1. Global, U.S., and Canadian Outlook

The global economy continues to expand, though heterogeneity and downside risks persist. The recovery in most advanced economies—where output remains below trend—is proceeding only gradually, and will continue to be constrained by the need to repair household, government, and financial sector balance sheets. Growth in emerging economies remains robust fueled by favorable external conditions, yet policies need to be tightened to avoid overheating.

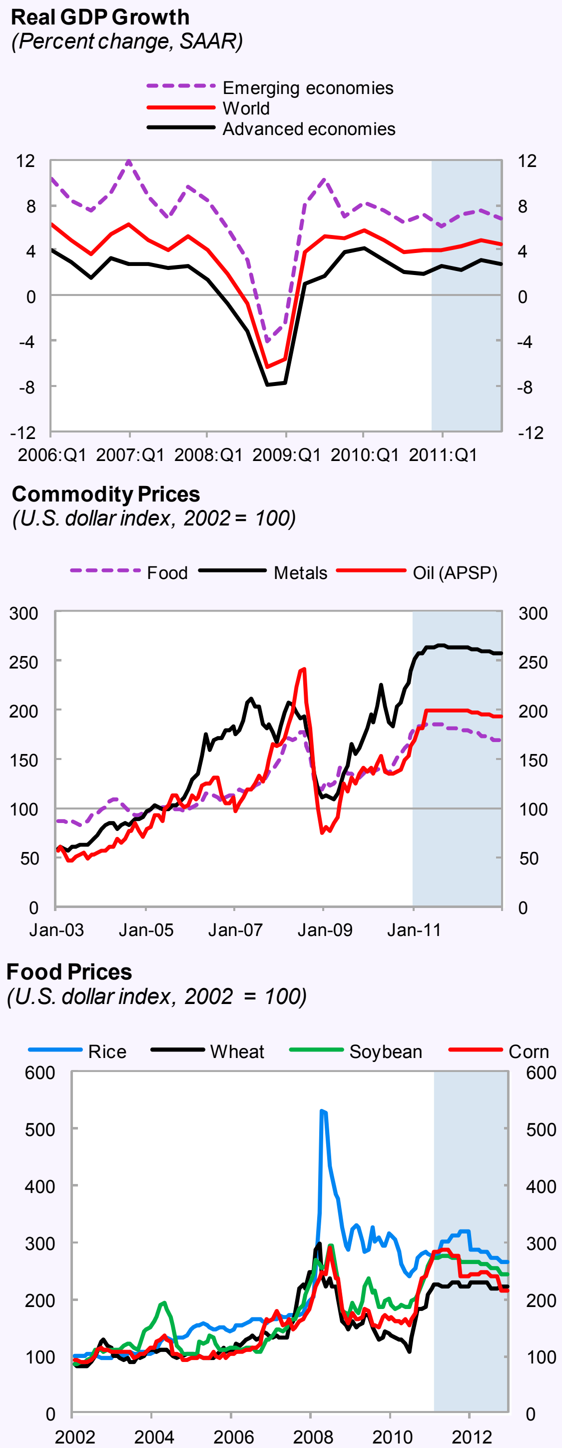
1.1. The Global Outlook—A Dual Speed Expansion Proceeds with Increasing Risks

The world economy continues to expand at multiple speeds (Figure 1.1). The recovery in advanced economies remains tepid considering the depth of the recession, and unemployment remains stubbornly high. On the other hand, output gaps have closed in many emerging market economies where growth remains brisk and overheating risks are emerging.

Commodity prices have risen further, reflecting strong demand from emerging Asia, particularly China. Weather-related supply shocks have contributed in pushing food prices to above precrisis levels, and recent political tensions in the Middle East and North Africa have added pressures to oil prices. While futures markets price in a gradual decline in commodity prices during the course of this year, as uncertainties dissipate and supply reacts, commodity prices will remain relatively high and above last year's average.

Financial conditions have been generally improving, though they remain stressed in some areas. Strong corporate profits have pushed equity prices higher, while more recent bouts of volatility in

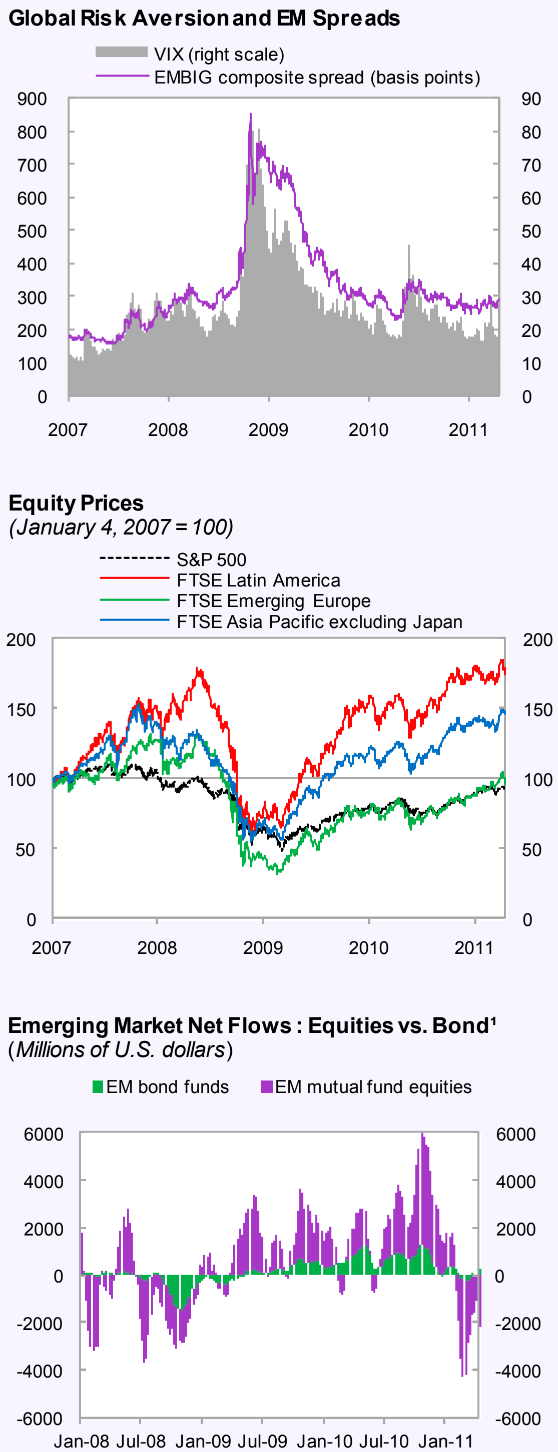
Figure 1.1. Dual speed expansion proceeds, in the context of rising commodity prices.



