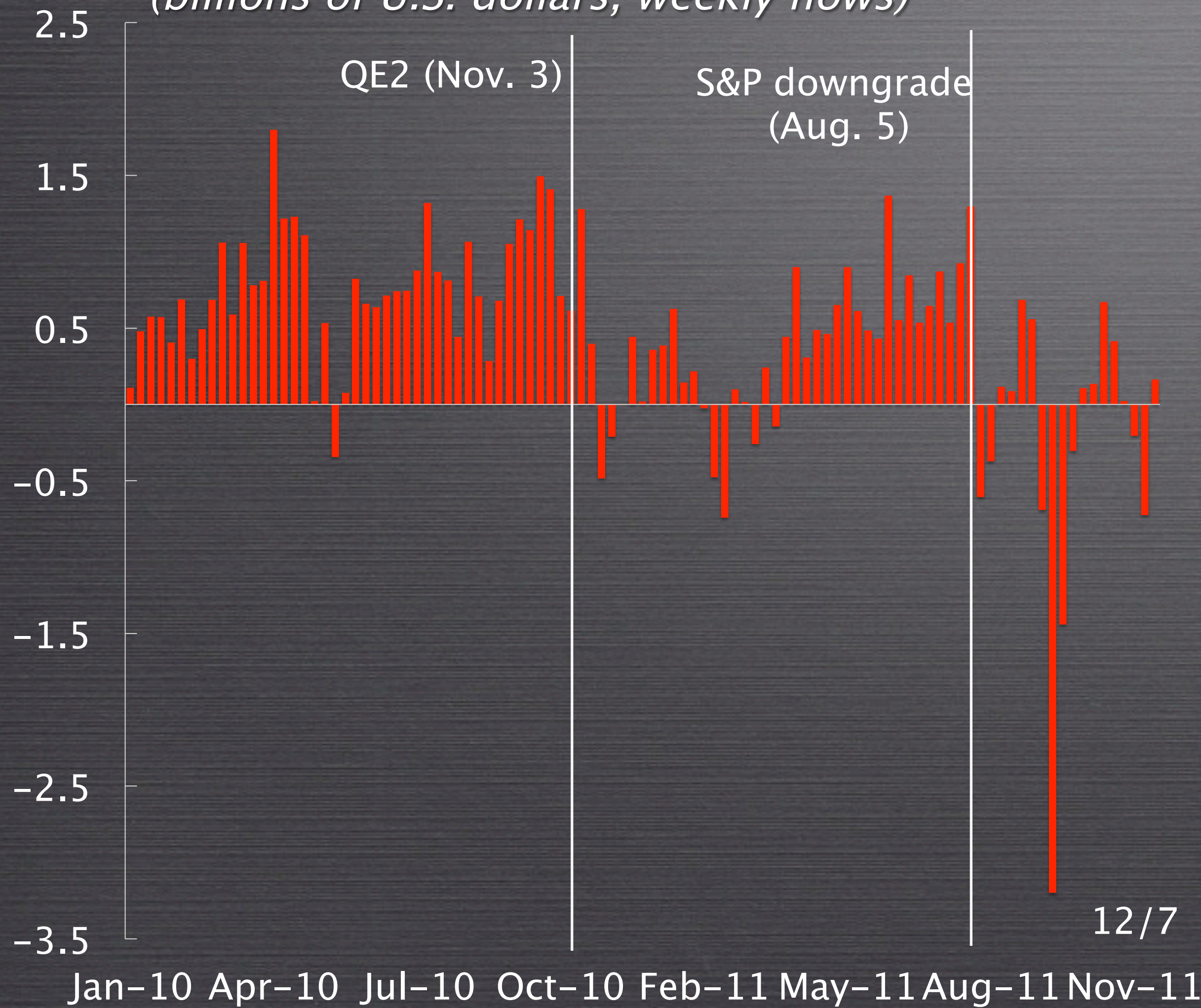
Asset Price Change from **September 2011** to mid-December

(percent change; VIX in percentage points; VIX and WE sovereign CDS inverted)

