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

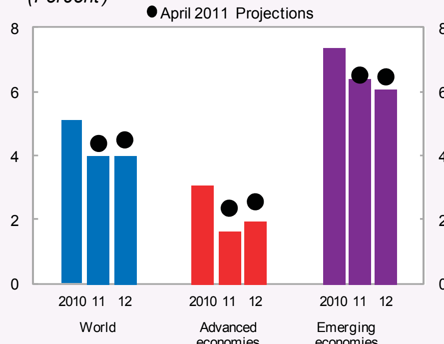
Global activity has slowed, and the expansion has become more uneven with increasing downside risks, accompanied by bouts of global financial market volatility. Although the transient factors that contributed to the slowdown in the first half of the year will dissipate, the loss of confidence associated with perceived policy paralysis in many advanced economies along with deepening balance sheet fragilities will hold back growth going forward. These factors have already unnerved markets in recent weeks. Growth in emerging economies has thus far been somewhat more resilient, though there are increasing signs of moderation as global financial conditions have deteriorated.

1.1. Global Outlook: Slowing Growth with Dominant Downside Risks

The pace of global expansion has weakened with increasing concerns about its sustainability (see the September 2011 *World Economic Outlook* [WEO] [IMF, 2011h]) (Figure 1.1). Growth in advanced economies has slowed markedly, reflecting both temporary factors as well as stronger than expected drags from weak balance sheets and stubbornly high unemployment. Fears of another recession in advanced economies, in which policy space for maneuver has diminished considerably, have increased global risk aversion and sparked market volatility. In Europe, negative feedback loops between weak sovereigns and financial institutions remain a concern, and in the United States, fragile household balance sheets and their linkage with housing troubles are holding back the recovery. In contrast, emerging economies have been expanding rapidly, with global uncertainties weighing on growth only more recently.

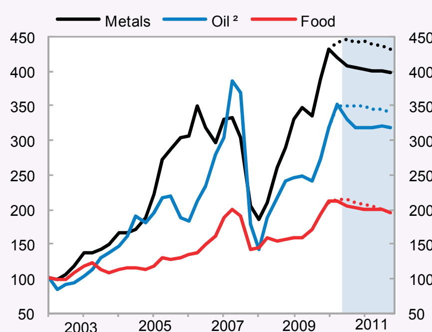
Figure 1.1. Growth in advanced economies is projected to slow sharply, with emerging markets and commodity prices being more resilient. Downside risks dominate.

World: Real GDP Growth
(Percent)



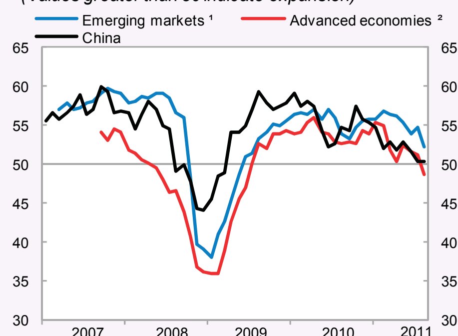
Source: IMF, *World Economic Outlook*.

Commodity Prices: Current versus April Projections[1]
(U.S. dollar index, 2003:Q1 = 100)



Sources: IMF, *World Economic Outlook*; and IMF staff calculations.
[1] Dotted lines represent the projections reported in the April 2011 WEO. Shaded area represents projection period.
[2] Average of West Texas Intermediate, Dated Brent, and Dubai Fateh.

Purchasing Managers Index: Output
(Values greater than 50 indicate expansion)



Sources: Haver Analytics; and Markit.
[1] Average of Brazil, India, and Russia.
[2] Average of euro area, Hong Kong, Japan, and United Kingdom.

Note: This chapter was prepared by Luis Cubeddu and Evridiki Tsounta with contributions from Oya Celasun and Martin Sommer. Alejandro Carrion provided excellent research assistance.

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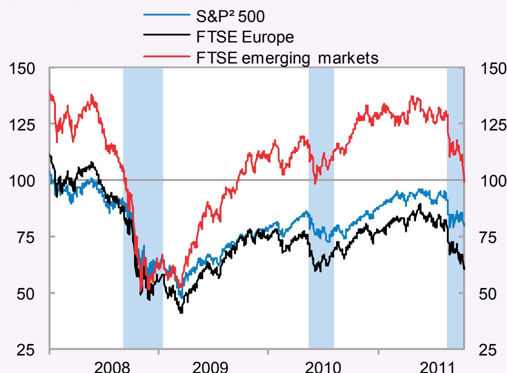
Figure 1.2. Global risk aversion has risen, leading to declines in equities and a reprise in flows to emerging markets.

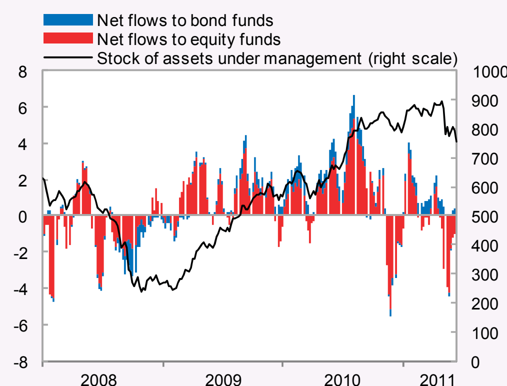
Sources: Bloomberg, L.P.; and IMF staff calculations.
[1] Shaded areas correspond to periods of VIX stress.
[2] Average for Greece, Ireland, Portugal, and Spain.
CDS = Credit default swap; VIX = Chicago Board Options Exchange Market Volatility Index.

Equity Prices[1]
(January 4, 2007 = 100)



Sources: Haver Analytics; and IMF staff calculations.
[1] Shaded areas correspond to periods of VIX stress.
[2] S&P = Standard and Poor's.

Mutual Fund Net Inflows to Emerging Markets[1]
($ US billions)



Sources: EPFR Global; Haver Analytics; and IMF staff calculations.
[1] Net flows data presented as 3–week moving average.

Prices for commodities have come down recently, but remain high in historical perspective. After peaking in May at levels last seen prior to the financial crisis, the prices of oil and metals have retreated, mainly reflecting lower demand from Asia (notably China) and global outlook concerns.[1] While commodity prices are still projected to remain at fairly high levels, risks are increasingly tilted to the downside, especially if activity in China decelerates more than expected.