Sources: IMF, *International Financial Statistics*; and IMF staff calculations.

Note: This chapter was prepared by Oya Celasun and Luis Cubeddu, with contributions from Nicoletta Batini and Martin Sommer.

Figure 1.2. Low global interest rates and risk aversion are helping to push equity prices higher, though flows to emerging economies slowed in recent months.



Sources: Bloomberg, L.P.; Datastream; EPFR Global; and Morgan Stanley.
[1]Five-week moving average of net flows.

periphery Europe (Ireland and Portugal) have had limited and short-lived spillovers on global financial conditions (Figure 1.2). Attractive interest rate differentials, higher growth prospects, and other relatively more favorable fundamentals (including healthier public and private balance sheets in emerging markets than in many advanced economies), combined with declining global risk aversion, have supported strong capital flows to emerging economies through most of 2010. More recently, however, some positive news on the U.S. economy, as well as inflation risks and higher asset prices in emerging markets, have slowed such capital flows. The recent turmoil in the Middle East and North Africa and the earthquake in Japan are adding to overall uncertainties, though the impact on global risk aversion has been limited thus far.

Against this backdrop, IMF staff projects world growth to moderate somewhat from about 5 percent in 2010 to slightly less than 4½ percent during 2011–12, a scenario not very different from six months ago. Growth in advanced economies is expected to reach 2½ percent in 2011, ½ percent lower than last year as most countries consolidate their public finances, but still somewhat above potential growth rates. Emerging and developed economies are projected to expand by 6½ percent in 2011 (from 7¾ percent in 2010), as the policy stimulus is unwound and they gradually slow to trend growth.

Downside risks to the global outlook continue to dominate. While the likelihood of a double-dip recession in the United States has receded since the last *Regional Economic Outlook*, new downside risks have emerged. The potential for continued turmoil in the Middle East and North Africa and a more protracted nuclear crisis in Japan could also dent global growth and add to overall uncertainties. Moreover, vulnerabilities remain elevated in periphery Europe, with attendant risks to financial sector balance sheets in core European economies. In the case of many emerging economies, risks are more balanced—delays in stimulus withdrawal could add to growth in the near term, although they would raise concerns about a hard landing down the road.

Global imbalances persist, with continued official reserve accumulation, particularly in emerging Asia. Although the current account balances of key surplus and deficit countries have receded from precrisis peaks, a disproportionate portion of demand rebalancing has been through a shift of demand from deficit countries to emerging economies with flexible exchange rates and open capital markets—but not large surpluses, and indeed many in Latin America with increasing deficits. IMF staff projects that the imbalances will widen again in the coming years. The lack of sufficient demand rebalancing—between important advanced economies with deficits and emerging economies with surpluses—is a key concern for the sustainability of the recovery over the medium term.

Advanced Economies

The main challenge for advanced economies is to secure the recovery, while making further progress in repairing government, household, and financial sector balance sheets. Because fiscal consolidation needs to proceed, monetary policy will likely remain accommodative for a prolonged period in some advanced economies, given high unemployment, subdued core inflation, and stable long-term inflation expectations. Survey-based expectations suggest the policy rate in the United States will remain unchanged through late 2011, with some participants not expecting hikes at least until mid-2012.

Most advanced economies are appropriately seeking to consolidate their public finances in 2011, with the exception of the United States and Japan, where fiscal policy will remain accommodative. In the euro area, fiscal deficits are projected to decline by an average of 1½ percent of GDP in 2011, and an additional 2½ percent over the course of the next five years, though the specifics of the adjustment measures need to be better defined to bolster credibility. In the United States, the government adopted in late 2010 a new stimulus package worth 1 percent of GDP in fiscal years 2011–12 (partially offset by the recently agreed cuts to FY2011 spending). This development, which was not anticipated at the time of the last *Regional Economic Outlook,* has modestly raised the U.S. growth outlook for 2011. At the same time, it adds to uncertainties over the speed and content of plans to stabilize and reduce public debt over the medium term. Structural fiscal adjustment also has been postponed in Japan, where spending is bound to increase even more following the recent earthquake.[1]

Financial sector repair in advanced economies needs to be accelerated, as discussed in the Spring 2011 *Global Financial Stability Report* (GFSR). As explained in the GFSR, market pressures persist in the euro area as countries continue to face large refinancing needs, and the European Central Bank should ensure orderly conditions in funding and sovereign debt markets while countries undertake the necessary fiscal and structural adjustments. Rigorous stress tests and credible recapitalization and restructuring plans are also needed to strengthen confidence particularly in Europe's financial sector. Similarly, in the United States, bank balance sheets will need to be strengthened should weaknesses in the housing sector persist, and a thorough implementation of financial sector reforms is necessary.

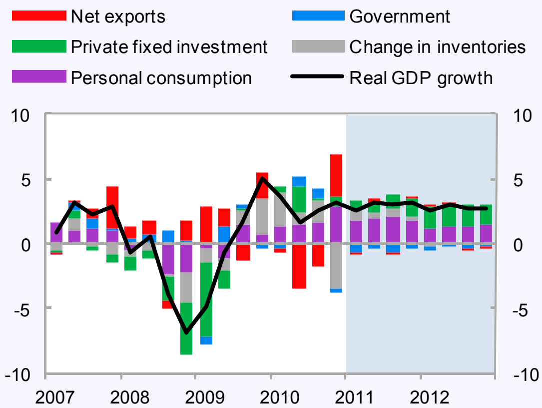
Emerging Market Economies

Policy challenges for many emerging market economies center on avoiding growing overheating risks resulting from favorable external financial conditions, remaining macroeconomic policy stimulus, and in some cases from improving terms of trade. These risks are manifesting themselves through a combination of higher inflation, widening current account deficits (prevalent in Latin America), and strong credit and asset price growth. Although most countries have begun to remove the policy stimulus implemented during the crisis, many remain behind the curve in normalizing monetary and fiscal policies.

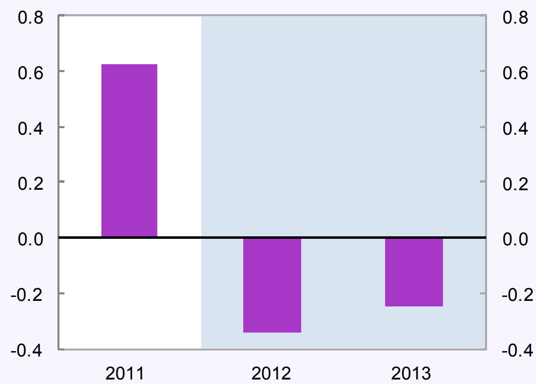
[1] Prior to the earthquake, Japan's fiscal stance was expected to be broadly neutral for 2011.