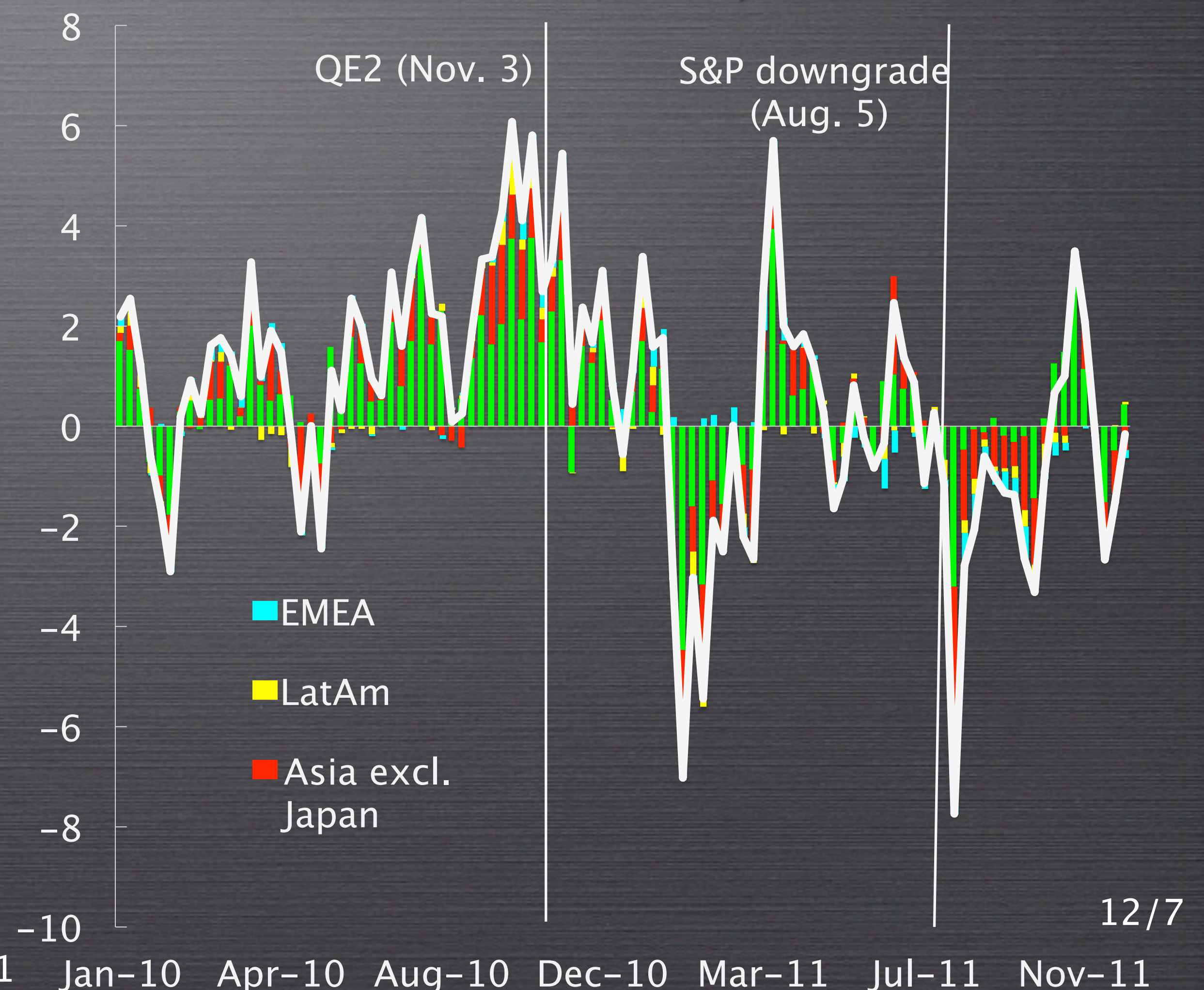


Capital Inflows to EM's have Vanished

Bond Fund Flows to Emerging Markets
