Without Economic Rebalancing, There Will Be No Healthy Recovery in EU Countries or in Global Economy

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Abstract: The global economic recovery is advancing. However, the recovery remains uneven, with downside risks in advanced economies remaining elevated, while overheating risks are growing in emerging economies. Rebalancing, internal and external, continues to be crucial. Without this economic rebalancing, there will be no healthy recovery. The argument is very simple: before the crisis, growth in many countries came from excessive domestic demand, be it consumption, or housing investment. This could not go on. Those countries must rely on other sources of demand. Until now, they have used fiscal policy to prop up domestic demand. This was needed, but it is not sustainable. Rebalancing is a complex process. No single measure, no one country holds the solution on its own. In other words, despite the overall global growth rebound, substantial shifts will be needed in order to secure the intended goals of strong, sustainable, and balanced global growth. Moreover, the critical role for enhanced global economic and financial policy cooperation is self-evident.

Keywords: economic recovery; rebalancing; cooperation

JEL Classification: A10; F01; G0

1. Introduction

2010 year was one of substantial accomplishments. Global economic growth staged a clear-cut recovery. Last year's estimated 5 percent annual global growth was above the 3.6 percent average rate of the previous decade—although the expansion remains uneven and incomplete**.** Financial sector reform efforts began to bear fruit**.** Significant reforms were agreed for the international financial institutions, including the International Monetary Fund. Within both groups of countries, advanced economy countries, as well as emerging and developing economies countries, growth performance, fragile for this moment, is expected to

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vary considerably across countries and regions, reflecting different initial conditions, external shocks, and policy responses.

2. Global Economy Trend in 2011

In accordance with the last IMF outlook, world economy growth is projected to reach a level of 4.4 per cent, in 2011 year (**Table No.1**, **Figure No.1**). Recovery in advanced economies is still expected to be weak by historical standards, with real output remaining below its pre-crisis level until late 2011. Moreover, high unemployment rates and public debt, as well as not-fully-healed financial systems in some countries are presenting further challenges to the recovery in these economies. World trade in goods and services volume is expected to grow by 7.1 per cent, in 2011.

There are still significant risks to the outlook.

On the upside:

- The reversal of the confidence crisis and the reduction in uncertainty may continue to foster a stronger-than-expected improvement in financial market sentiment and prompt a larger-than-expected rebound in capital flows, trade, and private demand;
- New policy initiatives in the United States to reduce unemployment could provide a further impetus to both U.S. and global growth.

On the downside:

- A key risk is that a premature and incoherent exit from supportive policies may undermine global growth and its rebalancing.
- Another important risk is that impaired financial systems and housing markets or rising unemployment in key advanced economies may hold back the recovery.
- Yet another downside risk is that rallying commodity prices may constrain the recovery in advanced economies.

Policymakers now face a difficult balancing act in judging the timing and sequencing of exit policies, both from the monetary and financial policies, as well as starting implementation of a medium term strategy for fiscal consolidation.

Table No.1 IMF – World Economic Outlook Projections (Percent change)

	Year over Year			
	2009	**2010**	**Projections**	
			2011	**2012**
WORLD OUTPUT	**-0.6**	**5.0**	**4.4**	**4.5**
Advanced economies	**-3.4**	**3.0**	**2.5**	**2.5**
United States	-2.6	2.8	3.0	2.7
Euro area	-4.1	1.8	1.6	1.7
Germany	-4.7	3.6	2.4	2.0
France	-2.5	1.6	1.7	1.8
Italy	-5.0	1.0	1.0	1.3
Spain	-3.7	-0.2	0.8	1.5
UK	-4.9	1.7	2.0	2.3
Japan	-6.3	4.3	1.6	1.8
Canada	-2.5	2.9	2.3	2.7
Other advanced economies	-1.2	5.6	3.8	3.7
Newly industrialized Asian economies	**-0.9**	**8.2**	**4.7**	**4.3**
Emerging and developing economies	**2.6**	**7.1**	**6.5**	**6.5**
Middle East and North Africa	1.8	3.9	4.6	4.7
Sub-Sahara Africa	2.8	5.0	5.5	5.8
Central and Eastern Europe	-3.6	4.2	3.6	4.0
Commonwealth of Independent States	-6.5	4.2	3.6	4.0
Russia	-7.9	3.7	4.5	4.4
Developing Asia	7.0	9.3	8.4	8.4
China	9.2	10.3	9.6	9.5
India	5.7	9.7	8.4	8.0
Latin America and the Caribbean	-1.8	5.9	4.3	4.1
Brazil	-0.6	7.5	4.5	4.1
Mexico	-6.1	6.2	4.2	4.8
WORLD TRADE VOLUME (GOODS AND SERVICES)	**-10.7**	**12.0**	**7.1**	**6.8**
Imports				
Advanced economies	-12.4	11.1	5.5	5.2
Emerging and developing economies	-8.0	13.8	9.3	9.2
Exports				
Advanced economies	-11.9	11.1	5.5	5.2
Emerging and developing economies	-7.5	12.8	9.2	8.8