Global financial conditions remain under stress, and this has led to a broad pullback in risk assets, including corporate and emerging market credit (September 2011 *Global Financial Stability Report* [GFSR] [IMF, 2011b]) (Figure 1.2). Spreads on European periphery sovereign debt have risen sharply since midyear, and tensions have more recently spilled over into core European countries, where the policy response to weak sovereign and financial balance sheets (and their feedback loops) has been perceived as inadequate thus far. In addition, the loss of confidence associated with the impasse over raising the debt limit in the United States, coupled with a weaker-than-anticipated recovery, contributed to generalized declines in equities (down by over 10 percent in advanced economies through mid-September).[2] Financial conditions in emerging markets, which until recently were relatively immune to the volatility in peripheral Europe, have become more volatile as fears of a global slowdown have become more generalized. Declines in equities and continued market volatility related to the situation in Europe are expected to put an additional drag on an already weak advanced-economy recovery.

Against this backdrop, IMF projections for global growth during 2011–12 have been revised down by about 0.5 percent (to around 4 percent), compared to the April 2011 *Regional Economic Outlook* (IMF,

[1] The release of crude oil and petroleum stocks from strategic emergency reserves by International Energy Agency members may have discouraged inventory building.
[2] The flight to safety has led to a strengthening of gold (until recently) and safe-haven currencies.

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2011e). This downward revision mostly reflects lower growth in advanced economies, which is expected to reach a mere 1.6 percent in 2011 and 1.9 percent in 2012, with fragile balance sheets continuing to provide strong headwinds. Growth in emerging economies and developing countries is expected to reach about 6½ percent in 2011, slightly below the April forecast round. The expansion will continue to be led by emerging Asia, where declines in export demand are expected to be offset by stronger domestic demand.

The baseline scenario assumes decisive and coordinated policy actions, and is subject to unusual uncertainty, with important downside risks. For example, the baseline as described in the September 2011 *World Economic Outlook* (IMF, 2011h) assumes that European policymakers contain the crisis in the euro area periphery; that US fiscal policy strikes a balance between near-term support for the economy and medium-term fiscal consolidation; that volatility in global financial markets does not escalate; and that key surplus emerging economies adjust policies to offset a slowdown in external demand. However, continued difficulties in designing and implementing effective remedies to address mutually reinforcing sovereign and banking balance sheets in Europe could add to a generalized loss of confidence and affect global credit markets. Much as in the Lehman event of 2008, emerging economies would not be immune to this downside scenario. A particular concern is that spillovers could occur if one of the more vulnerable emerging markets came under severe strain, much as occurred during previous crises. Moreover, a sharp slowdown in export-dependent Asia could lead to a renewed decline in commodity prices, with particularly negative effects on Latin American commodity exporters.

Policy Options: Rebalancing Demand

Advanced economies face the difficult task of balancing the need to support a still-weak recovery in private demand with the need to consolidate public finances over the medium term. In countries not facing market pressures, an overly front-loaded adjustment should be avoided, although a plan enshrined into law to consolidate public finances over the medium term is urgently required to reduce growing uncertainty about the course of future fiscal policy and to avoid a costly loss in confidence in fiscal sustainability. In Europe, a key priority is to enhance banks' capital buffers to end the negative macrofinancial loop between banks and sovereigns, while supporting orderly markets in peripheral sovereign debt. Given the weak recovery in private demand and the forthcoming fiscal drag, monetary policy in both the United States and Europe will need to remain supportive for a prolonged period.

Surplus *emerging economies* in Asia should consider boosting domestic demand to offset souring external demand and increasing exchange rate flexibility to ensure a stronger and more-balanced global expansion. Meanwhile, other emerging economies with deteriorating current account deficits (such as some countries in Latin America) should remain vigilant to overheating risks and build the necessary policy buffers to guard against a global downturn and sudden reversal in capital flows. This is particularly important for commodity exporters, which could also be subject to sharp declines in their export prices (see Chapter 3 for an in-depth analysis of the impact of terms-of-trade reversals). In a downside scenario, countries with policy room and credible frameworks could utilize that room to offset the drag from weaker global growth and financial markets volatility.

1.2. United States: A Tough Balancing Act

The U.S. recovery has lost steam, reflecting both temporary factors and weaker-than-anticipated private consumption resulting from persistent fragilities in household balance sheets and stubbornly high unemployment. Policies need to strike the right balance between supporting the recovery in the near term and restoring public debt sustainability over the medium term.

The U.S. economy slowed sharply in the first half of 2011, expanding at an annual rate of 1 percent, well below the 2.8 percent growth registered in the second half of 2010 (Figure 1.3). Although the slowdown reflected the temporary effect of higher

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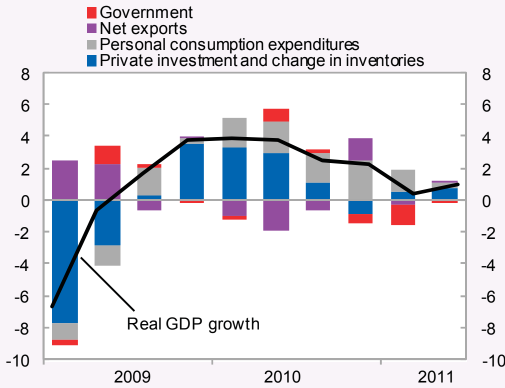
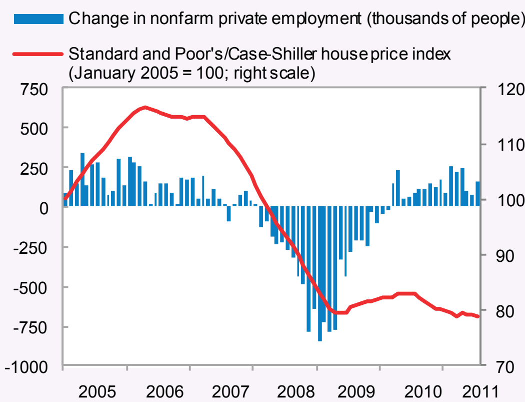
Figure 1.3. U.S. growth slowed sharply in the first half of 2011, reflecting temporary factors and continued weaknesses in labor and housing markets.

United States: Contributions to Real GDP Growth
(*Percentage points, seasonally adjusted annual rate*)



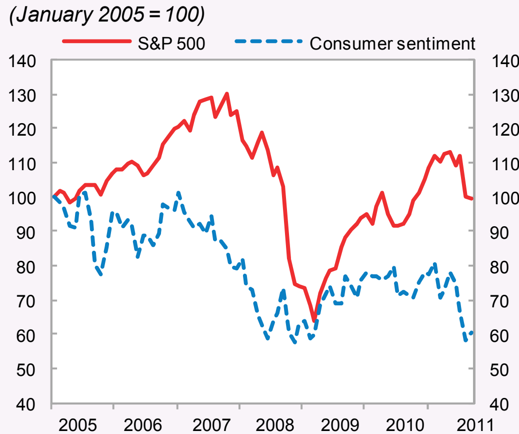
Sources: Haver Analytics; and IMF staff calculations.