(billions of U.S. dollars, weekly flows)

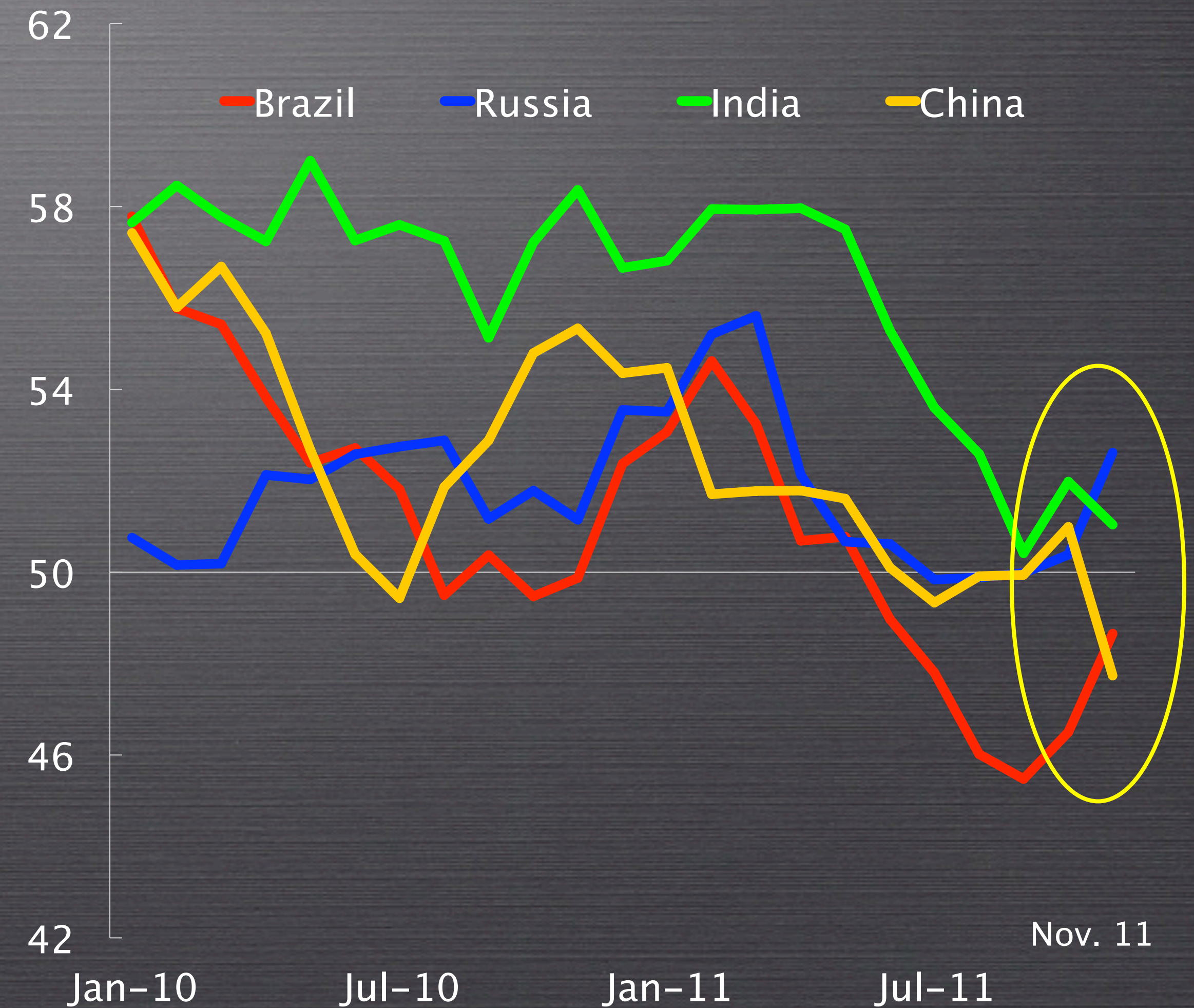
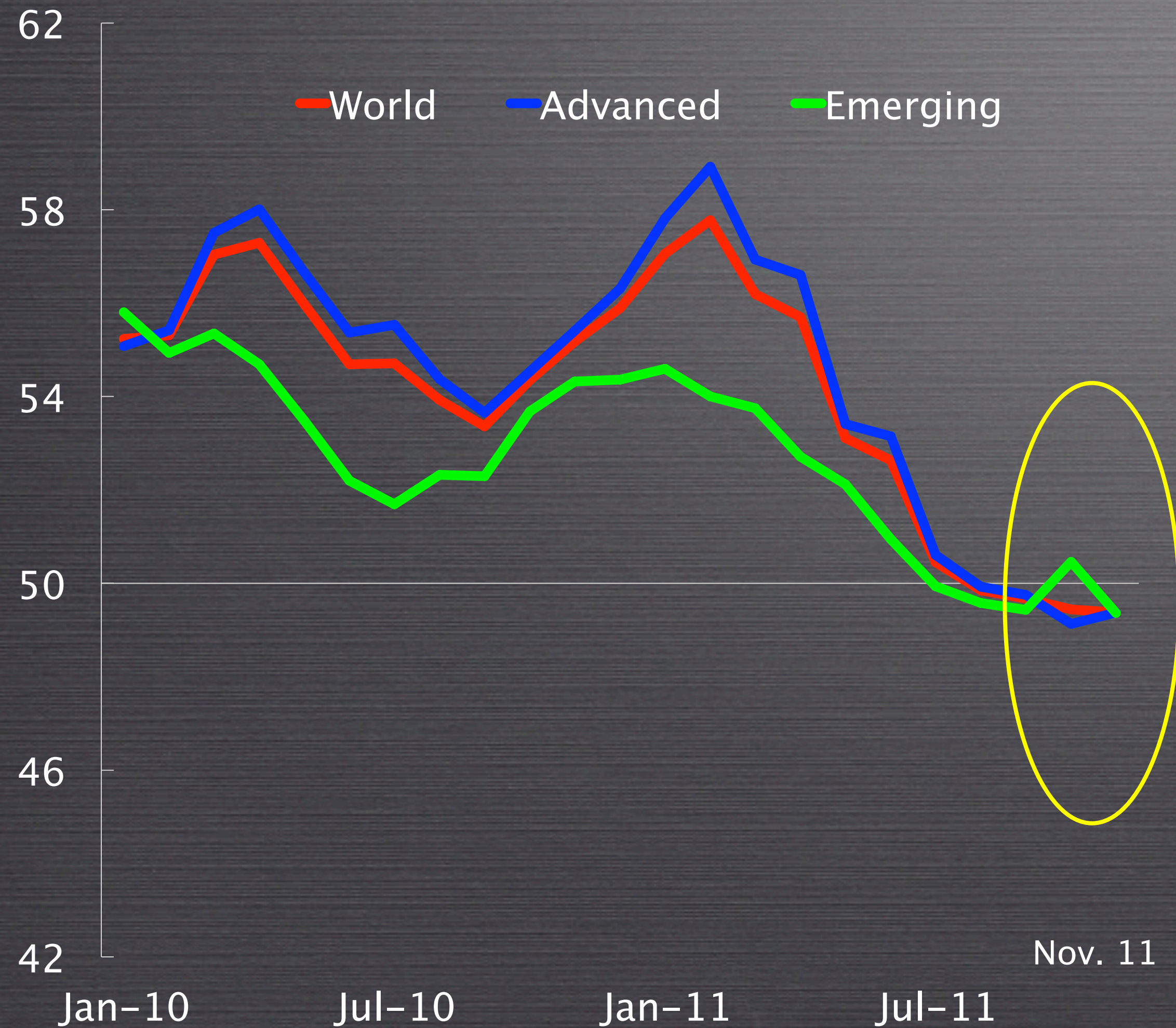