COMMODITY PRICES (US dollars)				
Oil	-36.3	27.8	13.4	0.3
Non-fuel (average based on world commodity export weights)	-18.7	23.0	11.0	-5.0
CONSUMER PRICES				
Advanced economies	0.1	1.5	1.6	1.6
Emerging and developing economies	5.2	6.3	8.0	4.8

Source: IMF World Economic Outlook Update, January 2011
EU Commission – Interim Forecast, February 2011

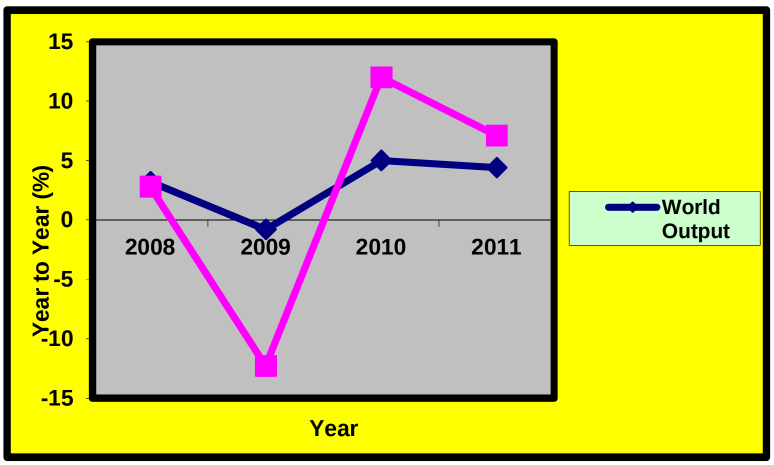

Figure 1 World Output and International Trade Indices in 2008 – 2010, 2011 Outlook Projections

Source: IMF World Economic Outlook Update, January 2011

The two-speed global economic recovery is likely to dominate 2011 and beyond, with:

- Weak growth in advanced economies barely enough to bring down unemployment. In G-20 advanced economies, the pace of growth in the second half of 2010 was somewhat stronger than expected, but insufficient to appreciably lower unemployment. The recovery in many advanced economies continues to be slow and sluggish, amid persistently high unemployment, significant excess capacity, and subdued private demand. In the United States, this has prompted further monetary and fiscal stimulus, notwithstanding an already challenging fiscal outlook. Meanwhile, in the euro area periphery, austerity measures prompted by market pressures continue to hamper growth in the short term.

In the *United States*, data showed some strengthening of the recovery in the fourth quarter of 2010, owing to robust growth in private consumption and exports, and a sizable drop in imports. Consumer durables posted particularly strong growth in the quarter, a tentative sign that households are becoming more positive about the economic outlook. However, looking ahead, continued weaknesses in employment and income growth, a sizable overhang in housing markets, and balance sheet repair are expected to remain a drag on private demand.

In Japan, after a strong third quarter, the recovery likely hit a temporary soft patch at the end of the 2010 year, reflecting mainly the withdrawal of policy stimulus. Recent indicators point to a resumption of the recovery this year supported by growing exports, especially to the rest of the region. Private demand is expected to recover gradually due to the sluggish labor market and subdued business sentiment.