United States: Employment and Housing Indicators



Sources: Haver Analytics; and IMF staff calculations.

United States: Stock Market and Consumer Sentiment [1]
(*January 2005 = 100*)



Sources: Haver Analytics; and IMF staff calculations.
[1] University of Michigan's consumer sentiment index.

world oil prices and disruptions to supply chains following the Japan earthquake, private consumption has turned out to be weaker than expected, in part reflecting fragile household balance sheets and feeble income. Weak consumption, in turn, is interacting with sluggish labor markets, exacerbating housing market weakness and vice versa (see Box 1.1).[3] Unemployment remains above 9 percent, with extremely subdued job creation. In addition, fiscal withdrawal has weighed on demand.

Core inflation has been on the rise during the past six months, largely reflecting pass-through from high commodity prices and higher rent costs. However, staff expect that amid economic slack and moderation of commodity prices, inflation will decline somewhat. In fact, expectations of a federal funds rate increase have been pushed well into 2013, following the U.S. Federal Reserve's statement that economic conditions would likely warrant exceptionally low levels for the federal funds rate at least through mid-2013, and more recently, further unconventional easing (Operation Twist).

Under our baseline, the U.S. economy is projected to expand by over 1½ percent in the second half of the year (quarter-over-quarter, seasonally adjusted annual rate). Lower equity prices, the sudden drop in sentiment, and increased uncertainties about the outlook will weigh on business investment and consumer demand, partly offsetting the uplift from the dissipating temporary drags of the first half of the year.[4] Growth is expected to reach a mere 1.5 percent in 2011 (nearly 1 percentage point lower than projected in the April 2011 *Regional Economic Outlook*) and increase to just 1.8 percent in 2012 on the back of a pickup in private demand and net exports, with the latter benefiting from the weakening U.S. dollar. The fiscal contraction in the pipeline is projected to subtract from growth in 2012, with the structural primary deficit falling by about 1¼ percent of GDP. However, this estimate

[3] For a discussion of the jobless aspect of the current recovery see Estevão and Keim (2011).
[4] The loss of U.S. household wealth from the recent market turmoil could reach 20 percent of disposable income.

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assumes that some of the stimulus measures adopted in December 2010, such as unemployment insurance and payroll tax reductions, are extended.[5]

Risks to the U.S. baseline are clearly tilted to the downside, with the likelihood of another U.S. recession, although still contained, on the rise:

- Heightened concerns over sovereign and bank weaknesses in Europe could spill over into the United States, negatively affecting U.S. banks and money market funds with considerable holdings of European bank paper (Box 1.2).[6] Under this tail-risk scenario, global credit markets could be affected, with negative consequences for U.S. and global growth. Although spillovers to U.S. financial markets so far seem to have been manageable, vigilance for possible bouts of illiquidity will be essential.
- On the domestic front, an overly front-loaded fiscal adjustment and continued household balance sheet fragilities would further dampen the near-term outlook. Over the medium term, uncertainties about the U.S. fiscal outlook and failure to tackle debt sustainability could undermine confidence and lead to higher U.S. Treasury rates, with negative spillovers onto the cost of credit and the housing market more generally.

Some bright spots persist. Strong corporate balance sheets and pent-up demand for consumer durables present upside risks, and the weaker U.S. dollar could have a positive impact on net exports.[7] New measures to support repair in the housing market, if adopted, may also boost consumption.

[5] Nonextension of these measures could imply a fiscal withdrawal of ¾ percentage points of GDP in 2012. The IMF's baseline forecast already incorporates the equivalent of 40 percent of the total package proposed by President Obama on September 8, 2011.

[6] See also the IMF's spillover report for the United States (IMF, 2011f).

[7] See Batini and Felman (2011) for an assessment of U.S. corporate balance sheets.

U.S. Policy Options

With growth in low gear, fiscal policy needs to be carefully calibrated not to undermine growth in the near term, yet must be complemented by a plan enshrined into law to restore public debt sustainability over the medium term. Indeed, such a plan could free up room for measures to offset the underlying near-term fiscal tightening, by underpinning confidence in medium-term fiscal sustainability. In addition, targeted policy actions to support ailing housing and labor markets should be considered.

In this context, *monetary policy* should remain supportive of growth over the next few years. The U.S. Federal Reserve's recent decision to maintain interest rates at historically low levels until at least mid-2013 and extend the maturity of its security holdings (Operation Twist) is appropriate; consideration may need to be given to further unconventional measures should the recovery weaken further (Figure 1.4).[8] Low interest rates will also support financial market stability, although authorities should be vigilant to bouts of illiquidity arising from financial strains in Europe.

On the *fiscal front*, a credible medium-term plan that is sufficiently back-loaded, so as not to jeopardize a weak recovery, remains urgently needed. If approved in its entirety, the proposed American Jobs Act (AJA) would offset the fiscal tightening in train for 2012, while being budget-neutral over the medium term.

But a credible medium-term adjustment plan that stabilizes debt remains missing.[9] Such a plan should

[8] The second asset purchase program (QE2) for US$600 billion ended in June 2011. In September, the Federal Reserve announced that it would purchase, by end-June 2012, US$400 billion in long-term Treasury securities, while selling an equivalent amount of shorter-term Treasury securities. It also indicated that it would reinvest principal payments from its holdings of agency debt and agency mortgage-backed securities in agency mortgage-backed securities.

[9] The consolidation plan under the August debt ceiling agreement did not consider entitlement reforms or revenue-raising measures, and fell short of the President's April strategy of achieving US$4 trillion savings over 12 years.

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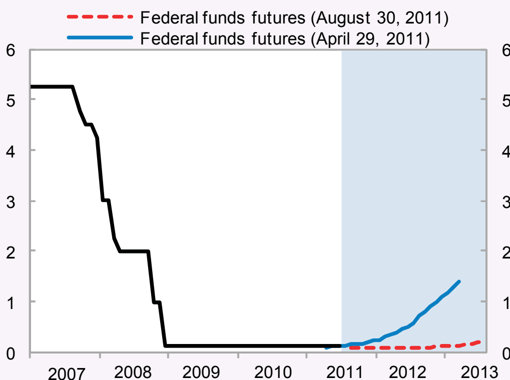
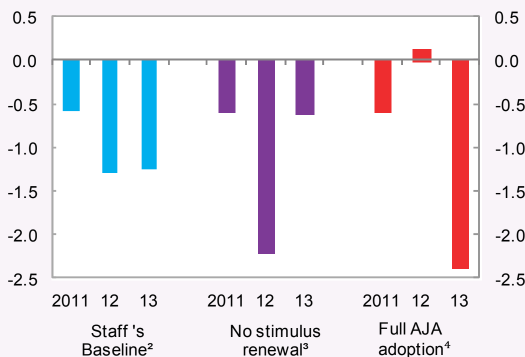
Figure 1.4. Monetary policy will remain accommodative for a more-prolonged period, with much-needed fiscal consolidation providing some drag on growth.