Equity Fund Flows to Emerging Markets
(billions of U.S. dollars, weekly flows)



Result: Global Economy Slowing Sharply

Global Manufacturing PMI
(index; >50=expansion; sa)



Source: Haver Analytics.

Crisis of Confidence

Outlook



Risks

Policies

Risks — Adverse Feedback Loops

Lower growth

Automatic
stabilizers
held back

Worsen
fiscal
balance

Lower bank
asset quality

Less bank
lending

Fiscal

Higher
guarantees

Sovereign
risks
increase

Financial

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

Downside Scenario

I

Shock: European banks delever sharply

II

Spillovers: Risk premia rise, commodity prices fall

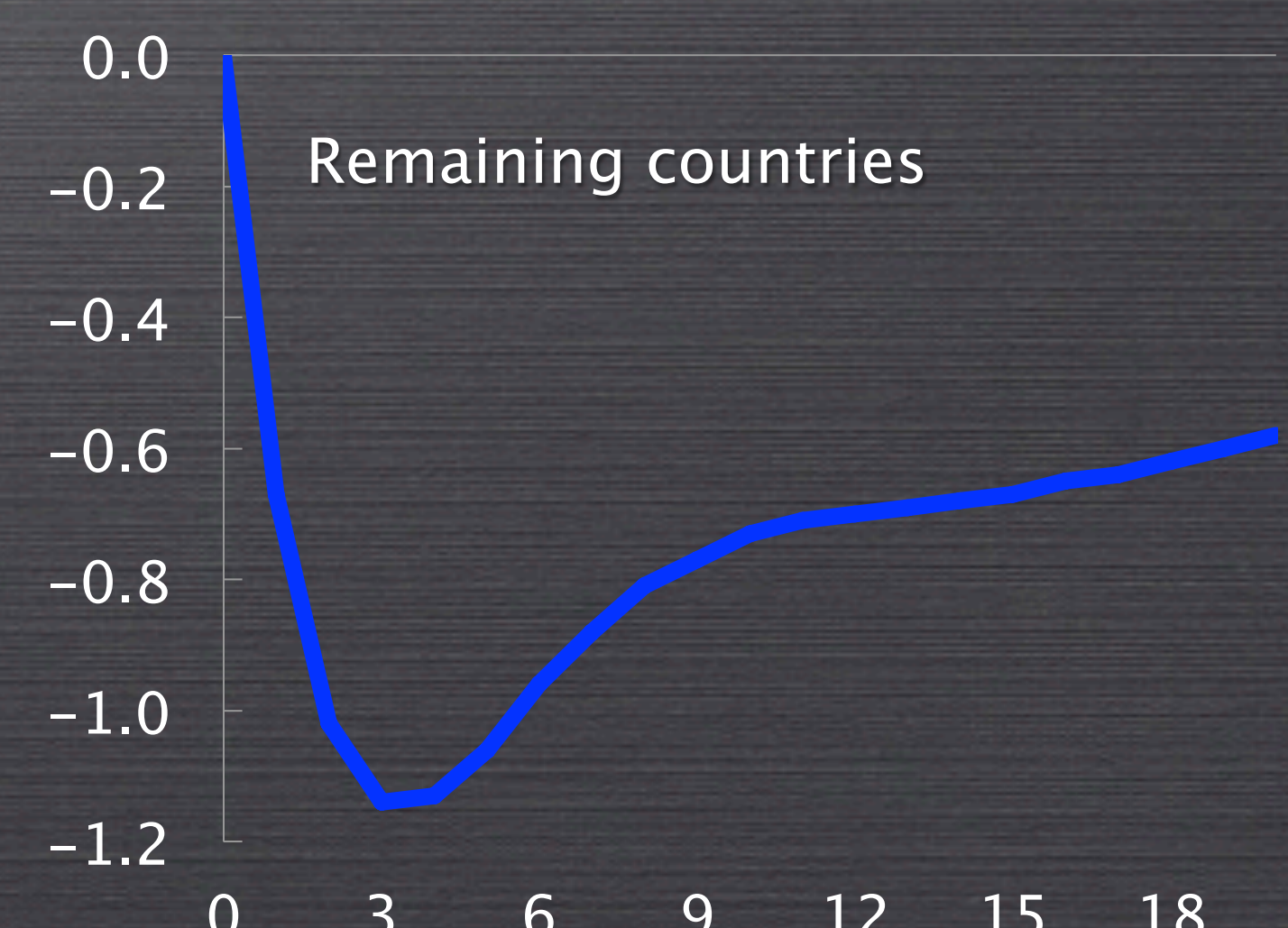
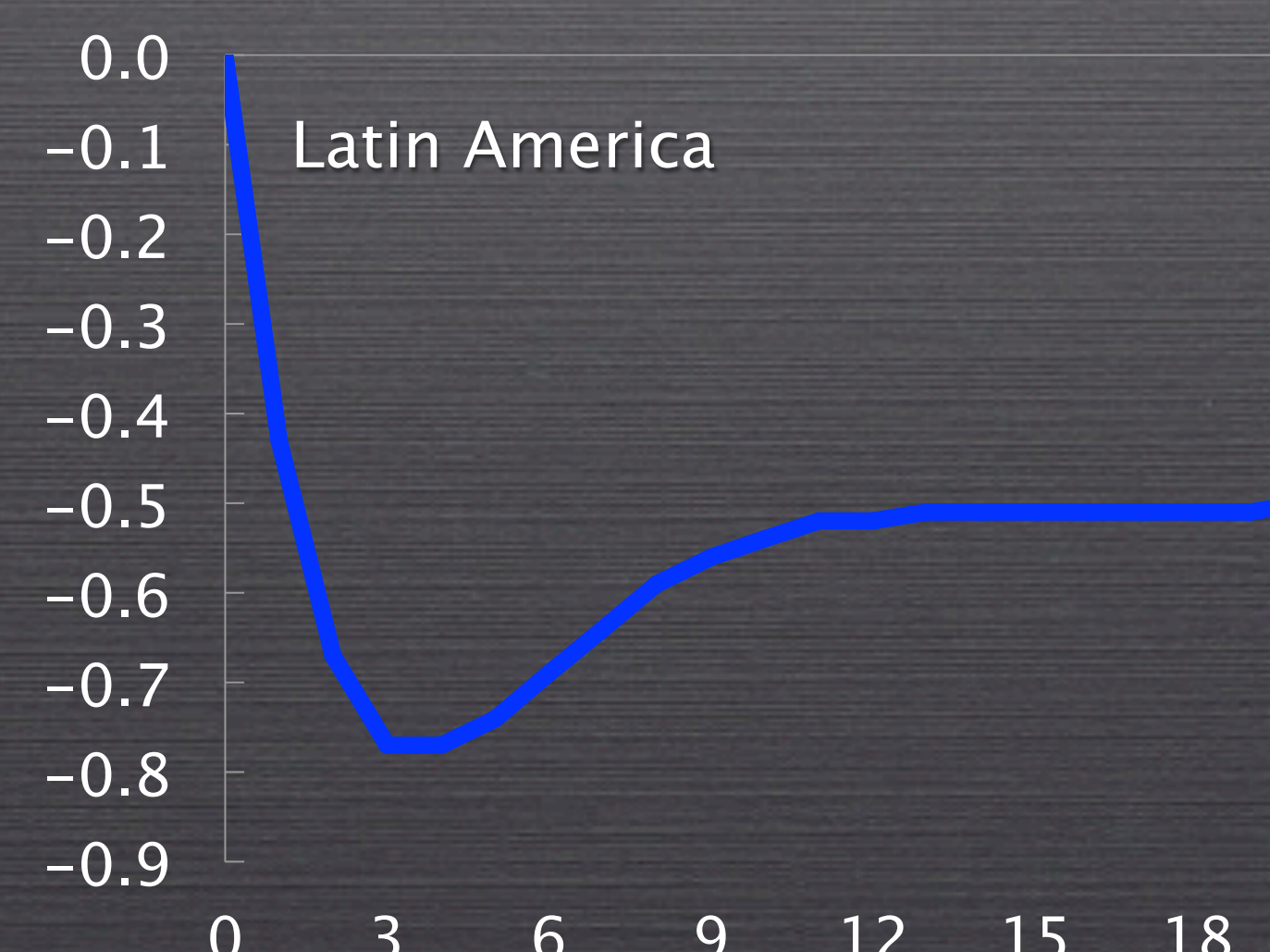
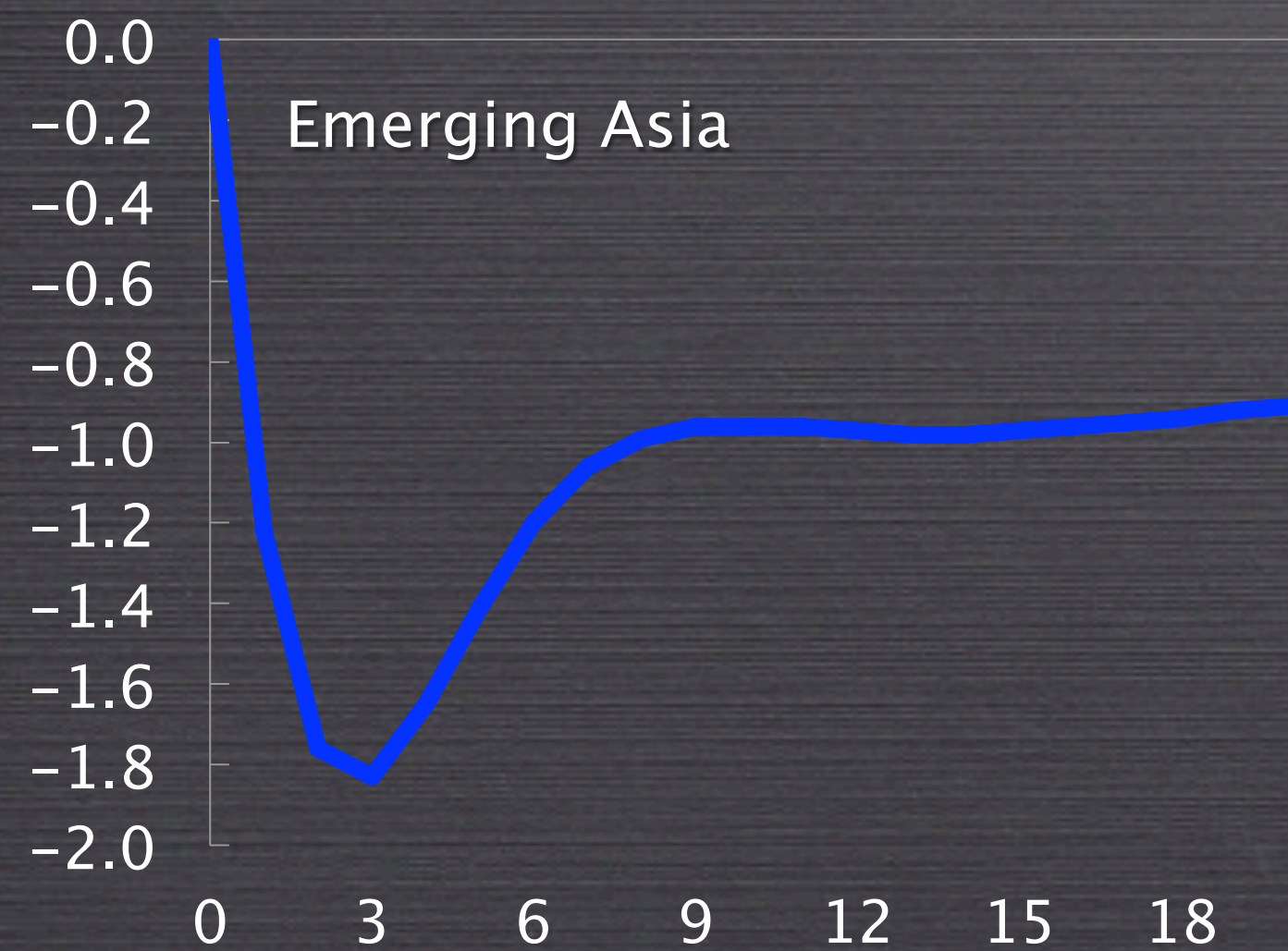
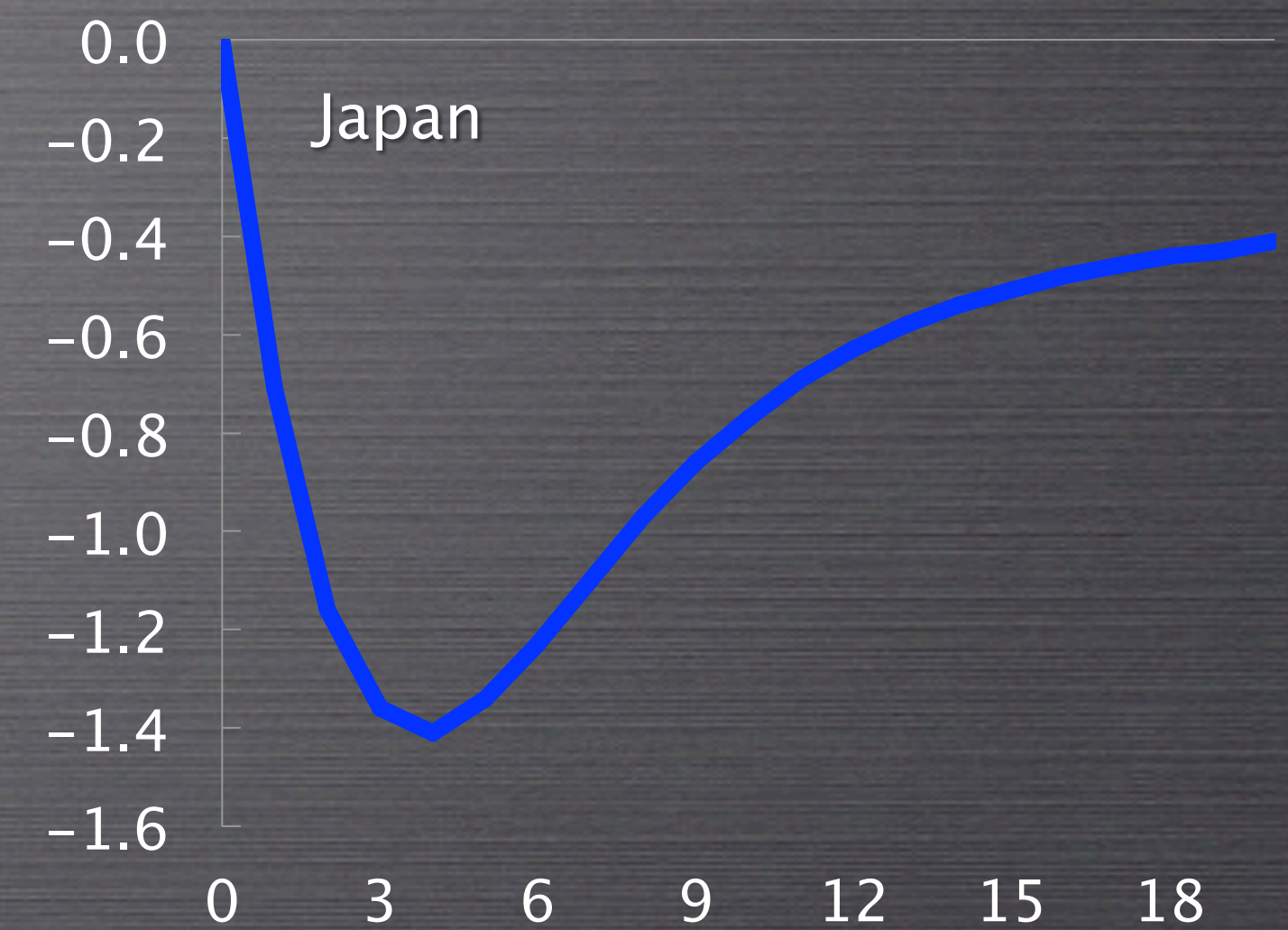
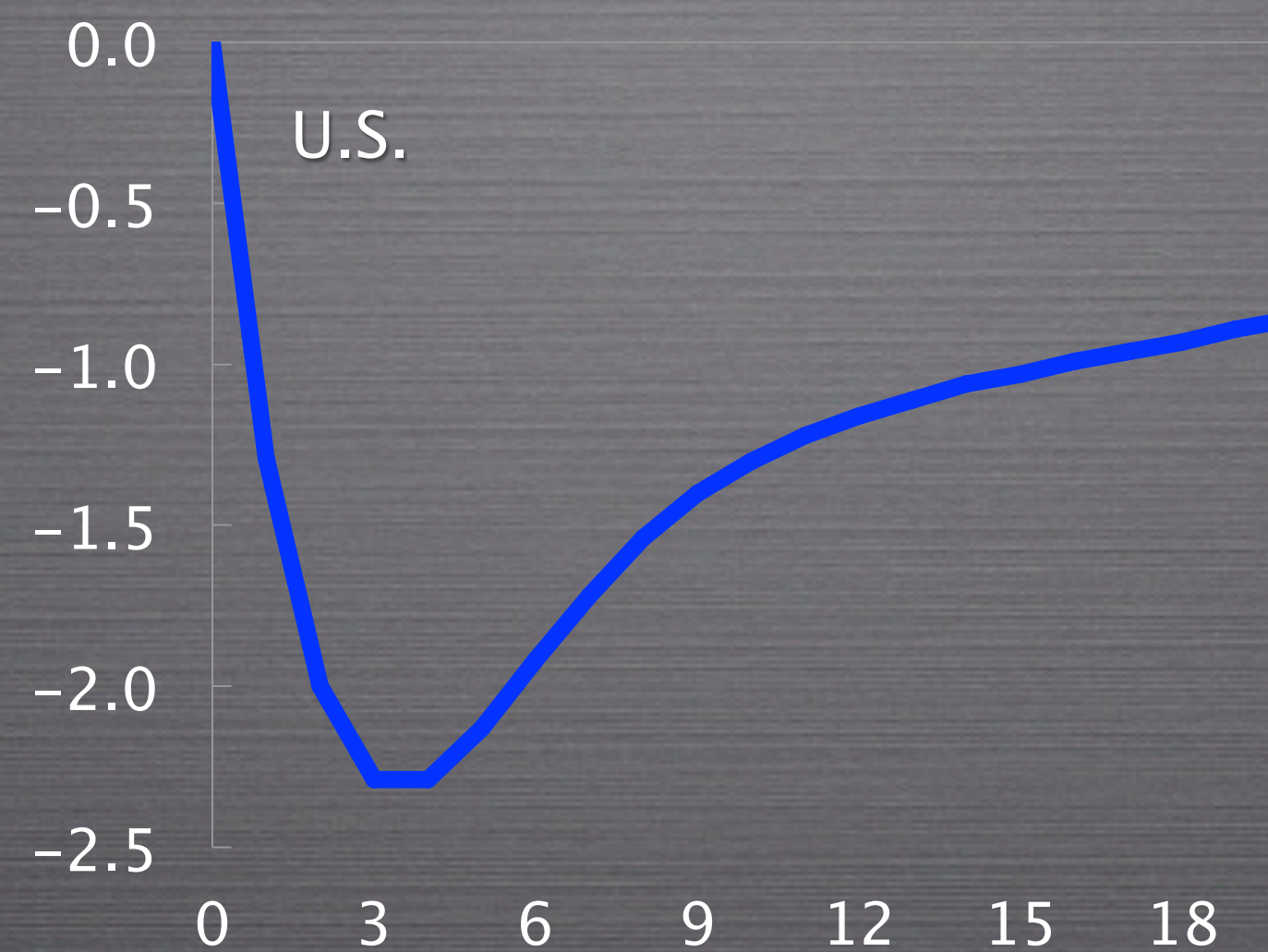
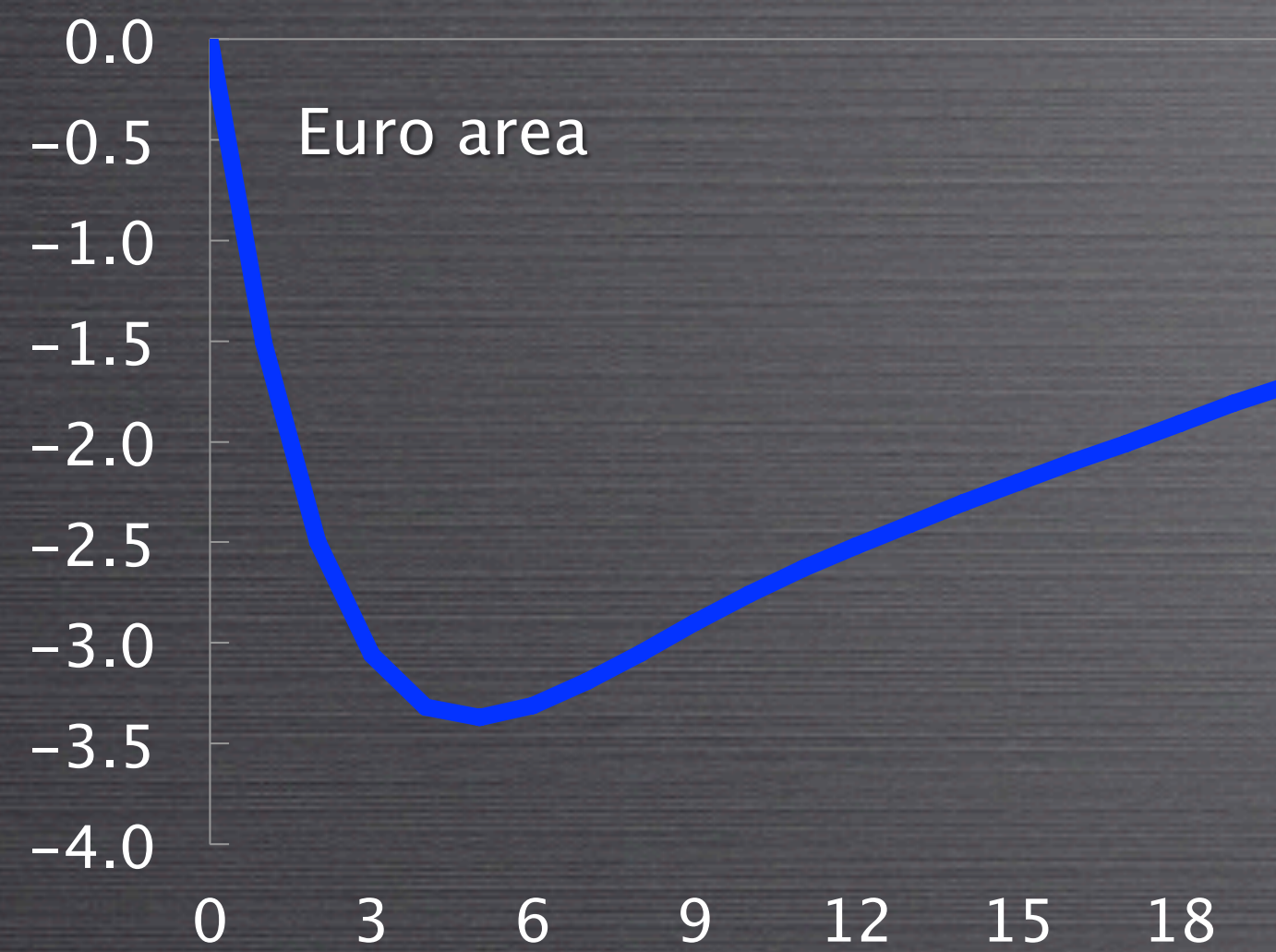
III