Figure 1.3. Growth will be led by the private sector as the policy stimulus is withdrawn.

United States: Contributions to Real GDP Growth
(Percentage points, SAAR)



United States: Impact of the December Fiscal Stimulus Package on Growth
(Percent of GDP under a no-stimulus baseline)



Sources: Bureau of Economic Analysis; and IMF staff calculations.

Emerging economies facing large capital inflows and appreciation pressures should generally tighten fiscal policy ahead of the full withdrawal of monetary accommodation. They may also need to strengthen prudential measures to contain the excessive procyclicality of credit and prevent asset bubbles from forming. Under certain circumstances, and provided appropriate macroeconomic policies are in place, temporary restrictions to the capital account may be needed. Such measures, however, cannot substitute for essential action on these other policy fronts. Rising food and fuel prices are adding to the challenge, both in terms of containing inflation and protecting the poor.

1.2. United States—Ongoing Recovery with Downside Risks

The U.S. economy continues to recover but downside risks are still dominant. Output and employment gaps are likely to close only gradually. Weak household, financial, and government balance sheets will continue to weigh down the growth outlook.

The U.S. economy expanded by an above-trend growth of 2.8 percent in 2010. After a strong start driven by a massive inventory boost, growth cooled considerably in the late spring just as European sovereign strains started to roil financial markets. Yet the economy managed to shrug off pervasive talk of a renewed dip and deflation risks, eking out above trend growth in the second half of 2010, helped by improved confidence on a new round of U.S. Federal Reserve easing. In particular, private consumption—after gradually accelerating through the year—gained some speed at end-2010. However, the recovery failed to produce a meaningful recovery in the labor market, and core inflation weakened to midcentury lows, given high levels of idle capacity.

The tentative signs of a stronger and more self-sustaining recovery at end-2010 have since been followed by certain setbacks and new risks. In particular, the surge in oil prices, if sustained, could significantly slow the recovery.

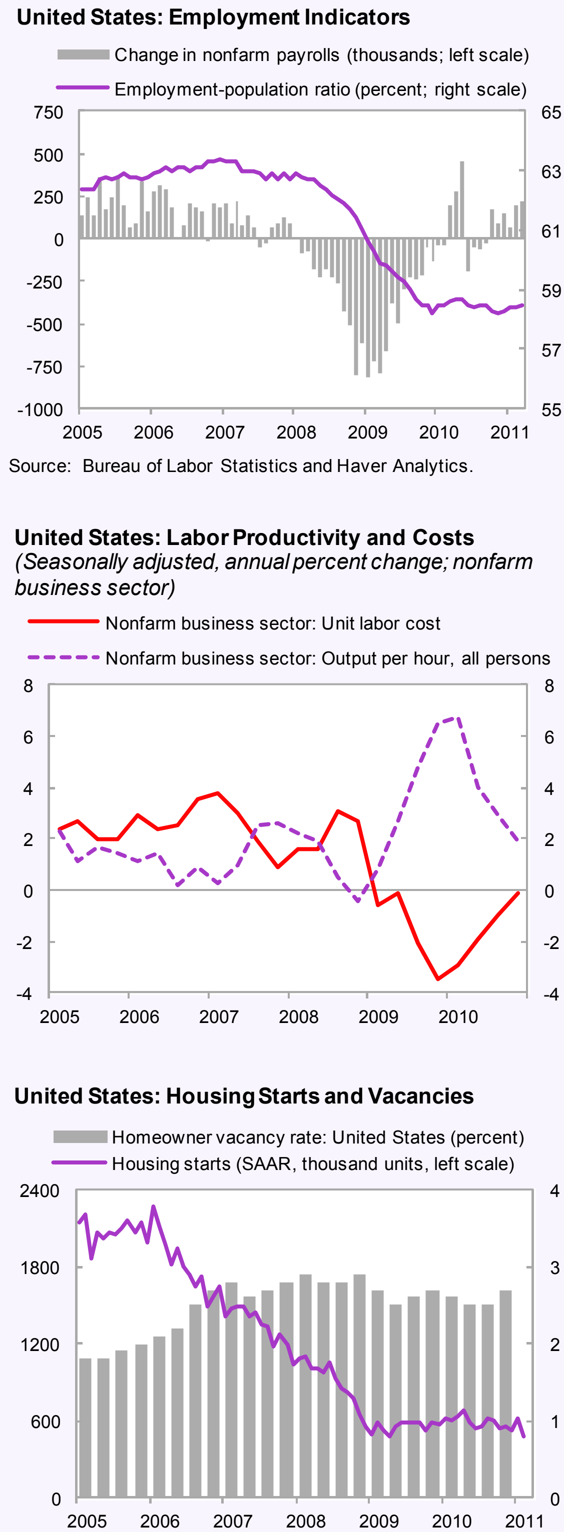
Monetary policy will remain supportive of growth through much of 2011. Policy interest rates are at the lower bound, with the U.S. Federal Reserve's bond purchases providing accommodation in the face of high unemployment and low inflation. Meanwhile, in contrast to what was projected six months ago, the federal fiscal structural deficit is now estimated to increase by 1¼ percent of GDP in 2011, following approval of the new stimulus package in December 2010 and despite the recently agreed cuts to federal FY2011 spending (Figure 1.3). The U.S. administration is committed to halving the federal fiscal deficit by 2013 relative to 2010, an adjustment that is included in staff forecasts. The commitment implies a large

5 percent of GDP cumulative structural primary adjustment for the federal government during fiscal years 2012–13.

Drags from labor and housing fronts persist. Despite the recent decline in unemployment rates (from a peak of 10.1 percent to 8.8 percent in March 2011), long-term unemployment remains near historical highs and the employment-population ratio has barely increased since output began to recover in mid-2009 (Figure 1.4). Although the downtrend in initial unemployment insurance claims since early 2011 suggest some strengthening ahead, payroll growth has so far gathered only limited momentum. The mirror image of the weak growth in jobs has been sizable labor productivity gains and declining unit labor costs. The pace of job creation would need to increase significantly from current levels to meaningfully lift the employed share of the population. And without a serious improvement in employment and aggregate hours worked, consumption growth is likely to remain tepid, given the ongoing repair of household and bank balance sheets, and sluggish nominal wages.