United States: Federal Funds Rate Expectations Implied by Futures Contracts
(Percent)



Source: Bloomberg, L.P.

United States: Change in Cyclically-Adjusted General Government Balance[1]
(Percent of GDP)



Sources: IMF, *World Economic Outlook*; and IMF staff calculations.
[1] Estimates for 2011 incorporate revised budget outturns.
[2] Staff projections assume a 2-year extension of unemployment insurance (calendar years 2012-13) and a one-year extension of payroll tax relief (calendar year 2012).
[3] Staff projections excluding renewal of unemployment insurance and payroll tax relief.
[4] Staff projections including all the measures in the American Jobs Act (AJA). Baseline projections include measures equivalent to about 40 percent of the resources provided under the AJA.

include both revenue-raising measures (such as fewer tax loopholes and deductions, higher taxes for the higher-income households, and consumption and carbon taxes) and changes to entitlement programs as well (such as raising the retirement age, trimming future benefits for higher-income retirees, and encouraging greater cost sharing with Medicare participants) amid population aging and rising health costs. In addition, strengthening fiscal and budget institutions would yield significant benefits, including reducing the uncertainty of fiscal policymaking (see Box 1.3).

Support is needed for *labor and housing markets* in light of the sluggish recovery, but within the envelope defined by a medium-term plan. On the *housing front*, courts could be allowed to amend the terms of residential mortgages ("cramdowns"), and programs to refinance mortgages and assist homeowners who are unemployed or have negative housing equity could be expanded. Government-sponsored enterprises could play a more active role in principal write-downs (Kiff and Tsounta, 2011). On the *labor front*, improving and consolidating the 50 existing job training and job search assistance programs, and adopting further tax incentives to spur hiring of the long-term unemployed—as proposed in the AJA—could avoid the erosion of job skills that accompanies long-term unemployment.

The continuous implementation of last year's *reform of financial supervision and regulation* is essential to address the weaknesses exposed during the 2008 crisis and prevent another crisis down the road. Although most of the recommendations made by the IMF's 2010 Financial Sector Stability Assessment for the United States have been addressed, funding constraints and delays in appointments are slowing the implementation of the Dodd-Frank Act (see IMF, 2010). Moreover, the still-fragmented regulatory system remains a concern, with the effectiveness of the new regulatory framework in stemming systemic risk and containing risks from too-big-to-fail institutions still untested. In particular, it would be important to ensure that the Financial Stability Oversight Council undertakes transparent and proactive surveillance of

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systemic risks. Last but not least, further progress is required in strengthening risk retention and disclosures for securitized debt and redefining the roles of the rating agencies (with greater emphasis on investor due diligence along with steps to address potential conflicts of interest).

1.3. Canada: A Slowing Recovery

The Canadian economy is slowing, largely reflecting close linkages to the United States. Policy challenges are less pressing than in the United States, given relatively strong financial and sovereign balance sheets and still-elevated commodity prices.

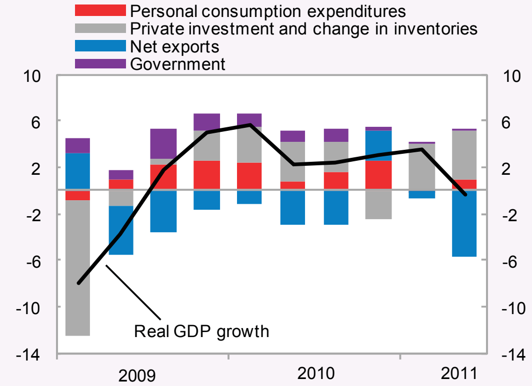
After expanding by about 3½ percent in late 2010 and early 2011, the Canadian economy contracted marginally during the second quarter of 2011, reflecting temporary factors (like those affecting the United States) and weakening private consumption from highly indebted households (Figure 1.5). Meanwhile, business investment remains robust, although net exports have continued to subtract from growth, reflecting a slowdown in U.S. demand and persistent strength in the Canadian dollar.

Contrary to what is taking place in the United States, labor and housing markets have performed relatively well. Unemployment fell below 7¼ percent in July 2011, and stricter mortgage rules were recently implemented to contain the growth in mortgage credit. Private credit remains strong, reflecting accommodative monetary conditions and a profitable banking system buttressed by strong regulation and supervision.[10]

The Canadian economy is now projected to expand by 2.1 percent during 2011, moderating to about 1.9 in 2012. Downward revisions to the outlook (½ percentage point in both 2011 and 2012) largely reflect weaker U.S. and global growth. Global factors have contributed to regional disparities, as the resource-rich western provinces benefit from

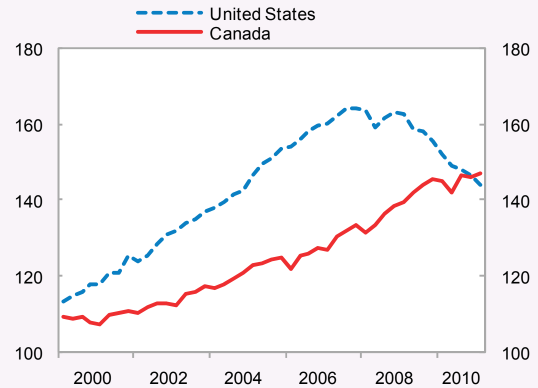
Figure 1.5. Canada is slowing, reflecting close ties with the United States. Fiscal consolidation and high household indebtedness are also headwinds to growth.

Canada: Contributions to Real GDP Growth
(Percentage points, seasonally adjusted annual rate)



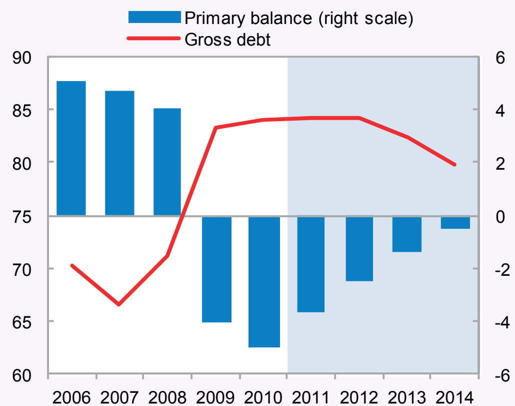
Sources: Haver Analytics; and IMF staff calculations.