Growth performance has varied substantially in the *euro area*, both within the core and across the countries in the periphery. Data suggest that output in the euro area as a whole expanded at about 1½ percent annualized in the second half of 2010. However, while growth in Germany has remained robust, recoveries in other core economies, including France and Italy, have been more subdued, reflecting limited bounce-back in investment and sluggish export growth. In peripheral euro area economies most affected by financial market strains, austerity measures continue to weigh on domestic demand. So far, intra-regional trade has provided limited impetus to growth in these countries due to sluggish activity in trading partners and slow progress being made towards restoring competitiveness.

In several key *G-20 advanced economies*, unemployment rates have persisted, in 2010, at high levels, paralleling their subdued recoveries. Persistent weakness in labor markets is a concern not only due to the economic impact, but also for the large human and social costs of high long-term unemployment. In the United States, the unemployment rate dropped to 9 percent in January 2011, but businesses remain reluctant to hire, given uncertainties about the strength and sustainability of the recovery. Labor markets in the euro area are mixed, reflecting the size, nature, and persistence of crisis-related shocks and divergences in paths of recovery. The unemployment rate has fallen to its lowest level in nearly two decades in Germany, while it has persisted at high levels in other countries (e.g., Ireland and Spain).

While core inflation has generally remained low in *G-20 advanced economies*, reflecting still-large output gaps and moderate recoveries, headline inflation rates have been edging up recently in response to rising commodity prices.

- Growth in G-20 emerging economies remains robust, but signs of overheating are emerging in some economies. Robust domestic demand and the recovery of global production continue to power the expansion in emerging economies. Strong growth in key *emerging economies*—China, India, Indonesia, and Turkey—and growing intra-regional trade, particularly in Asia, is offsetting weaker demand from advanced economies. Among *G-20 emerging economies*, with some exceptions (e.g., Mexico and South Africa), unemployment has been trending downward as the expansions have gathered momentum. Output gaps have been closing rapidly, and some countries have begun to experience excess demand. This, combined with rising food and commodity prices, and in some cases strong capital flows, is fueling inflationary pressures in many emerging economies, including Brazil, China, India, Indonesia, and Russia.

The global economic recovery is advancing. However, the recovery remains uneven, with downside risks in advanced economies remaining elevated, while overheating risks are growing in emerging economies. Financial sector strains resulting from sovereign and banking sector fragilities in the euro area periphery represent a significant risk to recovery in the region and possibly beyond. Another downside risk stems from insufficient progress in developing medium-term fiscal consolidation plans in the United States and Japan. Rising overheating pressures in some emerging economies, exacerbated by large capital flows and rising commodity prices, and a potentially steep correction in property prices in China have also surfaced as pertinent concerns.

3. EU Recovery Making Headway

The economic recovery in the EU continues to make headway. After a strong performance in the first half of 2010, real GDP growth for both the EU and the euro area slowed down in the second half of last year. The deceleration was expected and in line with a soft patch in global growth and trade, which reflected the withdrawal of stimulus measures and the fading away of positive impulses from the inventory cycle. EU GDP growth in 2011 is set to be somewhat stronger than expected in the Commission's autumn 2010 forecast, despite lingering vulnerabilities in financial markets. This improved outlook is supported, inter alia, by better prospects for the global economy and upbeat EU business sentiment.

Based on an update for the seven largest EU Member States, growth prospects for this year have been revised slightly up in the Commission's February 2011 interim forecast. GDP growth in 2011 is now projected at 1.8% in the EU and 1.6% in the euro area, both 0.1 pp. higher than in the autumn. Germany continues to benefit from the robust external environment and strong domestic demand dynamics, whereas significant adjustment challenges still weigh on activity in several other countries.

The inflation projection has been revised up more markedly. A surge in energy and commodity prices in the last few months has led to an uptick in headline inflation. The inflation forecasts for 2011 are thus revised up, with consumer prices indices now projected at 2.5% and 2.2% in the EU and the euro area respectively. Nevertheless, the remaining economic slack, subdued wage growth and overall well-anchored inflation expectations should keep underlying inflationary pressures in check, with inflation expected to end the year at close to 2% in both regions.

