Global Outlook and Policy Challenges

Olivier Blanchard
Economic Counsellor
Research Department

February, 2009
### Global Outlook Has Deteriorated, but Modest Turnaround Anticipated with Policy Stimulus

#### WEO Real GDP Growth Projections

*In percent change from a year earlier*

<table>
<thead>
<tr>
<th></th>
<th>U.S.</th>
<th>Euro</th>
<th>Japan</th>
<th>China</th>
<th>India</th>
<th>World</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>2009 (Jan.09)</strong></td>
<td>-1.6</td>
<td>-2.0</td>
<td>-2.6</td>
<td>6.7</td>
<td>5.1</td>
<td>0.5</td>
</tr>
<tr>
<td><strong>2009 (Nov.08)</strong></td>
<td>-0.7</td>
<td>-0.5</td>
<td>-0.2</td>
<td>8.5</td>
<td>6.3</td>
<td>2.2</td>
</tr>
<tr>
<td><strong>Change</strong></td>
<td>-0.9</td>
<td>-1.5</td>
<td>-2.4</td>
<td>-1.8</td>
<td>-1.2</td>
<td>-1.7</td>
</tr>
<tr>
<td><strong>2010 (Jan.09)</strong></td>
<td>1.6</td>
<td>0.2</td>
<td>0.6</td>
<td>8.0</td>
<td>6.5</td>
<td>3.0</td>
</tr>
<tr>
<td><strong>2010 (Nov.08)</strong></td>
<td>1.5</td>
<td>0.9</td>
<td>1.1</td>
<td>9.5</td>
<td>6.8</td>
<td>3.8</td>
</tr>
<tr>
<td><strong>Change</strong></td>
<td>0.1</td>
<td>-0.7</td>
<td>-0.5</td>
<td>-1.5</td>
<td>-0.3</td>
<td>-0.8</td>
</tr>
</tbody>
</table>

Source: IMF, World Economic Outlook.
Deteriorated Outlook Reflects Abrupt Fall in Industrial Activity and Global Trade

**Industrial Production**
(Annualized percent change of 3mma over previous 3mma)

**Merchandise Exports**
(Annualized percent change of 3mma over previous 3mma)
Behind the Forecasts—Advanced Economies

Causes of the collapse of output: Continued financial crisis.

- Less through direct effects (so far) of credit crunch.
- Than through indirect effects
  - Lower wealth
  - Collapsing confidence
  - Wait and see
Fall in Stock Markets and Consumer Confidence

Equities
(1/1/2007=100; FTSE)

Consumer Confidence
(Jan. 2005=100)
Behind the Forecasts—Emerging Economies

Three Major Shocks:

- Declining External Demand and Exports.
- Tighter Credit (External Financing).
- Lower Commodity Prices.
Emerging Economies Growth Slowed By Falling Exports and Industrial Production

**Industrial Production**
*(in percent change from a year earlier)*

**Merchandise Exports**
*(in percent change from a year earlier)*
Sharply Lower Commodity Prices

Commodity Price Indices
(index: Jan. 2002=100)
External Financing Pressures

Selected Emerging Markets Sovereign CDS Spreads
(index: 7/1/2007=100)

- Current account surplus or small deficit
- Current account deficit larger than 5% of 2007 GDP
Syndicated lending to emerging markets has contracted sharply as banks delever.
Market-based financing tighter with home bias

Emerging Markets Bond Financing
(in billions of U.S. dollars)

Source: Dealogic
Emerging Market Corporates will have Large Rollover Needs in Coming Years

Historical Issuance and Upcoming FX-Denominated Debt
(in billions of U.S. dollars)

Source: Dealogic, Bloomberg, Staff Estimates
Policy Challenges—Advanced Economies

- Need to decrease uncertainty and tail risk
- Need to repair financial system, get credit going 3 legs, but only 1 working
- May need to substitute / do it yourself for some time Central banks and “credit easing”
- Need to boost demand (fiscal stimulus) Spending more than general tax cuts, higher multipliers
Clarifying Asset Prices and Capital Adequacy

Writedowns and Credit Losses vs. Capital Raised
(In billions of US$; cumulative since 2007Q2)