Household Leverage[1]
(Percent of disposable income)



Sources: Haver Analytics; and IMF staff calculations.
[1]Adjusted for data to be comparable across countries.

Canada: General Government Primary Balance[1] **and Gross Public Debt**
(Percent of GDP)



Sources: IMF, *World Economic Outlook;* and IMF staff calculations.
[1] Primary Net Lending/Borrowing.

[10] Canadian banks were much less exposed to toxic assets and wholesale funding than were U.S. banks. See Box 1.3 of the April 2011 *Regional Economic Outlook* (IMF, 2011e).

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elevated commodity prices, and the manufacturing-hub eastern provinces suffer from links to the slow-growing United States and reduced competitiveness.

Significant risks stem from the uncertain global environment, as well as potential fragilities in domestic consumption. International risks include a weaker-than-expected U.S. and global outlook, which could trigger a reversal in commodity prices. On the domestic front, consumption might moderate more than expected from a large retrenchment in highly indebted households amid concerns of a drop in house prices. The latter are estimated to be above levels dictated by economic fundamentals in some key provinces. On the upside, improved global financial conditions could bolster confidence, supporting domestic demand.

Canada Policy Options

Following a combined fiscal stimulus in 2009–10 of more than 4 percent of GDP, the Canadian authorities embarked on a generally adequate fiscal consolidation plan (ex-post, some measures were adopted to reduce the up-front adjustment), which would bring the budget into surplus before fiscal year 2016. In this context, monetary policy should remain accommodative as long as inflation expectations remain well anchored.[11] In light of the weaker outlook, markets now expect a small rate cut in the near term, as well as no withdrawal of the monetary stimulus well into 2013.

Developments on the housing front require increased vigilance, and consideration may need to be given to additional prudential measures to prevent a further buildup in household debt.

1.4. Implications for Latin America and the Caribbean

Our global baseline scenario suggests that the region's more open economies will continue to benefit from the double tailwinds of high commodity prices and easy external finance, although both are now projected to be far less stimulative and more volatile than six months ago:

- The weaker-than-anticipated recovery in advanced economies (coupled with the need for fiscal consolidation) implies that unusually low international interest rates will remain in place for a prolonged period. However, bouts of risk aversion are likely to continue until advanced economies design and adopt comprehensive plans to address fragile balance sheets. In this context, capital inflows will likely remain more muted, especially given the environment of heightened exchange-rate volatility.
- Continued robust growth in emerging Asia is expected to keep commodity prices at relatively strong levels, although somewhat lower than anticipated 6 months ago particularly in the case of oil and metals (excluding gold and silver).

However, souring global conditions are having uneven implications for the region. Countries with strong real links with advanced economies (such as Mexico and the countries of Central America and the Caribbean) are expected to be harder hit by the recent slowdown. Although the Mexican economy is more dependent on U.S. manufacturing and trade, Central America and the Caribbean are more reliant on remittances and tourism flows, which in turn are very dependent on U.S. labor and housing market developments. Preliminary data point to only a minor slowdown in remittances and tourism receipts so far, though some further moderation is expected, as these flows typically manifest themselves with some lag. That said, remittances and tourism flows remain well below those observed prior to the crisis:

- Remittances have been hard hit by the adverse feedback loops between housing and labor markets, which have particularly affected Hispanic workers in the United States

[11] Inflation is expected to remain around 3 percent in the near term—above the Bank of Canada's 2 percent target—amid temporarily high commodity prices, returning to the target next year.

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(Figure 1.6).[12] Unemployment among Hispanics is about 2½ percentage points higher than average, since they overwhelmingly work in low-skilled sectors (construction, extraction, transportation, and services) that have been hardest hit by the financial crisis. Moreover, weak housing markets may be crimping remittances through the wealth channel.[13]

- The recovery in tourism receipts remains weak. Although tourist arrivals have been on an upward trend since mid-2009, spending per tourist is down to levels last seen in 2004. Efforts to diversify the tourism base toward faster-growing regions have had limited impact thus far.

Whereas our global baseline scenario would have a relatively mild impact on much of the region, the materialization of *downside risks* would have a serious adverse impact:

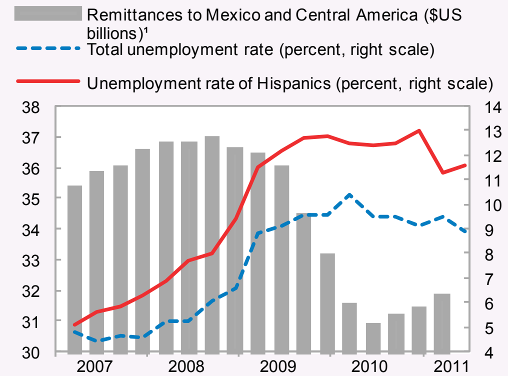
- A recession in advanced economies could lead to a sharp slowdown in emerging Asia and in turn a reversal in commodity prices and capital inflows. This scenario would particularly affect South America's commodity exporters. In contrast, renewed declines in prices of commodities (particularly energy) would help buffer the impact of a global downturn in Central America and the Caribbean, which would suffer from reduced tourism receipts and remittances.

- Although the financial impact of sovereign debt problems in Europe has been relatively contained,[14] a full-blown sovereign and financial crisis in Europe would have very negative ramifications for the region's financial credit

[12] Remittances to Central America fell from an average of 12½ percent of GDP in 2006 to about 10 percent in 2010.
[13] According to Taylor, Fry, and Kochhar (2011), median home equity of Hispanics has fallen by more than 50 percent since 2005, in part because they tend to live in places hardest hit by the housing collapse (such as Florida and California).
[14] Despite the strong presence of Spanish banks in some countries (particularly Chile and Mexico), direct financial strains from Europe have been limited, since Spanish banks with presence in the region follow a subsidiary model relying heavily on retail funding.