The U.S. housing market—a key source of macrofinancial headwinds against a faster recovery—also remains weak. The large inventory of houses for sale is keeping a lid on residential construction (Figure 1.4). House prices—a key determinant of households' net worth and consumption—have declined in January for seven months in a row, and their outlook is clouded by the sizable shadow inventory of foreclosures—that is, the stock of mortgages that are either delinquent but not-yet written down, or current but deeply in negative equity, or modified but likely to redefault. Indeed, household deleveraging is occurring largely on the back of defaults on mortgages (as well as other household debt), exerting downward pressure on house prices through the adverse effects of distressed home sales on the prices of neighboring houses. The feedback loop between weak and uncertain house prices, vulnerable household and bank balance sheets, and private consumption is a major factor behind the sluggish pace of recovery (Box 1.1).

Figure 1.4. Employment's growth remains weak, in part reflecting slow recovery of housing.

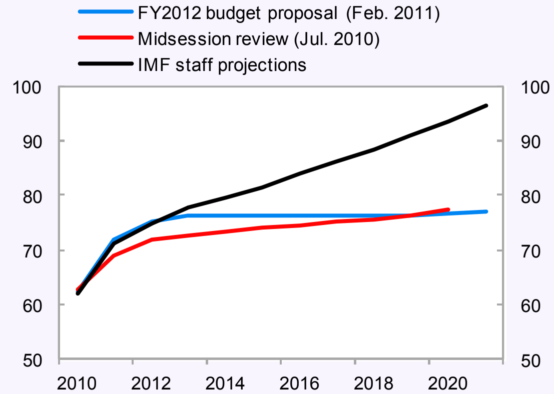


Sources: Bureau of Labor Statistics; U.S. Census Bureau; and IMF staff calculations.

Box 1.1. Long-Term Outlook for the U.S. Federal Government Finances

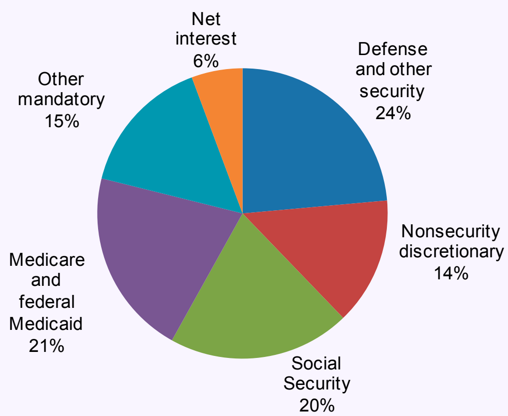
The U.S. public finances are on an unsustainable trajectory. According to the authorities' budget projections, federal debt held by the public is projected to increase from 62 percent of GDP in FY2010 to about 90 percent in FY2030, and continue rising thereafter owing to pressures from population aging and rapid cost growth in the health care sector. The debt dynamics are even bleaker under the IMF staff's more conservative macroeconomic assumptions. Because the financial crisis is expected by IMF staff to cause a permanent loss of output and budgetary revenues, federal debt could approach 95 percent of GDP already by the end of this decade (see figure at right)—approaching the levels last seen in the aftermath of World War II—and put upward pressure on interest rates both in the United States and abroad.

Federal Debt Held by the Public
(Percent of GDP; fiscal years)



Sources: U.S. Office of Management and Budget; and IMF staff calculations.

Composition of Federal Spending



Sources: U.S. Office of Management and Budget; and IMF staff calculations.

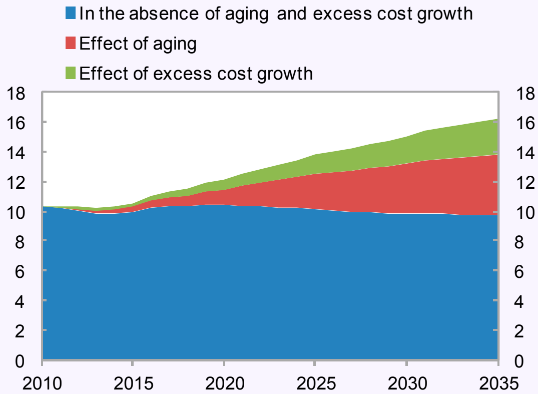
The long-term budgetary outlook remains troublesome despite the existing efforts to curb deficits. Although last year's health care reform is expected to bend the health care "cost curve" (the pace of increase in health costs) to some highly uncertain degree, the federal health care bill could still increase by 3 percent of GDP over the next 20 years according to the Congressional Budget Office. Other measures proposed by the administration such as a 5-year freeze on nonsecurity discretionary spending and defense savings are helpful, but cannot on their own address the fundamental long-term budgetary pressures, because mandatory health care, pension, and other spending make up a greater share of the budget and are projected to grow faster (see figure above). According to IMF staff calculations, the authorities would need to phase in additional saving measures worth roughly 2½ percent of GDP per year to achieve their federal debt projection of about 77 percent of GDP for FY2021. These measures would need to be implemented in addition to the existing plans, which include higher taxes for the upper-income taxpayers (from 2013) and lower tax concessions for certain industries. However, fiscal consolidation efforts should not stop there—additional saving will be needed to bring the debt ratio down to precrisis levels to avoid crowding out of private investment.

The authorities have a number of options to put the fiscal house in order without negative short-term effects on activity. Social Security (pension) reform would help reduce long-term fiscal imbalances without undermining the ongoing recovery—measures such as increasing the retirement age or lowering future benefits for upper-income retirees would have a minimal impact on current private

Note: This box was prepared by Martin Sommer.

spending. Identifying additional saving in health care and other mandatory spending categories would also be desirable (see the April 2011 *IMF Fiscal Monitor* for a discussion on options to reduce health care spending). Meanwhile, the tax system is riddled with loopholes and regressive tax expenditures worth over 7 percent of GDP. Gradually curbing this tax spending (including the mortgage interest deduction which largely benefits upper-income taxpayers) would help raise needed revenue while enhancing efficiency. Given low revenue from indirect taxes, consideration should also be given to the national VAT or sales tax, and higher energy taxes.

Sources of Growth in Federal Spending on Major Mandatory Health Care Programs and Social Security, 2010–35
(Percent of gross domestic product)



Source: U.S. Congressional Budget Office.