Policy response: Advanced countries constrained

WEO Downside Scenario

(deviation from baseline; quarters)

— Debt crisis in Europe



Source: IMF staff estimates.

Confidence

Outlook



Risks

Policies

Policy Challenge

Global economy entering a danger zone

Urgent and collaborative action required to restore confidence

Euro Area Task: Rebuilding Confidence

Adjustment

- Implement credible medium-term fiscal plans
- Rebuild bank capital buffers (sources: private/national/EFSF)
- Accelerate structural reforms to increase growth

EMU Arrangements

- Deliver a clear common vision of a more viable EMU
- This requires greater fiscal risk sharing, with much stronger governance

Financing

- Restoring confidence will take time
- In the meantime, sovereigns and banks will need liquidity

Rest of the World: Sustaining Demand

Advanced Economies

- Address medium-term fiscal imbalances, to create short-term fiscal room
- Explore ways to accelerate balance sheet repair

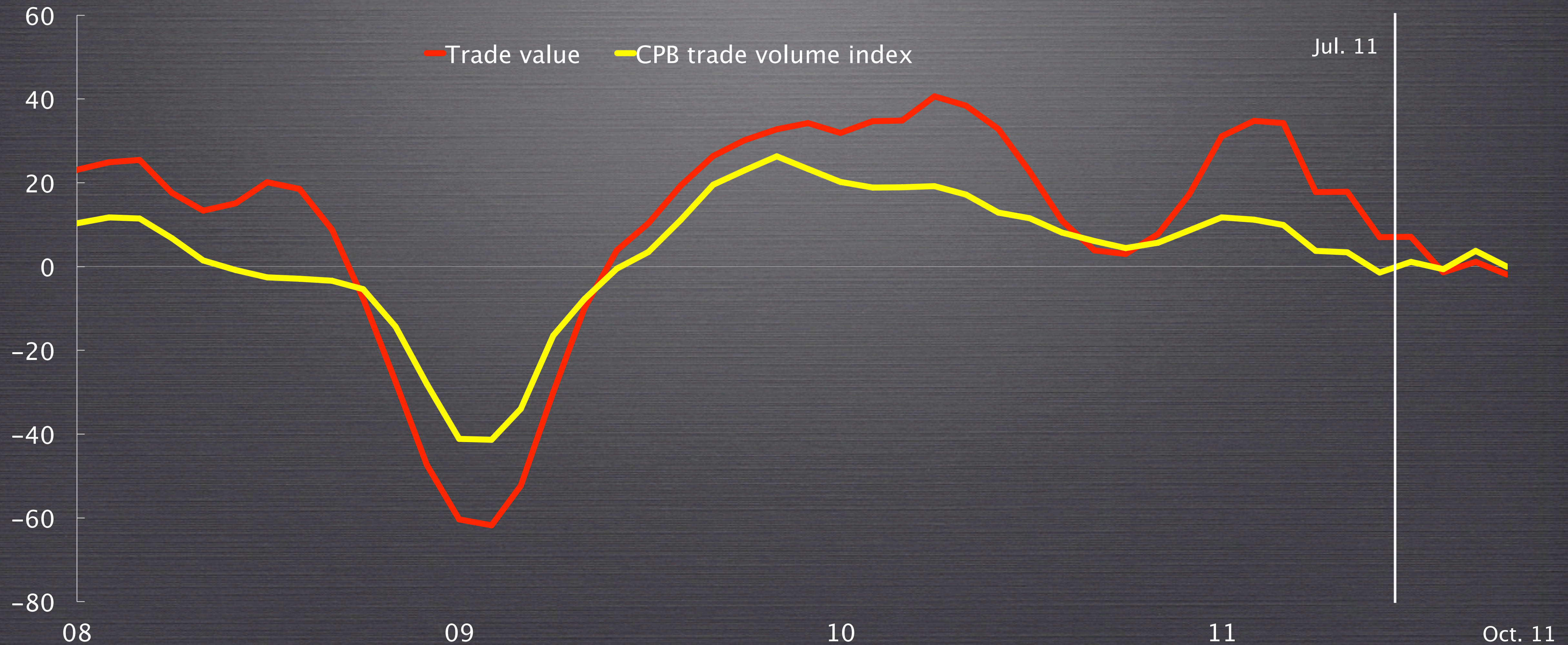
Emerging Markets

- Prepare for financial strains
- Be ready to shift the macro policy stance

A Sudden Slowdown

World Trade

(annualized percent change of 3 month moving average over previous 3 month moving average)