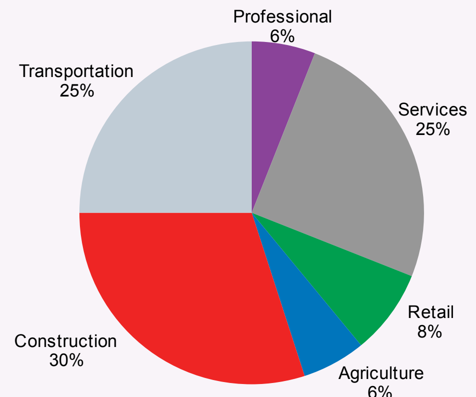
Figure 1.6. Recovery in remittances has been slow, reflecting high levels of unemployment among Hispanics, who were employed in sectors hardest hit by the recession.

United States: Unemployment and Remittances to Latin America



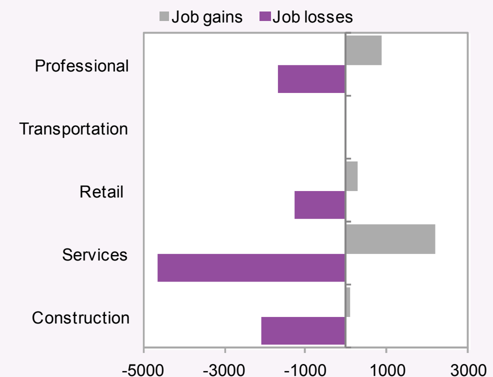
Sources: Haver Analytics; and IMF staff calculations.
¹ Simple sum over four quarters for the Dominican Republic, El Salvador, Guatemala, Honduras, and Mexico.

United States: Employment of Mexican Male Immigrants by Sector, 2009



Sources: Brick, Challinor, and Rosenblum (2011); and IMF staff calculations.

United States: Employment Flows since Recession¹
(*Thousands of jobs*)



Sources: Haver Analytics; and IMF staff calculations.
¹ Includes data from January 2008–August 2011.

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markets (see Boxes 1.2 and 2.1), similar to those observed during the Lehman episode. A sudden stop in capital flows would particularly affect those banking systems that rely more on wholesale funding.

Over the medium term, prolonged and increased uncertainties about the U.S. fiscal outlook could eventually push up U.S. Treasury interest rates. Shocks to U.S. interest rates tend to have a strong bearing on the region's growth, particularly in countries where banking and corporate sectors rely on external debt. For the near term, safe-haven flows are likely to keep U.S. Treasury rates—which could even strengthen in a downside scenario—in check, but this dynamic should not breed complacency about medium-term U.S. fiscal challenges.

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Box 1.1. U.S. Housing and Labor Markets: Headwinds to Recovery

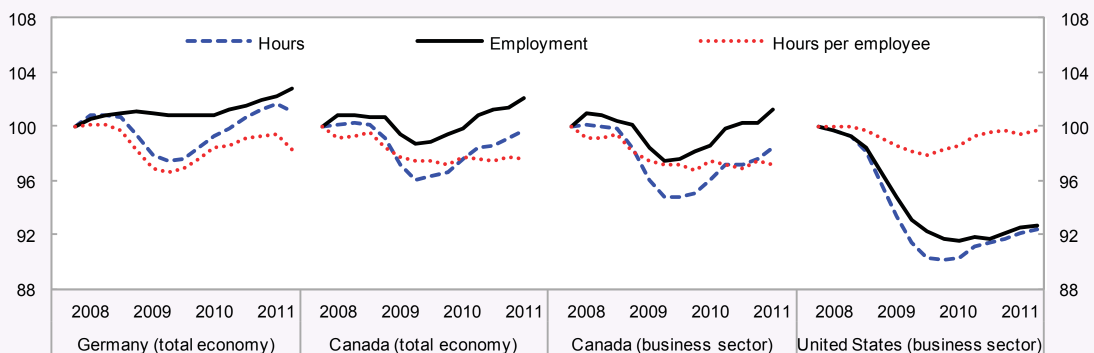
The housing market remains depressed (see figure, next page). Five years after the burst of the housing bubble, construction activity and house sales are close to record lows, with an estimated overhang of three million vacant homes depressing new construction activity. House prices—down more than 30 percent from their peaks—are again declining after the expiration of the homebuyers' tax credits in mid-2010. This decline is in part a natural consequence of past excesses, but it is also an outcome of elevated levels of foreclosures. Foreclosures are detrimental for the housing recovery, as they typically sell at a discount of 30 percent, lowering the price of neighboring properties as well. Indeed, Tsounta (2011) estimates that preventing one million foreclosures could raise house prices on aggregate by as much as 4 percent over the medium term.

Have we reached bottom in the housing market? Most analysts and IMF staff now expect further declines until late 2011, with a very subdued recovery over the medium term, amid record levels of "shadow" inventory of distress sales. These are properties—estimated at around six million—that could enter the market through distress sales and include houses currently in foreclosure or at risk for being foreclosed upon.

The state of the housing market plays an important role in explaining the weakness of U.S. private demand via households' balance sheets. Household real estate assets—which account for about one-quarter of total assets—are down 30 percent from their peak, whereas household debt as a share of disposable income remains well above prebubble levels, despite elevated numbers of mortgage defaults. Celasun and Li (2011) find that a 10 percent house price depreciation could lower consumption by 1½ percent over the medium term, as households save more to buttress their finances. Thus, the weak outlook for house prices and housing wealth would continue to be a significant headwind against a faster recovery in output in the United States.

Indeed, the weak recovery in aggregate demand is partly responsible for sluggish job growth. U.S. unemployment has been hovering at rates last seen in the early 1980s for the past two years, with employers largely responding to the crisis by laying off workers rather than by shortening the workweek, in contrast to the experience in other advanced economies, notably Canada and Germany (see figure below). The recovery, in turn, has featured a relatively rapid increase in productivity but sluggish job creation—with uneven employment gains across sectors, suggesting that structural changes could be at play (for details, see Estevão and Keim, 2011). Given subdued income growth, elevated uncertainty regarding job prospects, and average unemployment duration at record levels, consumer confidence remains anemic, which is also reflected in subdued consumption growth. With prospects for unemployment remaining elevated for a while and some concerns in regard to rising structural unemployment, the outlook for private domestic demand remains subpar.[1]

Comparison of Labor Input Cutbacks in the United States, Canada, and Germany
(Indices, 2007:Q4 = 100)



Sources: Bureau of Labor Statistics; Haver Analytics; Statistiches Bundesamt; Statistics Canada; and IMF staff calculations.

Note: This box was prepared by Evridiki Tsounta.

[1] Estevão and Tsounta (2011) find that skill mismatches and weak housing markets might have put upward pressure on structural unemployment, especially in regions were both effects are present.

