* Column title, "Equilibrium"
* Suggested story title: The Right Kind of Recovery
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The Right Kind of Recovery

Growth is recovering across the globe from the Great Recession. The IMF's latest World Economic Outlook projects global growth of 4½ percent this year (available at http://www.imf.org/external/pubs/ft/weo/2011/update/01/index.htm). However, as pointed out in a recent speech by IMF Managing Director Strauss-Kahn, while the recovery is underway, it is not the recovery we wanted (see http://www.imf.org/external/np/speeches/2011/020111.htm for the entire speech).

It is a recovery beset by tensions and strains—which could even sow the seeds of the next crisis—as evidenced by two dangerous imbalances. First, the recovery is unbalanced *across* countries. While growth this year remains below potential in the advanced economies (2½ percent), emerging and developing economies are growing much faster (6½ percent) and Asia (excluding Japan) even stronger still (8½ percent)—and some may soon be overheating. Second, the recovery is unbalanced *within* countries. Global unemployment remains at record highs, with widening income inequality adding to social strains.

The pressure points across countries declined during the global financial crisis, but now the pre-crisis pattern of global imbalances is re-emerging. Growth in economies with large external deficits, like the U.S., is still being driven by domestic demand. And growth in economies with large external surpluses, like China and Germany, is still being powered by exports. The "global growth gap" puts the sustainability of the recovery at risk and is also straining the recovery in other ways. Energy prices are rising swiftly, reflecting rapid growth in the emerging economies. Food prices are rising too—though here supply shocks are the main reason—with potentially devastating consequences for low-income countries. Together, these price increases are beginning to feed into headline inflation. Large and volatile capital flows to emerging economies is another challenging development. They are complicating macroeconomic management and in some cases are raising concerns about financial stability.

How best to re-balance the recovery? The priorities are by now well-known. In the advanced economies, the key is to promote growth and job creation through structural reforms to make these economies more competitive. This will take time. In the meantime, the most urgent task is to repair and reform the financial sector, to reduce risk and pave the way for healthy credit growth. Restoring fiscal sustainability is another top priority for the advanced economies. The average public debt to GDP ratio is set to exceed 100 percent of GDP this year—and will rise even higher in the absence of medium term adjustment. This could have worrying implications for global growth and even for financial market stability. Where the recovery is strengthening, countries should move quickly to formulate and implement credible medium-term fiscal consolidation plans. At the same time, monetary policy in the advanced economies should remain supportive. As long as inflation expectations are well anchored and unemployment stays high, this is the right policy from a domestic perspective. For emerging economies, macroeconomic policies should be tightened in countries where output is growing at potential, exchange rates should be allowed to adjust, and those countries with large surpluses need to diversify the drivers of growth.

The second imbalance occurs within countries: high unemployment and rising income and wealth inequalities. The sharp rise in global unemployment is a major social and economic problem. Over the next decade, as 400 million young people join the labor force, the world faces a daunting employment challenge. Income inequality is also something that touches countries at all stages of development. In the U.S., for example, income inequality before the crisis was back to levels not seen since 1929—right before the Great Depression. But income inequality matters for emerging and developing economies too.

In Asia, there have been remarkable social advances over the last decades, with over half a billion people lifted out of poverty. At the same time, income inequality has been on the rise. There are abundant social and ethical reasons why we should care about income inequality. But there are also important macroeconomic reasons. Inequality can dampen economic opportunity, since the poor have less access to credit. It can divert people toward unproductive activities. It can also make countries more prone to shocks—where fewer people have savings for a rainy day, more will suffer when the storm hits. Inequality can even make it harder to recover from shocks: more equal societies tend to grow for longer.

How best to respond to these challenges? In countries facing high joblessness, well-designed unemployment schemes, social assistance and public work programs effectively prevent long-term unemployment and help shorten recovery from recession. Adequate social protection, drawing on a basic social protection floor, can protect the most vulnerable from the brunt of the crisis. As fiscal consolidation gets underway in the advanced economies, care should be taken to ensure that fiscal policy remains as job-friendly as possible.

Over the long haul, the most effective way to promote income growth at the lower end of the distribution is to invest in education, innovation, and ramping up the skills of workers. The 21st century economy is ultimately a knowledge economy, where returns to education are tremendously important.

There are no quick fixes to the imbalances above, but it should be recognized that there are no domestic solutions to these challenges. If policymakers around the world ignore these challenges—or take them only lightly—we face risks far greater than the recovery running out of steam particular from rising protectionism of trade and of finance and rising social and political instability within nations.

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