(By Region)

<table>
<thead>
<tr>
<th>Region</th>
<th>Capital</th>
<th>Losses</th>
</tr>
</thead>
<tbody>
<tr>
<td>Worldwide</td>
<td>1000</td>
<td>1000</td>
</tr>
<tr>
<td>Americas</td>
<td>500</td>
<td>500</td>
</tr>
<tr>
<td>Europe</td>
<td>300</td>
<td>300</td>
</tr>
<tr>
<td>Asia</td>
<td>100</td>
<td>100</td>
</tr>
</tbody>
</table>

(By Type)

<table>
<thead>
<tr>
<th>Type</th>
<th>Capital</th>
<th>Losses</th>
</tr>
</thead>
<tbody>
<tr>
<td>Banks/Brokers</td>
<td>700</td>
<td>700</td>
</tr>
<tr>
<td>Insurers</td>
<td>200</td>
<td>200</td>
</tr>
<tr>
<td>GSE</td>
<td>100</td>
<td>100</td>
</tr>
</tbody>
</table>

Source: Bloomberg, L.P.
Counteracting Portfolio Shifts through “Credit Easing”

**U.S. Commercial Paper Rates**
(30-day rates; in percent)

- Non-Financial (A2/P2)
- Asset-backed (AA)
- Financial (AA)

**U.S. Credit Spreads**
(over Treasuries; in basis points)

- Credit Cards ABS
- Jumbo mortgage
- Corporates (BBB)
- Conforming mortgage
- TALF
- MBS Prgm.
Global Growth and Contributions of Fiscal Stimulus 1/

World
(in percent, GDP Growth)

United States
(in percent, GDP Growth)

1/ GIMF simulation; fiscal shock based on G-20 fiscal packages plus two-year monetary accommodation.
Policy Challenges—Advanced Economies

- Big challenge if long rates go up (sustainability concern), then much of the positive effects is offset
- Need well defined, credible medium-run plans
Rising Concerns Over Fiscal Sustainability

**Industrial Economies**
*(5yr Sovereign CDS; in basis points)*

- United States
- United Kingdom
- Japan

**Selected Europe**
*(5yr Sovereign CDS; in basis points)*

- France
- Germany
- Italy
- Spain

Source: Bloomberg, L.P.
Ireland Sovereign and Bank CDS Spreads Before and After Public Guarantees

Irish Bank and Sovereign CDS Spreads
(5-year CDS Spreads; in basis points)

Government guarantees

Bank of Ireland

Allied Irish Bank

Ireland Sovereign

Jun-08 Jul-08 Aug-08 Sep-08 Oct-08 Nov-08 Dec-08 Jan-09
Policy Challenges—Emerging Economies

Same as advanced economies (bad loans, tight credit), plus more:

- Lower commodity prices.
- Lower export growth.
- Usual advice: Smooth if you can (reserves, exchange rates, fiscal policy).

Two issues:

- How long? One year, or many more?
- Capital account: ‘‘Creeping stops’’ of financing (home bias)

Need liquidity support (reserves, swaps, new Fund facility)
New IMF Facility?

Some directions:

- Creeping stops: Largely exogenous, Slow, Long Lasting.
- Prequalification, not conditionality
- Precautionary. Available for 6 months, one year?
- Long lasting. Same terms as SBA?
Recovery Prospects and Risks

Recovery prospects based on: Slow improvement of financial system; housing price stabilization; fiscal impulses and other key policy actions.

Key Risks:
- Policies not in place soon enough (more serious real and financial feedbacks)
- Policies in place, but do not work well (Japan, 1990s)
- Policies cannot help avoid sustained deflation
- Policies help some at expense of others

Still, some reasons for optimism. Crisis of confidence, but confidence can return fairly fast with right policies.
U.S. Housing – Signs of Stabilization?

**Real House Prices**  
*(index, 1995 = 100)*

**Housing Inventories**  
*(new homes)*

- OFHEO
- Case-Schiller
- NAR
- OFHEO trend
- NAR trend

**Thousands of units**  
(LHS)

**Months of supply**  
(RHS, SA)
How Great Are Deflation Risks?

1/ Simulations from Global Projection Model (GPM).