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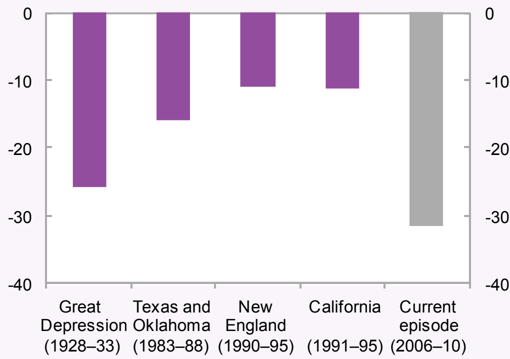
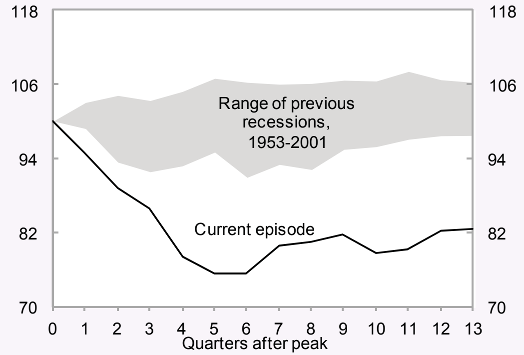
United States: Housing and Labor Markets – Impediments to Growth

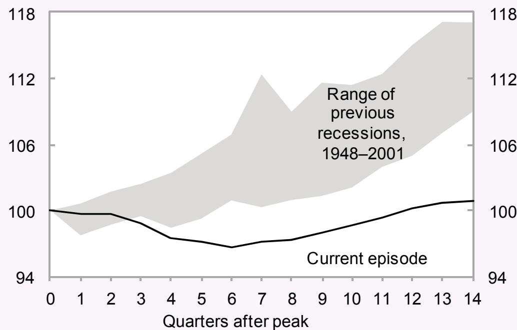
House Price Declines in Major U.S. Real Estate Busts
(Percent)



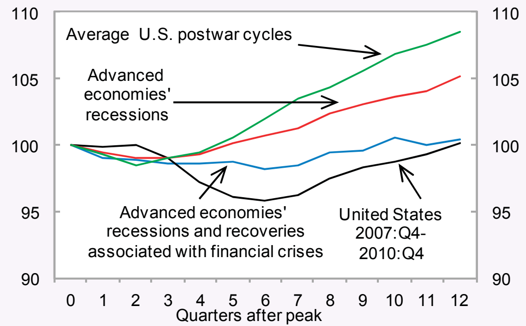
Household Net Worth as a Percentage of Disposable Personal Income
(Indices, business cycle peak = 100)



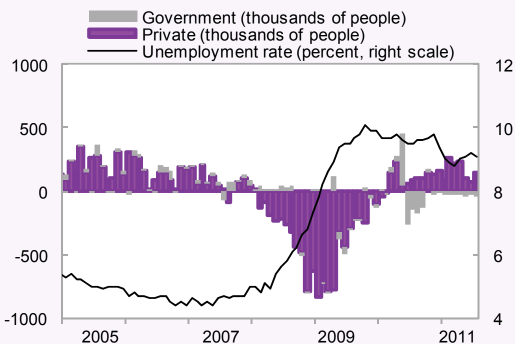
Output Paths
(Indices; business cycle peak = 100)



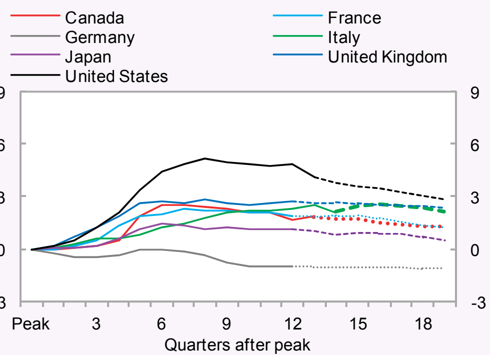
Personal Consumption Expenditures
(Indices; business cycle peak = 100)



Change in Non-Farm Payrolls and Unemployment



U.S. Unemployment Rate versus G-7
(Percentage point difference from peak GDP[1])



Sources: Bureau of Economic Analysis; Bureau of Labor Statistics; Freddie Mac; Haver Analytics; IMF *World Economic Outlook*; MacroMarkets LLC; Robert Shiller; Standard & Poor's/Case-Shiller Home Price Indices; and IMF staff calculations.

[1] The dates of the peaks are 2007Q3 for Italy, 2007Q4 for the Canada and United States and 2008Q1 for France, Germany, Japan, and United Kingdom. Dotted lines represent IMF staff projections.

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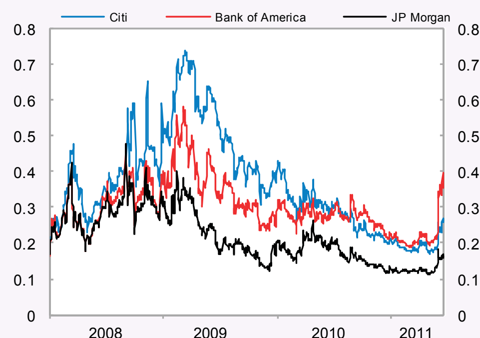
Box 1.2. U.S. Financial Exposure to Europe

Net direct exposure of U.S. banks to European peripheral countries seems limited. Banking statistics from the Bank for International Settlements and the U.S. Federal Reserve indicate limited direct claims of U.S. banks on European peripheral countries, although potential exposure—including derivatives, unused credit commitments, and guarantees—is larger. However, uncertainties surrounding the estimates of these potential exposures are amplified by the lack of data on the insurance purchased by U.S. banks against default in European peripheral countries, which would offset default insurance sold and limit the scope of net exposure.

Probability of Distress in U.S. Banks Given Distress in Selected European Countries[1]



Sources: Bloomberg L.P; Datastream; and IMF staff calculations.
[1]The sample consists of Greece, Ireland, Italy, Portugal and Spain as well as the three largest U.S. banks by capital: Citi, Bank of America, and JP Morgan.

Meanwhile, although investors' concerns about the potential spillover to U.S. banks have increased in recent weeks, they remain primarily focused on domestic developments. Using market information, Conditional Probabilities of Distress (CoPoDs) are estimated to represent the market's assessment of potential spillovers through direct exposure to European peripheral government debt (see figure).[1] Results suggest that whereas the probabilities of distress in European sovereigns have continued to increase, U.S. banks remain more sensitive to domestic events. Specifically, spikes in CoPoDs for all major U.S. banks occurred between 2008 and 2009, around credit downgrades, the Lehman bankruptcy, and the launch of various government programs—such as the Term Asset-Backed Securities Loan Facility and aid to American International Group. Still, despite limited sensitivity to European sovereigns, were distress in euro area peripheral sovereigns to spill over to banks, and in particular core euro area banks, the potential impact on U.S. banks could be much greater given their significant exposures to European banks.