In light of the daunting fiscal outlook, early agreement on a comprehensive consolidation strategy is essential. The U.S. administration and Congress should find early political agreement on a comprehensive and balanced set of specific measures, based on the detailed blueprints put forth by the president's fiscal commission, various policymakers and other analysts. Preferably, such a plan should include legislation that sets out a clear medium-term debt target and addresses the key driver of long-term deficits—the mandatory spending related to pensions and health care (see figure above). The consolidation plan should also be prepared under credible economic assumptions. The current budget projections, for example, are based on GDP growth assumptions that are considerably more optimistic than the consensus forecast.

The overall balance of risks to the U.S. outlook remains tilted to the downside. The risk of deflation has lessened relative to six months ago, partly because of policy actions—in particular unconventional monetary easing. Meanwhile, the external environment continues to pose tail risks. Renewed financial turmoil in the euro area could substantially tighten global financial conditions and weaken global demand. And substantially higher oil prices could dampen confidence and weaken consumer spending. On the domestic front, housing prices could decline by more than expected, given the large shadow inventory of distressed properties, with adverse effects on household and financial balance sheets (see Box 1.2). On the other hand, strong corporate balance sheets and pent-up demand for consumer durables present upside potential.

What Kinds of Policies Are Needed?

High levels of slack in the labor and housing markets, low core inflation, and persistent downside risks call for a supportive macroeconomic policy stance. However, there is also an increasingly urgent need for implementing a comprehensive strategy to stabilize and then reduce public debt.

In that context, the U.S. Federal Reserve continues to signal that the high level of unemployment and low inflation call for near-zero policy rates for an extended period, and to implement its plan to purchase US$600 billion in Treasury bonds through June 2011. Although the bond purchase program is likely to add only modestly to growth, it has reduced perceptions of downside risks by reinforcing the U.S. Federal

Reserve's commitment to support the recovery and prevent a damaging fall in long-term inflation expectations. After the U.S. Federal Reserve started signaling in August 2010 the possibility of renewed large-scale asset purchases, equity prices rose strongly and inflation compensation embedded in indexed Treasury securities increased to normal levels. Nominal long-term yields have increased since the official announcement of purchases in November 2010 given the improved outlook and normalized inflation expectations. Bond yields will likely increase only gradually over the medium term.[2] That said, the absence of a well-defined medium-term fiscal adjustment plan could put upward pressure on U.S. interest rates and tighten global financial conditions.

Although the recent fiscal stimulus was justifiable given the weak labor and housing markets, it could have been better targeted. The extension of unemployment benefits and extension of the Bush tax cuts to medium- and lower-income taxpayers are helpful because they put cash directly in the hands of those most likely to spend it; however, most other components of the package are not targeted to areas of weakness. The federal fiscal deficit is now projected by staff to reach 10½ percent this year—the largest among major advanced economies—while the gross debt of the general government will likely exceed 110 percent of GDP by 2016.[3] The high deficit this year will require a larger structural adjustment for the United States to meet its G-20 commitment to halve the deficit between 2010 and 2013.

[2] Celasun and Sommer (2010) argue that once private sector deleveraging ceases, the 10-year Treasury bond yields could rise by about 100 basis points (beyond cyclical factors) to close the projected gap between the supply and potential demand for federal debt securities.

[3] The fiscal projections reflect IMF staff views on the economic outlook (which are generally more pessimistic than the authorities') and assessment of likely policies. Given the ongoing debate in congress, IMF staff assume more frontloaded (and deeper) discretionary spending cuts than planned by the administration and a delayed action on revenue measures.

The unsustainable fiscal outlook makes urgent the need for the administration and Congress to agree on a comprehensive and balanced medium-term fiscal consolidation package.
The alternative proposals recently put forward by the National Commission on Fiscal Responsibility and Reform, various policymakers and other analysts contain many useful ideas and provide comprehensive blueprints on which the policymakers can build. These proposed measures generally include reforms to entitlement programs, caps on discretionary spending, tax reform, and a strengthening of fiscal institutions.

The recent overhaul of financial system regulation and supervision has been encouraging, but will need to be followed by strong and early implementation.[4] In particular, it will be critical to strengthen: (i) coordination across regulators to detect and act on systemic risks; (ii) transparency and accountability in the securities and derivatives markets; and (iii) monitoring of the shadow banking sector.

Despite the restoration of financial stability, fragilities in the housing sector continue to weigh down banks' balance sheets, and challenges remain in implementing financial sector reforms. The U.S. authorities have presented Congress with a set of proposals to reform housing finance markets, as mandated by the Dodd-Frank Act. The recommendations include winding down the government-sponsored enterprises (GSEs) and crafting more focused housing policies, with more explicit government support and targeted benefits to lower-income households. The eventual reform will need to strike the right balance between delivering an appropriate level of government intervention and discouraging another cycle of overinvestment. Its timing will probably be influenced by the strength of the housing market. Also, the authorities should ensure that foreclosure documentation problems are promptly resolved and that banks recognize real estate losses in a timely fashion.

[4] See Box 1.3 from the October 2010 *Regional Economic Outlook: Western Hemisphere* for a fuller discussion.

Box 1.2. Household Deleveraging in the United States

Deleveraging is a hallmark of the aftermath of credit-fueled housing bubbles. True to form, the pace of the recovery from the Great Recession has been held back by the need for both households and lenders to repair their balance sheets.

How is the process of household deleveraging playing out in the United States? How much longer will it last, and what implications does it have for the outlook? Household leverage—defined as the ratio of debt to assets—climbed to a higher plateau in the late 1990s, as lending standards eased and households borrowed more to purchase houses of ever-increasing value and also borrowed against their housing equity to finance consumption. It then surged during the crisis as the values of both houses and financial assets collapsed, setting off the subsequent deleveraging cycle. Household debt stood at 122 percent of disposable annual income as of the end of the third quarter of 2010, down from its peak at 133 percent at end-2007. It would take another six years for liabilities to decline to the prebubble level of about 90 percent of disposable income if debt continues to decline at the pace seen since the peak. Experience with prior housing bubbles in advanced economies—most notably the Scandinavian countries—suggests that indebtedness indeed tends to return to prebubble norms over time.

How is the adjustment taking place? The stock of liabilities evolves with new loan originations, net repayments, and defaults that result in write-offs of debt. More than 60 percent of the reduction of liabilities since early 2008 is estimated to have happened through defaults, especially on mortgage debt. Meanwhile, originations of new loans are also weak, in line with reduced demand and tighter lending standards reported by senior loan officers in commercial banks.

