SHORT AND MEDIUM TERM OUTLOOK OF THE WORLD ECONOMY

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Abstract

In keeping with the January 2010 IMF prognoses, world output is expected to rise this year by 4 per cent in comparison with the 2009 level. This represents an upward revision of ¾ per centage point from the October 2009 World Economic Outlook.

In 2011, world economy growth is projected to reach a level of 4.3 per cent.

Reform of financial market supervision and regulation is clearly necessary to build a more resilient financial system. Here, the efforts need to focus on identifying the market imperfections that gave rise to the incentives for excess risk taking and high leverage, as well as the regulatory failures that together caused this unprecedented global financial crisis.

Key-words*:* *world economy, recession, recovery, stimulus measures*

JEL Classification*:* M_{16}

1. **Introduction**

Following the collapse of Lehman Brothers in mid-September 2008, a generalized loss of confidence between financial institutions triggered reactions akin to a 'blackout' in global financial markets. Spreads in credit and bond markets surged to very high levels, paralyzing credit and money markets. Prompt and massive policy action to restore confidence and provide liquidity appears to have successfully limited the period of panic, but the need for financial institutions to operate with less leverage and to repair their balance sheets remains. This process of adjustment will take time and impair the flow of credit, and is the key factor weighing on activity going forward.

The financial crisis is not the only development shaping the projections. Other important drivers include ongoing adjustments in housing markets, which in many European economies, based on past housing cycles, still have a long way to go. The dominant downside risks include a longer than assumed period before financial conditions normalize, further failures of financial institutions, and the possibility that emerging market economies will be hit harder by the downturn in global trade and foreign investor risk re-assessments. For 2010, widespread risks remain, but these are more equally distributed, reflecting the possibility of an earlier economic recovery.

Reform of financial market supervision and regulation is clearly necessary to build a more resilient financial system. Here, the efforts need to focus on identifying the market imperfections that gave rise to the incentives for excess risk taking and high leverage, as well as the regulatory failures that together caused this unprecedented global financial crisis.

The experience of the past year has highlighted the importance of continuing with structural reforms that boost growth and strengthen the resilience of the economies to better withstand and absorb shocks. In this respect, a quick, successful completion of the Doha Round would contribute to supporting world growth, boost confidence, and demonstrate a commitment to competitive and open markets.

2. **Actual and future trends in the world economy**

Following the deepest global downturn in recent history, economic growth solidified and broadened to advanced economies in the second half of 2009 and in the first months of 2010.

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

Driving the global rebound was the extraordinary amount of policy stimulus, especially in the field of monetary and fiscal policy. In advanced economies, the beginning of a turn in the inventory cycle and the unexpected strength in U.S. consumption contributed to positive developments.

Final domestic demand was very strong in key emerging and developing economies, although the turn in the inventory cycle and the normalization of global trade also played an important role. Growth in emerging and developing economies is expected to rise to about 6 per cent in 2010, following a modest 2 per cent in 2009. Key emerging economies in Asia are leading the global recovery. For the Asia region (excluding Japan), growth is likely to exceed 7 per cent this year. A few advanced European economies and a number of economies in central and Eastern Europe and the Commonwealth of Independent States are lagging behind.

In keeping with the January 2010 IMF prognoses, world output is expected to rise this year by 4 per cent in comparison with the 2009 level. This represents an upward revision of ¾ percentage point from the October 2009 World Economic Outlook. Output in the advanced economies is now expected to expand by 2 per cent in 2010, following a sharp decline in output in 2009. In the most advanced economies the recovery is expected to remain sluggish by past standards, and still dependent on government support. This is why policy support should be maintained until there are clear signs of a recovery in private demand and employment growth. High unemployment, in particular, is a major concern – especially in Europe and the U.S.

The IMF specialists expect world trade to continue recovering and the global volume to increase by 5.8% on average in 2010 after having slumped by over 12% in 2009.

Year-by-year, in 2009, exports from **G7** countries were down 17.5% while imports were 14.6% lower.

The **United States** economy is projected to grow just 2.7 per cent in 2010 after declining an estimated 2.5 per cent in 2009.

IMF also changed its forecast for the **Canadian** economy, hiking the projected growth for 2010 to 2.6 per cent, half a percentage point above the last projection. The forecast for 2011 was unchanged at 3.6 per cent growth.

Germany. IMF specialists are optimistic that during 2010 the recovery will continue and the expected real GDP will grow more than 2% after having contracted by 5% in 2009.

This upturn, which is currently still being largely driven by monetary and fiscal policy, will become increasingly self-sustaining. This is indicated by the stabilization of the financial markets, the synchronized global economic upturn, low inflation and the improved sentiment among both companies and households.

Private consumption looks set to rise again this year by around ¾%, as households benefit from further tax relief, inflation remains low and only marginal employment declines.

With exports recovering and profits rising, investment is also likely to resume despite the gross underutilization of production capacities. Investment in plant and equipment is forecasted to rise almost 6% after tumbling 20% in 2009. Construction investment could grow nearly 1%, in particular on account of brisk public-sector construction activity triggered by the stimulus packages.

In the **UK**'s economy as a whole, a growth of 0.9% is predicted this year. Manufacturing firms expect production to grow by an average of 1.2% this year, rising to 3.4% in 2011.

Japan's quarterly exports rose 11.5% in the third quarter while imports were up 7.2%. In 2009, year-by-year exports were down 25.1% while imports were 12.7% lower.