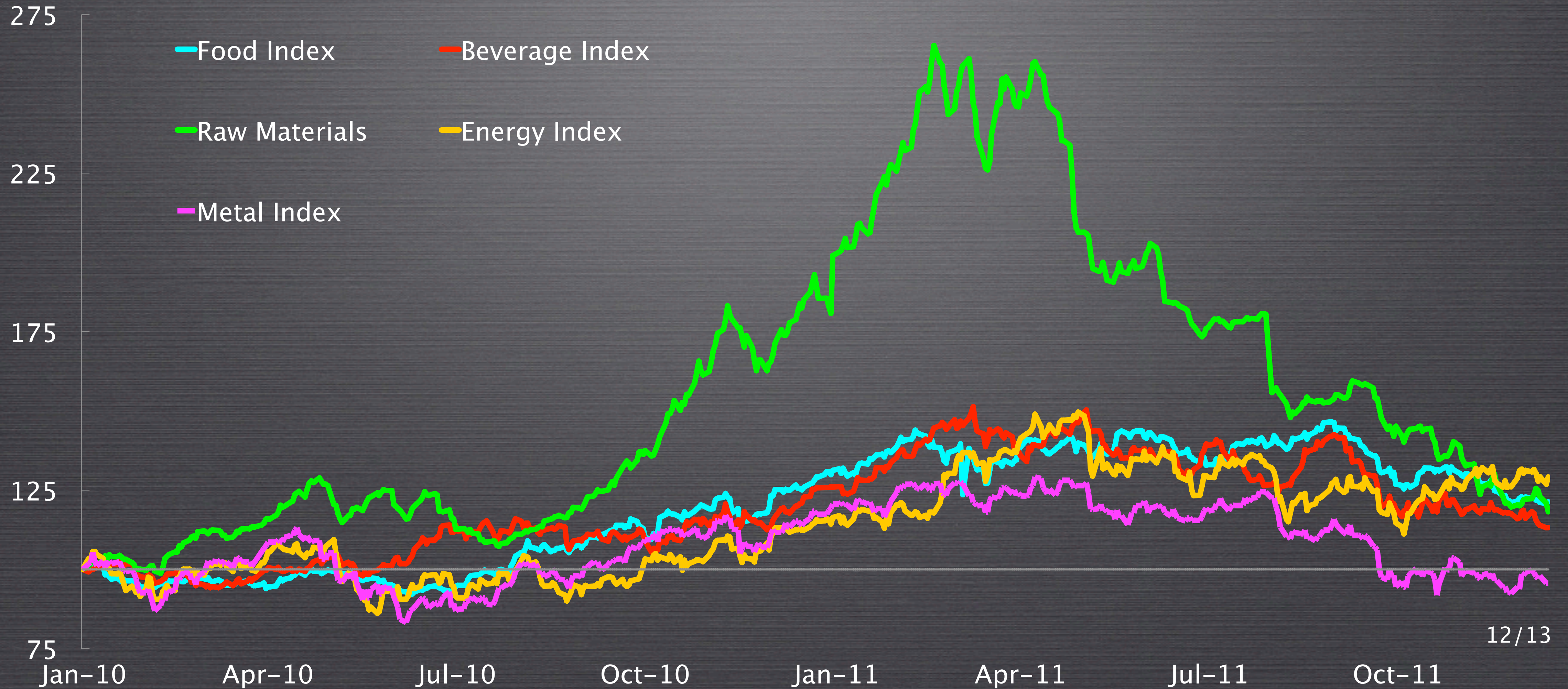


Source: Haver Analytics.

Declining Commodity Prices

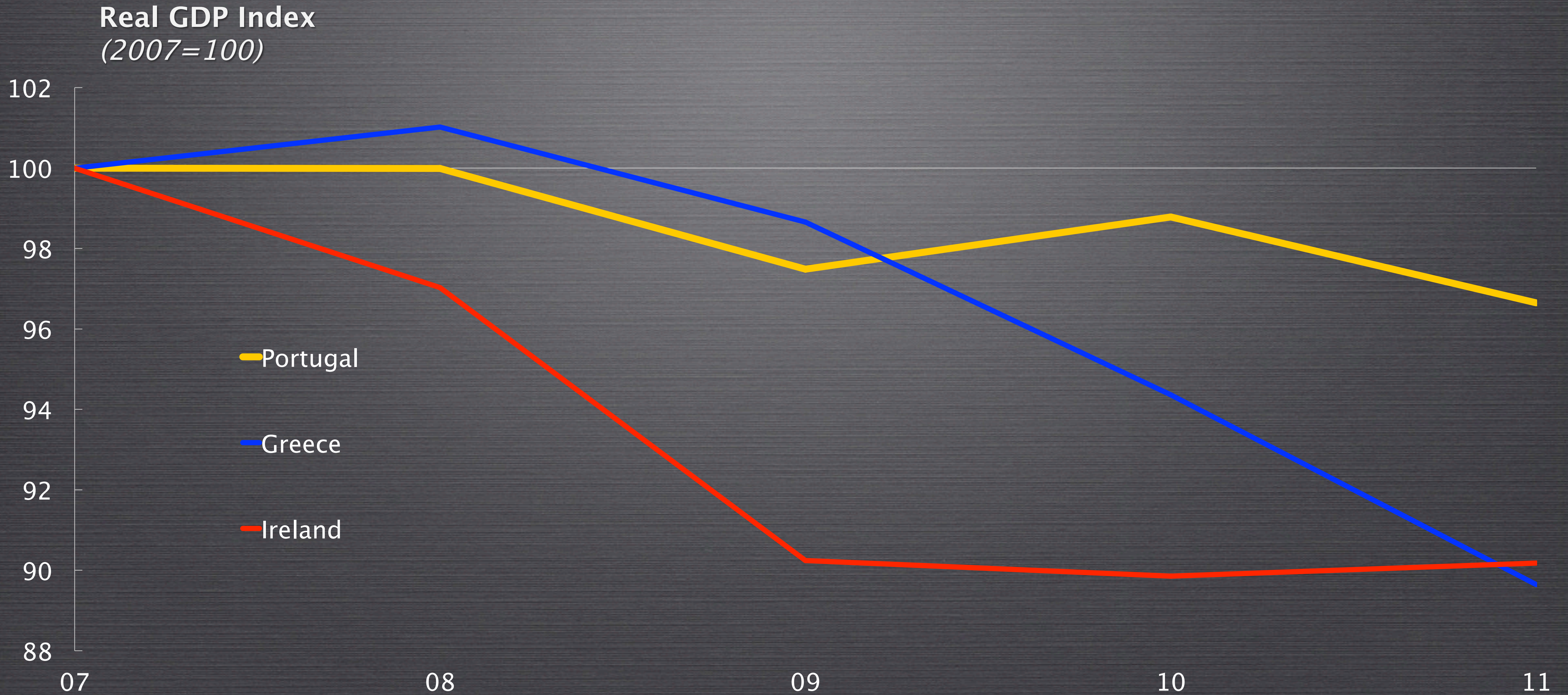
Selected Commodity Prices

(January 2010=100)



Sources: IMF, Commodity Price System; and IMF staff estimates.

GIPs: Falling Output



Source: IMF, *World Economic Outlook*.