What does this mean for the outlook? The reduced level of new originations comes hand in hand with subdued demand for houses and other consumer durables. Household saving rates are kept high by the unwillingness of consumers to take on new debt given their uncertain income prospects or because their liabilities are already high enough to raise the risk of financial distress. The unwillingness of lenders to extend new loans given their own balance sheet uncertainties also increases household saving. This process of deliberate deleveraging paves the way for healthier balance sheets and stronger consumption in the future, although it prevents a more rapid macroeconomic rebound in the meantime. But the reduction in household debt that occurs through defaults on mortgages has significant negative externalities for the broader economy. Distressed house sales have a disproportional adverse impact on house prices and thereby on household net worth—a key determinant of consumers' spending decisions.[1] Sustainable debt restructurings, which would break the vicious circle between weak aggregate demand, employment, foreclosures, and house prices, have proven elusive.[2] The weak outlook for house prices and housing wealth is a significant headwind against a faster recovery in output and employment in the United States.

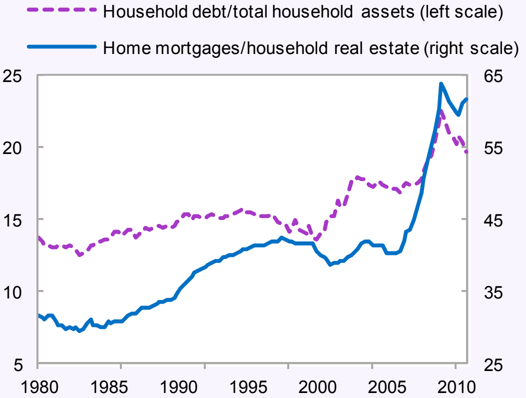
Note: This box was prepared by Oya Celasun.

[1] Campbell, Griglio, and Pathak (forthcoming) and Hartley (2010), among others, estimate that foreclosed residential properties lead to significantly lower prices in nearby property sales. Carroll, Otsuka, and Slacalek (2010) document that changes in housing wealth have significant effects on private consumption in the United States.

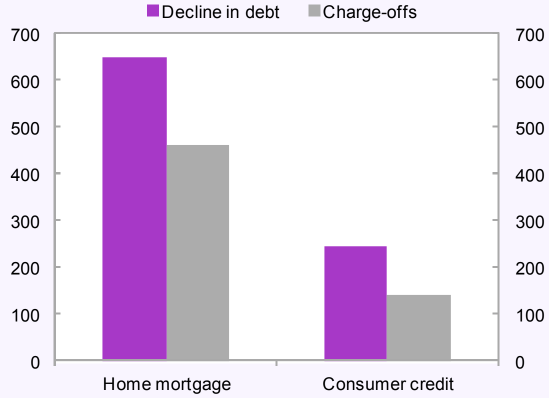
[2] Box 1 of the April 2011 *Global Financial Stability Report* discusses the ability of U.S. banks to absorb mortgage principal reductions.

Box 1.2. Household Deleveraging in the United States (*continued*)

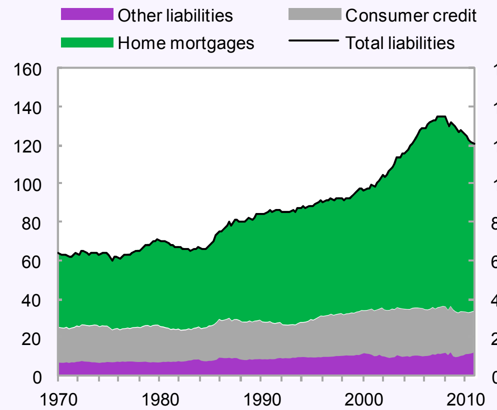
Household Leverage and Assets
(Percent)



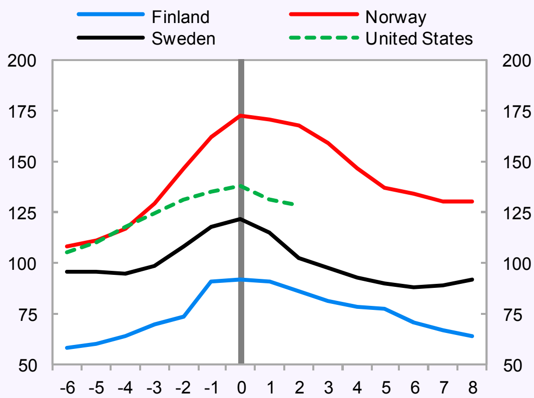
Deleveraging and Charge-offs, 2008:Q2–2010:Q3
(Billions of U.S. dollars)



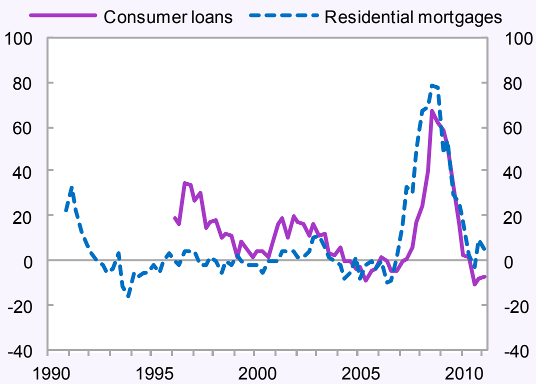
Household Liabilities
(Percent of disposable personal income)



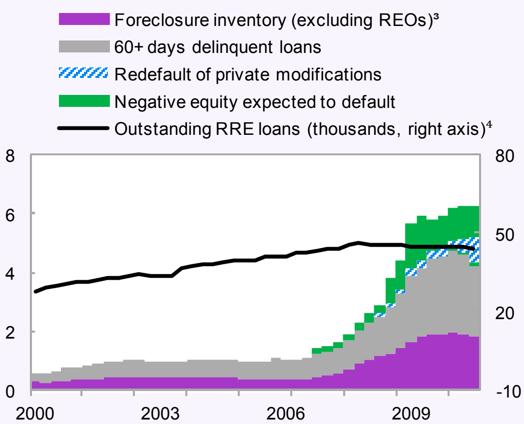
Household Debt in Percent of Disposable Income[1]



Lending Standards[2]
(Net share of domestic respondents indicating tightening standards)



Shadow Inventory of Houses
(Millions of outstanding mortgage loans)



Sources: Board of Governors of the Federal Reserve System; U.S. Federal Reserve Economist Jim Kennedy; IMF, World Economic Outlook; Norges Bank; Organization for Economic Cooperation and Development; Riksbank; and Statistics Finland.

[1] *t* = 0 corresponds to precrisis peak.

[2] Weighted average of lending standards for credit card and other consumer loans, weighted by the share of total consumer loans. Weighted average of prime and nontraditional loans, weighted by shares of total mortage loans.

