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Where Does the Recovery Stand?

Financial markets, and sentiment more generally, have been jittery recently. Despite generally strong earnings growth and corporate balance sheets, markets remain nervous about the strength and unevenness of the global recovery and downside risks have come to the fore. In each economy one can point to pockets of strength, but also of weakness. Between countries too, there are those that do well (in some cases too well) and those that appear to falter. This gives rise to significant uncertainty and cooperation within and between countries is needed to lift the tide for all. The latest World Economic Outlook provides an assessment where the recovery stands and the key risks and policy challenges ahead of us (available at: <http://www.imf.org/external/pubs/ft/weo/2011/01/index.htm>).

Harry Truman once famously asked to see a one-armed economist, having grown tired of economists proclaiming “On the one hand, this” and “On the other hand, that”. Nevertheless, this is exactly how we could describe the current state of affairs in the global economy: “On the one hand, the recovery is on track and well entrenched”, but “On the other hand, downside risks have increased and uncertainty and policy challenges remain unusually large”.

For advanced economies, the good news is that the handoff from public to private demand is advancing, reducing concerns that diminishing fiscal policy support might cause a “double-dip” recession. On the downside though, unemployment remains high, real income growth sluggish, and although financial conditions continue to improve, they remain unusually fragile including in light of the high funding requirements of banks and sovereigns. Weak sovereign balance sheets and still-moribund real estate markets continue to present major concerns, especially in certain euro area economies. In addition, the earthquake in Japan not only has exacted a terrible human toll, its macroeconomic impact has also been severe and even though output will revive in the second half of the year as reconstruction spending accelerates and supply constraints ease, the IMF in its latest Article IV consultation now projects overall growth will fall to -0.7 percent this year.

For many emerging market economies, the good news is that demand is robust and growth is strong. On the other hand, new downside risks are building on account of high commodity prices, notably for oil, and, relatedly, geopolitical uncertainty, as well as overheating and booming asset markets. Rising food and commodity prices pose a threat to poor households, adding to social and economic tensions, notably in the Middle East and North Africa. Strong and, at times, volatile capital inflows present another challenge for many emerging markets.

On the one hand, macroeconomic policies have contributed to mitigating the global recession. On the other, many old policy challenges remain unaddressed even as new ones come to the fore. In advanced economies, strengthening the recovery will require keeping

monetary policy accommodative as long as wage pressures are subdued, inflation expectations are well anchored, and bank credit is sluggish. At the same time, fiscal positions need to be placed on sustainable medium-term paths by implementing fiscal consolidation plans and entitlement reforms supported by stronger fiscal rules and institutions.

This need is particularly urgent in the United States to stem the risk of globally destabilizing changes in bond markets. The U.S. policy plans for 2011 have actually switched back from consolidation to expansion. Efforts should be made to reduce the projected deficit for fiscal year 2011. Measures to trim discretionary spending are a move in this direction. However, to make a sizable dent in the projected medium-term deficits, broader measures such as Social Security and tax reforms will be essential.

In Japan, the immediate fiscal priority is to support reconstruction. Once reconstruction efforts are underway and the size of the damage is better understood, attention should turn to linking reconstruction spending to a clear fiscal strategy for bringing down the public debt ratio over the medium term. In the euro area, despite significant progress, markets remain apprehensive about the prospects of countries under market pressure. For them what is needed at the euro area level is sufficient, low-cost, and flexible funding to support strong fiscal adjustment, bank restructuring, and reforms to promote competitiveness and growth. More generally, greater trust needs to be reestablished in euro area banks through ambitious stress tests and restructuring and recapitalization.

The challenge for many emerging and some developing economies is to ensure that present boom-like conditions do not develop into overheating over the coming year. Inflation pressure is likely to build further as growing production comes up against capacity constraints together with large food and energy price increases. Real interest rates are still low and fiscal policies appreciably more accommodative than before the crisis. Appropriate action differs across economies, depending on their cyclical and external conditions, but generally a tightening of macroeconomic policies is needed in many emerging market economies. This would include a more rapid pace of removing monetary accommodation, tighter fiscal positions, appreciation of the exchange rate, as well as providing well-targeted support for poor households that struggle with high food prices.

There is broad agreement on the contours of the policy responses sketched here. However, with the peak of the crisis now past, the imperative for action and willingness to cooperate among policymakers is diminishing. The task facing policymakers is to convince their national constituencies that these policy responses are in their best economic interests, regardless of the actions others are taking.

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