While exports should continue supporting the recovery going forward, rebalancing of growth towards domestic demand is expected for 2011, driven by growth in private investment. A better export outlook should translate into a stronger impetus for equipment investment, which will increasingly contribute to growth. In addition to this impetus from the export-led industrial rebound, equipment investment should benefit from the continued improvement in corporate profits, stronger order inflows and the low level of stocks, as well as from higher capacity utilization rates, now close to their long-term averages. This view is supported by the strong business confidence and the latest Commission's investment survey, which suggests robust investment plans for 2011. Construction investment is, however, projected to remain relatively subdued this year due to ongoing adjustment in this sector.

However, the above aggregate picture masks uneven developments across Member States. In the euro area, Germany is expected to lead the ongoing recovery, with GDP growth projected at 2.4%, followed by France (1.7%) while Spain's recovery remains muted (0.8%). Outside the euro area, growth in Poland and the UK is respectively projected at 4.1% and 2.0%. All these developments confirm the Commission's expectation of a multi-speed recovery within the EU. This is not surprising given differences in the scale of adjustment challenges and ongoing rebalancing within the EU and euro area.

Amid still high uncertainty, risks to the EU growth outlook at the current conjuncture appear broadly balanced for 2011.

On the upside, stronger global growth – beyond that allowed for in the baseline – would further benefit EU export growth. Also, the impetus from exported industrial rebound to domestic demand could prove stronger than assumed. Moreover, the strong business confidence could translate into stronger domestic demand than currently projected. A further upside risk relates to the spill-over from stronger activity in Germany to other Member States, which could materialize to a greater extent than expected at present.

On the downside, the still relatively fragile financial-market situation remains a concern. Tensions in some segments of the financial markets, though easing, remain, and potential spillover to other market segments and to the real economy cannot be ruled out. These concerns would be aggravated in case of further increases in long-term government bond yields. Significant fiscal sustainability issues are yet to be tackled in key countries outside the EU. Another downside risk relates to renewed increases in commodity prices, negatively affecting disposable incomes and thereby private consumption. Finally, the fiscal consolidation in a number of Member States may weigh more on domestic demand than currently envisaged.

Over the past two decades, increasing economic integration in the EU has been one of the main drivers of growth and job creation in the bloc. Even so, the EU economy has still not fully exploited the opportunities opened up as barriers have come down. The Commission has identified 12 priority measures to improve mobility for workers and businesses. These are measures most likely to foster growth and employment by helping people, goods, services and capital to move more freely throughout the EU.

The priorities are:

- Helping **small- and medium businesses** get easier access to financing by allowing venture capital funds to invest in any EU country.
- Revising laws so professional **qualifications are recognized** throughout the EU - reducing the barriers to employment in another country.
- Creating a **single European patent** for intellectual property and inventions - cutting costs and red tape for businesses.
- Establishing procedures to **resolve disputes out of court** when consumers encounter a problem after buying goods or services in another EU country, including on the internet.
- Introducing Europe-wide standards for the **services** sector.
- Improving **energy, transport and communications** infrastructure by identifying strategic networks for targeted investment.
- Legislating the mutual recognition of electronic identification and authentication methods to boost **internet use** between individuals, businesses and public administrations.
- Encouraging **social entrepreneurship** by developing investment funds for companies pursuing social, ethical or environmental goals.
- Adapting taxes on the energy industry to meet the EU's **climate and energy** goals.
- Strengthening the rules for **workers posted** by their companies to another EU country.
- Simplifying **accounting guidelines** for companies and cutting red tape - with a focus on small businesses.

- Making it easier for small firms to compete for **government contracts** in other EU countries.

4. Actual and Prospective Trends of Foreign Direct Investment

Developed countries. The short- and medium-term prospects for FDI inflows have improved during the first half of 2010, in line with developed countries' economic recovery – reflected in growing production and foreign trade. FDI inflows are expected also to increase due to a new round of privatizations in European countries with large public debts. In the medium term, inward FDI to developed countries could recover to the levels seen in the first half of the past decade, provided no major economic shocks hit these economies. The further integration of developed countries' markets, competitive pressures and the ongoing liberalization process in several areas – such as the European energy and information technology network industries – are also fostering inward FDI to these countries. A further stimulus could be expected from developing economies' TNCs, which are increasingly interested in expanding their presence in developed countries.