[3] REO = real estate owned.

[4] RRE = residential real estate.

1.3. Canada—Recovery Gathers Strength

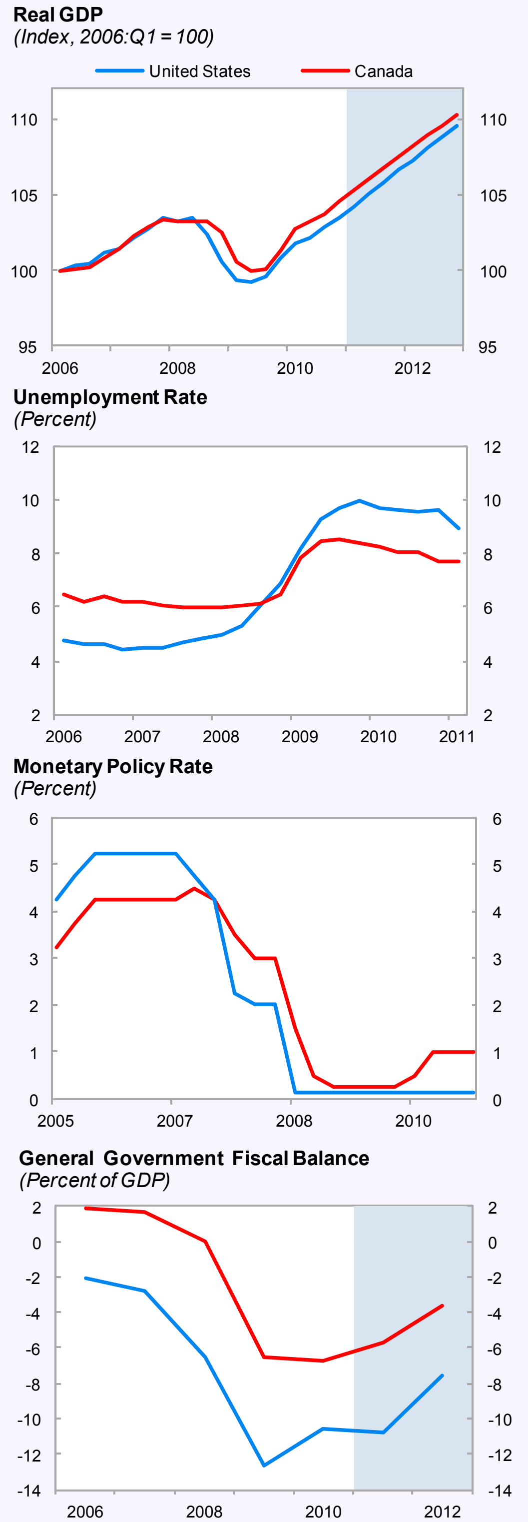
Despite its close ties to the United States, Canada's recovery from the global crisis has been relatively swift (Figure 1.5). Real GDP reached its precrisis level by 2010:Q2, initially led by strong domestic demand and accompanied by job creation, a large share of which has been in the form of temporary and part-time employment.

Fiscal and monetary policies were key to supporting the rapid turnaround of activity. On the fiscal side, the government launched a large and well-targeted stimulus—totaling 2 percent of GDP per year over 2009–10, including measures targeted at credit, housing, and labor markets. Likewise, monetary policy has remained highly accommodative, and interest rates have been unchanged following a small rate increase in mid-2010.

Canadian real GDP is estimated to have expanded by 3.1 percent in 2010, after contracting by 2.5 percent in 2009. Following a slowdown in 2010:Q3, growth picked up during the final months of last year driven by a large improvement in the net export balance. This improvement largely reflects better terms of trade, which increased by more than 6 percent in 2010, and a firming recovery of the U.S. economy.

Growth is projected to reach 2.8 percent in 2011, supported by high terms of trade. Domestic demand growth is projected to slow somewhat as household balance sheets are stretched and the fiscal stimulus is withdrawn (the general government deficit is projected to decline by 0.9 percentage points of GDP).[5] Markets expect that monetary policy will remain accommodative for an extended period of time, and that it will reach only gradually a neutral stance by end-2012.

Figure 1.5. The Canadian economy has been more resilient than that of the United States.

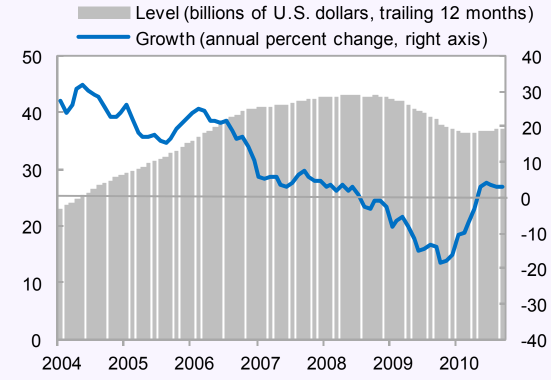


Sources: Bank of Canada; U.S. Bureau of Labor Statistics; U.S. Federal Reserve Board; and IMF staff calculations.

[5] Some of the stimulus measures adopted in 2009–10 were extended, including by postponing the normalization of employment insurance premiums and the deadline for the completion of certain infrastructure projects.

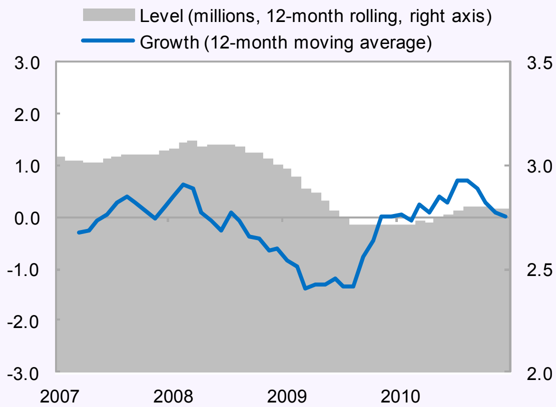
Figure 1.6. The recovery in remittances and tourism is being held back by labor conditions in advanced economies.

Remittances to Latin America and Caribbean[1]



[1] Includes Costa Rica, Dominican Republic, El Salvador, Guatemala, Honduras, Jamaica, Mexico, and Nicaragua. Data are through September 2010.

Caribbean: Tourist Arrivals[1]
(Index, 2007 = 100)



[1] Includes Bahamas, Barbados, Dominican Republic, ECCU, and Jamaica.

Sources: Caribbean Tourism Organization; national authorities; and IMF staff calculations.