Over the fourth quarter of 2009, the Japan's GDP growth registered a level of 1.1%, compared with the third quarter, as result of the domestic consumption recovery and the industrial investment growth.

Commodity prices rose strongly during the early stages of the recovery, despite generally high inventories. To a large extent, this was due to the buoyant recovery in emerging Asia, to the onset of recovery in other emerging and developing economies more generally, and to the improvement in global financial conditions.

Looking ahead, in 2010 and 2011, commodity prices are expected to rise a bit further supported by the strength of global demand, especially from emerging economies. However, this upward pressure is expected to be modest, given the above-average inventory levels and substantial spare capacity in many commodity sectors. Accordingly, the IMF's baseline petroleum price projection is unchanged for 2010 and revised up by a small amount in 2011 (to $82 a barrel, from $79 a barrel in October 2009). Other non-fuel commodity prices have also been marked up modestly.

Policymakers now face a difficult balancing act in judging the timing, pace, 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 and debt reduction. Withdrawing policy support prematurely would leave the financial system vulnerable to a re-intensification of pressures (such as in countries with weak recoveries and remaining financial vulnerabilities), while belated withdrawal could potentially ignite inflationary pressures and sow the seeds for future crises (such as in countries with risks of financial excesses and overheating).

Policy efforts so far have addressed the immediate threats to financial stability (through liquidity support, deposit insurance, and recapitalization schemes), but they have done little to resolve the uncertainty about the long-term solvency of financial institutions. The process of loss recognition and restructuring of bad loans is still incomplete. Therefore, financial sector policies should focus on advancing this process by forcing credible and coordinated loan loss recognition and by providing public support to the viable financial institutions. Such policies should be supported by measures to resolve insolvent banks and set up public agencies to dispose of the bad debts, including possibly through a "bad bank" approach, while safeguarding public resources.

Monetary policy remains an important policy lever. The projections incorporate a substantial easing in policy rates, although the effectiveness of interest rate cuts to support activity is likely to be constrained as long as financial conditions remain disrupted. With interest rates approaching zero in several major countries, central banks are exploring alternative policy approaches that rely on using their balance sheets to ease monetary conditions further. The focus should be on unlocking key (high-spread, low-liquidity) credit markets.

Over the medium term, policies should be aimed at entrenching financial stability, which will underpin strong, sustained and balanced global growth. Public sector risks will need to be reduced through credible fiscal consolidation, while risks emanating from private financial activities should be addressed by the adoption of a new regulatory framework.

At the same time, new sources of growth are needed in most of the world's economies to ensure a robust global economy.

First and foremost, strong growth must be restored. This will require a rekindling of private demand. In many countries, structural reforms will be needed. In particular, labour and product market reforms can boost productivity, and speed the transition. Efforts to boost the "green" economy can also support this restructuring effort.

A second goal is for growth to be sustainable. That is, to restore and sustain private demand, both consumption and investment will be needed. For sure, this will require dealing with pending fiscal challenges.

Third, global growth should be balanced. For this to happen, economic policies must be consistent with healthy external positions. This means maintaining sound fiscal, monetary, and exchange rate policies, and also avoiding domestic market distortions.

To achieve this, all countries will need to play their part.

Countries that have traditionally run large current account deficits recognize that they need to raise saving – often both private and public – and boost productivity. In the United States, for example, this is beginning to happen, with the household saving rate already up sharply since the start of the crisis, to about 5 per cent in 2009. It could rise even higher.

Countries that have traditionally run large current account surpluses and relied heavily on export-led growth recognize that new growth drivers, will need to be found. In China, for example, the government is taking steps to boost private consumption.

These major shifts in growth patterns will not be easily achieved, and certainly not overnight. But if the countries can move in this direction in the coming year, it is possible to have a "win-win" situation, with more sustainable global growth for all.

For this economic transformation to be successful, international policy collaboration will need to be more effective.

The recent experience in dealing with the crisis gives cause for hope. The nations of the world pulled together to respond to a profound economic – and potentially human – calamity. Governments worked together on many fronts – undertaking concerted and significant monetary easing; implementing large fiscal stimulus, where possible; and shoring up ailing financial sectors.

This spirit of cooperation has produced a much strengthened framework of international collaboration. The G-20 – in which Asia is playing a major role – has emerged as a key forum for the world's major economies to discuss policy priorities. The recent G20 meetings initiated an action plan and a process aiming to continue furthering multilateral co-ordination to overcome the immediate problems facing the global economy and to strengthen the international financial architecture over the medium term.

The G-20's new Mutual Assessment Framework is an important step. Through this process, the world's largest economies will be accountable – to each other – for adopting the policies needed to ensure strong, stable and sustainable growth over the medium term. This new framework can be one of the keys to the transformation of the global economy in 2010 and beyond.

Conclusions

In keeping with the January 2010 IMF prognoses, world economy growth is projected to reach a level of 4.3 per cent, in 2011. In spite of the revision, the 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 6.3 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.

On the short term, policies should be focused on ensuring that the recovery is maintained and that there is no recurrence of the negative feedback between the real economy and the financial sector. In those economies where financial vulnerabilities persist, efforts should continue to clean up bank balance sheets, ensure smooth rollover of funding, and restructure weak banks.

In those emerging market countries that are recovering rapidly, the policy priorities remain to address capital inflows through macroeconomic policies, including through greater exchange rate flexibility, and prudential measures.

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