Africa. Provisional figures and prospects for FDI inflows to Africa, in 2010 and 2011, suggest a slow recovery, as global economic and financial conditions are expected to improve and commodity prices to rebound from the lows reached in early 2009. The region's largest economies are relatively well positioned: South Africa ranked 20th among the top priority economies for FDI in the world, while Egypt ranked 31st in the UNCTAD's World Investment Prospects Survey.

The strong performance of emerging Asian economies that are important sources of FDI in Africa will support a revival of FDI inflows to Africa, and sustained intraregional investment will help small and low-income African countries ease their dependence on flows from traditional economies.

South, East and South-East Asia. FDI inflows figures were improving in 2010 and the prospects for 2011 are very good, as the region has been leading the recovery of the global economy, and TNCs continue to give priority to the region in their FDI plans. The timing and strength of the economic recovery vary across countries, thus affecting FDI performance: inflows to China and India have picked up since mid-2009 and are rapidly expanding (inflows to the two countries in the second half of 2009 rose both by 18 per cent from the same period of 2008); inflows to the Republic of Korea, Singapore and Taiwan Province of China, on the other hand, are expected to bottom out in 2010 and 2011.

Latin America and the Caribbean. Prospects for FDI inflows to Latin America and the Caribbean were improving in 2010, as the region is recovering relatively rapidly from the global financial and economic crisis. Flows are expected to recover faster, in 2010 and 2011, in South America, given the resilience and growth potential of Latin American economies, a sub-region more reliant on commodities and exports to emerging markets, where demand is picking up strongly.

FDI inflows to the region are likely to continue increasing in the medium term, given the resilience and growth potential of Latin American economies. Brazil and Mexico, in particular, remain among the top 10 FDI destinations for TNCs.

South East Europe and CIS Prospects for inward FDI remain positive in the medium term, on the back of stronger commodity prices, a faster economic recovery in large commodity exporting countries, and a new round of privatization.

5. Short and Medium Time Strategic Ways for Global Economic Recovery

Short and medium time strategic ways for economic recovery of the main groups of countries are as follows:

In many **advanced economies**, the crisis damage was much deeper. The financial system was badly broken. In many of these countries, markets are still uncertain about the true health of banks and financial intermediation is not working well. Combine this with the need to correct past excesses, from low saving to excess housing investment and the result is a slow recovery, barely strong enough to decrease unemployment.

Rebalancing, internal and external, continues to be crucial. Without this economic rebalancing, there will be no healthy recovery. The argument is very simple: before the crisis, growth in many advanced countries came from excessive domestic demand, be it consumption, or housing investment. This could not go on. Those countries must rely on other sources of demand. Until now, they have used fiscal policy to prop up domestic demand. This was needed, but it is not sustainable. The deficit countries must rely more on external demand, on exports. And, by symmetry, surplus countries must do the reverse, shift from external demand to domestic demand and reduce their dependence on exports.

This is not to say that without rebalancing, the recovery cannot continue. Continued fiscal expansion, or a return by U.S. consumers to their old, low-saving ways can sustain demand and growth for some time. But they will recreate many of the problems that were at the root of the crisis.

Rebalancing is a complex process. No single measure, no one country holds the solution on its own. Structural measures are required: for example, in Asia, measures to improve financial intermediation or provide more social insurance, in the United States, reforms of the financial intermediation system. The exchange rate adjustment is an integral part of the process.

Emerging market countries were affected by the crisis through both trade and financial channels. The turnaround in trade has been nearly as sharp as the earlier collapse. But while trade has not yet fully recovered, most emerging market countries have been able to increase domestic demand so as to return to high growth. In turn, their good performance has led capital flows to come back, in some cases, with much force.

Because of their more limited financial integration with the world economy, **low-income countries** were mostly affected by the crisis through the trade channel. As trade has largely recovered, and as strong growth in emerging market countries has pushed up commodity prices, many of them are doing well. Sub-Saharan Africa, for example, grew at more than 5 percent in 2010, and it is forecasted roughly the same for next year. Their performance, however, is not only due to exports. Previous sound policies allowed many to use fiscal measures to support their economies. And private domestic demand typically has also been quite strong.