U.S. money market mutual funds (MMMFs) have minimal direct exposures to peripheral European countries, but retain sizable exposures to core European financial institutions. According to market analysis, based on a sample of the 10 largest MMMFs, which represent 43 percent of the total prime fund universe, exposure to European banks accounts for almost half of U.S. MMMFs' assets. French banks (at nearly 12 percent of MMMFs' assets) form the largest country exposure, and 44 percent of the funds' total assets are concentrated in 15 banks. Therefore, if peripheral European sovereign distress reverberated to core European banks, U.S. MMMFs could also face significant strain (see also Box 1.4, "Why Do U.S. Money Market Funds Hold So Much European Bank Debt?" in the October 2008 *World Economic Outlook* [IMF, 2011b]).

In sum, given strong financial linkages with Europe, developments in Europe could have significant knock-on effects on U.S. financial institutions. In recent weeks, U.S. MMMFs have trimmed their core European bank holdings significantly, while their direct exposure to banks from the European periphery was already minimal. Such activities came at the time of heightened funding stress for European banks and could exacerbate these banks' funding difficulties. If the propagation of European sovereign credit crisis affects European banks beyond the periphery, and tension in the euro funding market escalates, the balance sheets of U.S. financial institutions could come under considerable strain.

Note: This box was prepared by Sally Chen and Francesco Columba.
[1] The sample consists of Greece, Ireland, Italy, Portugal, and Spain, and the three largest banks in the United States by capital: JP Morgan Chase, Citi, and Bank of America. Distress is defined as a (hypothetical) credit event that triggers credit default swap contracts; a credit event could be a failure to pay on schedule, default, or more broadly, a restructuring in which bondholders are forced to bear losses. CoPoDs are estimated as in Segoviano (2006a, 2006b) and Segoviano and Goodhart (2009).

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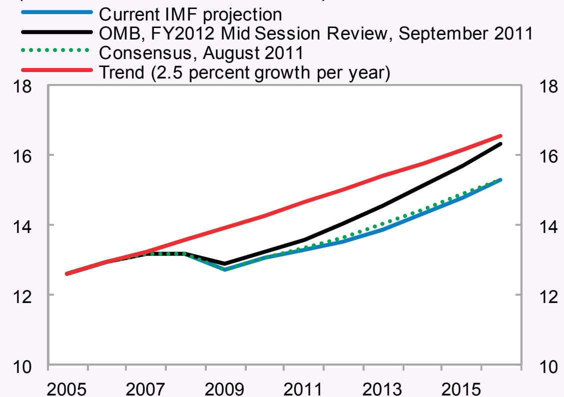
Box 1.3. Budget Institutions for U.S. Federal Fiscal Consolidation

The United States faces a large, multiyear fiscal adjustment that could be supported by reforms of federal budgetary institutions. In some relevant areas, the quality of federal budgetary institutions is excellent—for example, in fiscal reporting and forecasting, budget execution controls, and background analysis. In addition, the Budget Control Act adopted in August specifies a medium-term path for discretionary spending, saving US$900 billion over 10 years, potentially improving the predictability of the annual budget cycles, and helping to keep consolidation efforts on track over time. As for the mandatory expenditures and revenues which are not part of the regular budget cycles, the costs of new programs in these areas need to be offset by future savings under the pay-as-you-go principle. However, the rules are subject to many exemptions and do not address underlying spending pressures from programs such as Social Security. Also, the administration's macroeconomic projections have recently been significantly above consensus (see figure), raising questions about the official estimate of fiscal consolidation needs.

Comparison of Real GDP Forecasts
(Trillions of chained 2005 dollars)



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

The ability of U.S. policymakers to find consensus on a fully fledged medium-term fiscal consolidation framework is crucial for the success of deficit-reduction efforts. In this context, the following institutional enhancements could be helpful:

- *Clear medium-term objectives*. Endorsement of specific multiyear objectives by both chambers of Congress is essential to anchor expectations and achieve consistency with the administration's existing proposals. The objectives should include debt or deficit targets as a share of the economy, with the aim of stabilizing the debt ratio by mid-decade and gradually reducing it afterwards. The debate has so far focused on specifying dollar savings over a certain time frame, but fiscal outcomes can vary widely based on the baseline against which such savings are measured and macroeconomic assumptions.

- *Realistic macro framework*. The administration's macroeconomic framework could explicitly include inputs from private sector forecasters. Participation by outside participants in the forecasting process is common: notably, Canada has closely adhered to the consensus forecast (marked down with an additional prudence factor) since embarking on an ambitious consolidation strategy in the 1990s. Australia and Germany also consult widely on their macroeconomic framework. More recently, the United Kingdom created an independent agency to guide its forecasting process (see table).

- *Failsafe mechanisms*. Congress has mandated additional automatic spending cuts worth US$1.2 trillion starting from 2013 should the bipartisan Joint Committee fail to agree on a second round of deficit reduction measures. Although such an arrangement locks in additional deficit reduction, the automatic spending cuts would not be sufficient to stabilize the federal debt ratio. The fiscal consolidation framework could therefore include a failsafe mechanism recently proposed by the President that would trigger savings if the debt ratio fails to stabilize. It needs to be kept in mind, however, that such failsafe mechanisms cannot substitute for tough choices on specific fiscal consolidation measures (including those involving entitlements and taxes) and have not always been adhered to in the past.

Note: This box was prepared by Martin Sommer based on Sommer (2011).

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Who Prepares Macroeconomic Framework For Budget Projections?

Australia	Treasury, with inputs from an extensive consultation process, including through a Business Liaison Program.
Canada	Average of private forecasters. In the budgets for 2010 and 2011, the private sector average nominal GDP outlook was adjusted downward to account for risk related to the elevated level of economic uncertainty.
Germany	Interministerial Working Group, after consultation with research institutes and central bank.
France	Ministry of Finance, Forecasting Directorate.
Italy	Ministry of Finance.
Netherlands	Independent public agency.
Switzerland	Forecast by group of experts led by the State Secretariat for Economic Affairs, including representatives from the Federal Finance Administration, Customs, the Federal Statistical Office, and the Swiss National Bank.
United Kingdom	Forecast by independent public agency, based on iterative process between agency's macro model and revenue/spending departments' micro-based fiscal forecasts.
United States	Jointly developed by Council of Economic Advisers, Office of Management and Budget, and Treasury.

Source: Sommer (2011).

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