Risks remain tilted to the downside. The main external risk is a more sluggish U.S. recovery that could prolong Canada's own recovery; the rise in household debt in Canada is an added domestic risk.[6] Though a sharp increase in oil prices (owing to a supply shock) would be beneficial for Canada's trade balance (as it is a net oil exporter), it would be largely offset by its negative impact on global growth and a stronger Canadian dollar.

Looking forward, the policy mix for this year is appropriately set to entail a continued stimulative stance of monetary policy, as fiscal policy begins a path from extraordinary stimulus to medium-term budget balance, in the context of still high unemployment and idle capacity. Both federal and provincial governments are rightly focused on bringing budgets back toward balance, with the recently released federal budget now targeting a modest medium-term surplus. On the financial sector, maintaining resilience will require continued vigilance, with further steps toward managing the level of household leverage if needed (Box 1.3).

1.4. Implications for the Latin American and Caribbean Region

High commodity prices are supporting growth particularly in commodity-exporting countries with stronger trade links with Asia. However, the recent increase in global food and energy prices are adding to policy challenges, as countries seek to contain its impact on inflation and to protect the poor. A further supply-related increase in oil prices for a protracted period is a potential risk that could dampen global growth, particularly in Central America and the Caribbean given their dependency on imported oil.

The improved U.S. performance is having positive spillovers on growth, especially in Mexico and Central America. However, weak employment prospects, particularly in the construction sector, will continue to constrain the recovery of workers' remittances to those economies, which are still below precrisis levels (Figure 1.6). Similarly, tourism growth will remain subdued, given its linkages with labor conditions in Europe and the United States.

Fiscal constraints in advanced economies suggest that monetary policy will remain accommodative for some time. Low interest rates in the United States will continue to make available abundant and cheap private capital to the more financially integrated

[6] Since the mid-1980s, total household debt as a share of personal disposable income in Canada has almost tripled—from 50 percent to about 150 percent—with visible acceleration since 2007.

Box 1.3. Canada's Financial System Resilience: What Can Others Learn?

Canada's financial system displayed remarkable stability during the global turbulence. The system has avoided systemic pressures: no financial institution failed or required public capital injections (banks raised capital in markets, albeit at elevated cost owing to higher global risk aversion).

Key factors behind this relatively strong performance included:

- *Sound supervision and regulation:* The 2008 Financial Stability System Assessment Update found that the regulatory and supervisory framework meets best practice in many dimensions, including with regard to the revised Basel Core Principles for banking supervision.
- *Stringent capital requirements:* Solvency standards apply to banks' consolidated commercial and securities operations. Tier 1 capital generally significantly exceeds the required 7 percent target (which in turn exceeds the Basel Accord minimum of 4 percent). The leverage ratio is limited to 5 percent of total capital. The Canadian leverage cap is calculated on total (Tiers 1 and 2) capital (versus Tier 1 capital in the United States), and some off-balance-sheet exposures (for example, credit derivatives, financial standby letters of credit, guarantees, and surety arrangements) are included in its definition of assets (unlike the U.S. leverage calculation).
- *Low risk tolerance and conservative balance-sheet structures:* Banks have a profitable and stable domestic retail market, and (like their customers) exhibit low risk tolerance. Banks had smaller exposures to "toxic" structured assets and relied less on volatile wholesale funding than many international peers as reflected in their stock valuations.
- *Proactive response to financial strains:* The authorities quickly reacted to the crisis by expanding liquidity facilities, providing liability guarantees, and purchasing mortgage-backed securities (all of those facilities have now expired). In addition, the resolution framework was reformed providing authority for public capital injections and other transactions to support financial stability. More recently, and amid concerns of household indebtedness, new rules to curb mortgage credit were introduced, including: (i) reducing the maximum amortization period from 35 years to 30 years for new government-backed insured mortgages with loan-to-value (LTV) ratios of more than 80 percent; (ii) lowering the cap on borrowing to refinance mortgages (to 85 percent from 90 percent of the value of their homes); and (iii) withdrawing government insurance backing on lines of credit secured by homes, such as home equity lines of credit. These measures are consistent with the best practices for stable housing finance systems that recommend enhanced underwriting standards and a careful calibration of government participation to the housing market (see *Global Financial Stability Report*, April 2011, Chapter 3).
- *Effective coordination between supervisory agencies:* Officials meet regularly in the context of the Financial Institutions Supervisory Committee (FISC) and other forums to discuss issues and exchange information on financial stability matters.[1]
- *Regulation reviews:* To keep pace with financial innovation, federal authorities review financial sector legislation every five years—the next review is to be completed in 2012.
- *Conservative residential mortgage markets:* Only 5 percent of mortgages are nonprime and only 30 percent are securitized (compared with 25 percent and 60 percent, respectively, in the United States); all of which are effectively unconditionally government guaranteed. About two-thirds of residential loans are guaranteed, because almost all loans that are securitized, plus those with an LTV ratio above 80 percent held by regulated depository institutions must be insured for the full loan amount (rather than the portion above the 80 percent LTV, as in the United States). Also mortgage interest is nondeductible, encouraging borrowers to repay quickly; and mortgages are recourse, that is they allow the lender to come after the borrower's other assets in case of default.

Note: This box was prepared by Francesco Columba and Erika Tsounta.

[1] The FISC comprises officials from the Office of the Superintendent of Financial Institutions, Finance Canada, Bank of Canada, Canada Deposit Insurance Corporation, and the Financial Consumer Agency of Canada.

economies of the region, stimulating demand and giving rise to widening current account deficits and net capital inflows. The management of this environment poses an important challenge, because flows could reverse abruptly should global conditions worsen and risk appetite fall. The recent slowdown of inflows to emerging market economies highlights the importance of being prepared for the volatility of these inflows and an eventual tightening in monetary conditions in advanced economies.[7]

Renewed turmoil in the euro area, particularly if the epicenter shifts to Spain and core Europe, poses a downside risk to Latin America, though the financial impact will be limited by the fact that most Spanish banks in the region follow a subsidiary model where local deposits are the primary source of funding. The possibility of increased and continued political tensions in the Middle East and North Africa could sharply increase oil price and undermine the strength of the global recovery. In addition to the direct impact on growth, this downside scenario will likely be associated with some decline in non-oil commodity prices, at least in the near term, adversely affecting many of the region's agricultural and metal commodity exporters.

Countries in the region should take advantage of the current favorable external conditions to rebuild the policy buffers used during the crisis in case these downside scenarios materialize.

[7] Global liquidity conditions could tighten should key advanced economies have trouble defining and implementing their fiscal consolidation plans.