A number of countries from **Central and South East Europe** face a tough and long macroeconomic adjustment. In most cases, they would have had to do so whether or not the global crisis had taken place. The global crisis only makes it tougher.

After 1989, they had increased domestic demand excessively, and some had run very large current account deficits. Like others, they must shift from domestic demand to external demand. Stronger growth in core Europe, if it comes, will strengthen their exports and help the adjustment. But, based on past experience, a full return to health will likely take a long time. Social programs are essential, both for their own sake and to maintain broad political support.

The countries of the region are more or less reluctant to a joint program from the European Union and the IMF. But such programs can help, in two ways: First, by putting a ceiling on the interest rate at which governments can borrow on the international financial markets. Second, even if the programs do not ask for more than the country intended to do on its own, they reinforce the credibility of these commitments, and reassure markets about the medium run.

In other words, despite the overall global growth rebound, substantial shifts will be needed in order to secure the intended goals of strong, sustainable, and balanced global growth. Moreover, the critical role for enhanced global economic and financial policy cooperation is self-evident.

6. Consolidating Cooperation within G-20

Cooperative and well-timed policy initiatives across the G-20 are critical to sustain the global recovery, while reducing global imbalances, through:

- In *G-20 advanced economies*, the most urgent requirements are for comprehensive and rapid actions to overcome sovereign and financial stresses in the euro area and accelerate progress in developing medium-term fiscal consolidation plans. Rapid progress in the repair and reform of financial systems—critical to the normalization of credit conditions—would help reduce the burden on monetary and fiscal policy to support the recovery, and potentially help stem volatile capital flows to emerging economies.
- In *G-20 emerging economies*, the key policy challenge is to keep overheating pressures in check and respond appropriately to capital inflows. In key surplus economies, overheating pressures can be alleviated by permitting currency appreciation, facilitating a healthy rebalancing from external to internal demand.

The G-20 Leaders' cooperation process has been developed since late 2008 in response to the recognized need for more effective global cooperation on economic and financial policies. Each of the five Leaders' Summits has produced an agreement to broaden and deepen the mechanism for such cooperation. The recent Seoul Summit was no exception. In the immediate aftermath of the crisis, concerted policy action helped to limit the economic downturn and to set the stage for recovery. At that time, of course, policy prescriptions generally were similar across all economies.

The increased incentives for policy cooperation—together with the need to adjust policy programs to fit the disparate circumstances of the G-20 economies—has been anticipated in the decisions made by Leaders at their recent Seoul Summit. The Mutual Assessment Process (or G-20 "MAP") has been ratified as an ongoing initiative, to be guided by an agreed set of "indicative guidelines," with progress toward the underlying goals of strong sustainable and balanced global growth to be assessed at an individual economy level and reviewed by the Leaders at their next Summit. The Seoul Leaders' Declaration contained an extensive—but widely overlooked—list of each G-20 economy's proposed policy adjustments as part of the MAP.

The principal uncertainty is whether such an approach will be adhered to by the entire G-20. The MAP is a G-20-led exercise, but the Leaders have requested significant Fund support for the MAP process. For example, the G-20 Leaders asked the IMF to "provide an assessment as part of the MAP on the progress toward external sustainability and the consistency of fiscal, monetary, financial sector, structural, exchange rate and other policies." More broadly, the latest challenges and IMF reforms have both enhanced the Fund's role and responsibilities and increased the importance of the Fund producing analysis of the highest technical quality.

Therefore, 2011 will be a year in which advancements in IMF economic surveillance come to the fore. The Fund's Triennial Surveillance Review will take place this year, providing an opportunity for IMF members to assess the progress that has been made in this area, as well as to set priorities for the coming triennial period. In this regard, the Fund has begun to better integrate assessments of financial stability into regular country reviews. In particular, Financial Sector Assessment Programs—conducted jointly by the IMF and the World Bank—henceforth will be mandatory for all Fund members with systemically important financial sectors. Fund support for the G-20 MAP will constitute a challenging but potentially uniquely productive assignment, and it will help to deepen the surveillance dialogue with Fund members.

Like a conclusion: 2011 will be a pivotal year for the global economic recovery, for international policy cooperation, and for the Fund's role in dealing with both of these challenges.

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