2 DEVELOPMENTS IN THE GLOBAL ECONOMY AND FINANCIAL MARKETS

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The past year has been a roller coaster for the global economy.[4] The severe financial crisis that followed the collapse of Lehman Brothers in September 2008 had a significant negative effect on the world economy, with global output falling by ½ percent in 2009. Advanced economies were the most significantly affected by the financial crisis, having to deal with a serious credit crunch, battered balance sheets, and rising unemployment. In these countries, output fell by 3¼ percent in 2009. The crisis was transmitted swiftly across the globe through a number of channels—including a collapse in trade, a drying up of capital flows, and a drop in remittances. When the dust had settled, it became obvious that several emerging markets and low-income countries had been severely affected by the global crisis, the worst in over 60 years.

Policymakers responded to the crisis by implementing a set of bold and aggressive measures delivered in an environment of unprecedented cooperation. In monetary policy, countries pushed interest rates toward zero and embarked on unconventional measures. Central banks cooperated, with coordinated interest rate cuts and swap lines. In fiscal policy, countries adopted a countercyclical stance, accommodating the recession-induced increase in deficits and complementing it with a fiscal stimulus. All in all, major advanced economies and emerging markets delivered a 2 percent of GDP fiscal stimulus in 2009, and much of the gain came from the very act of coordination. Countries also put measures in place to support the financial system, including asset purchases, capital injections, and various types of guarantees.

These measures paid off. A recovery began to emerge in the second half of 2009 and gained steam in early 2010, although increased financial market volatility in May 2010 once again raised some questions about the recovery's durability. World growth is expected to hit 4½ percent in 2010 and 4¼ percent in 2011, although the recovery is proceeding at varying speeds—tepidly in many advanced economies, more solidly elsewhere. Among advanced economies, the United States is growing faster than Europe or Japan. Among emerging markets and low-income countries, emerging Asia is out in front, while many emerging European and Commonwealth of Independent States economies are lagging behind. Advanced economies should grow by 2½ percent in 2010 and 2011. In contrast, annual growth in emerging markets and developing economies is projected to be 6¾ percent in 2010 and 6½ percent in 2011, following a modest 2½ percent in 2009.

The uneven nature of the recovery will likely continue. The rapid rebound in emerging markets and developing economies reflects a more favorable starting position—in many cases, financial sectors in these countries were healthy and they ran prudent fiscal policies, giving them leeway to support activity during the downturn. In contrast, growth in many advanced economies is being held back by lasting damage to financial sectors and household balance sheets. In these regions, the recovery will be more sluggish than in the past.

Following a deep freeze, global financial markets also began to thaw. Risks to global financial stability have fallen substantially, but stability is not yet assured. The IMF's estimates of banking system write-downs through 2010 were revised downward from US$2.8 trillion to US$2.3 trillion. But while the aggregate situation is looking up, problem areas remain, and banks still face considerable challenges: a large amount of short-term funding needs to be financed over the next couple of years, more and higher-quality capital will be needed, and not all losses have yet been written down. In this environment, the recovery of private sector credit is bound to be weak, as credit demand is subdued and supply is constrained. Small and medium-sized enterprises are likely to bear the brunt of tight credit.

Despite the recovery in global growth, the outlook is subject to considerable uncertainty, especially with fiscal vulnerabilities coming to the fore in the advanced economies. Downside risks have clearly risen. Sovereign risks could threaten financial stability and extend the crisis. Markets have become increasingly unsettled by the significant fiscal consolidation challenges faced by some countries. This loss of confidence is already having serious effects, and the threat of contagion overshadows the recovery, especially in Europe. Room for policy maneuver in many advanced economies has become more limited, and in some cases exhausted, leaving the fragile recoveries exposed to new shocks.

A key task ahead is to reduce sovereign vulnerabilities. Fiscal policy appropriately cushioned the precipitous drop in private demand and staved off a far deeper recession, but public debt levels have moved significantly higher. Indeed, the debt-to-GDP ratio in advanced economies is expected to exceed 100 percent by 2014, 35 percentage points higher than before the crisis. Most of this increase is due to the slump in activity, with discretionary stimulus measures accounting for a relatively small portion. Fast-growing countries and those under pressure from financial markets should start tightening. Most advanced economies do not need to tighten in 2010, but should commit to credible adjustment plans. And if the recovery proceeds as projected, they should initiate fiscal adjustment in 2011, in line with the evolving balance of IMF policy advice away from fiscal stimulus toward fiscal consolidation. With looming demographic pressures in advanced economies adding to medium-term fiscal challenges, entitlement reform should be a priority.

Fiscal adjustment must go hand in hand with measures to boost growth. Structural policies to kick-start economic activity, make labor markets more effective, and boost productivity are important in many advanced economies.

Monetary accommodation will also need to be unwound. In the major advanced economies, monetary tightening can take a back seat to fiscal adjustment and the withdrawal of emergency support to the financial sector, especially since inflation expectations remain well anchored and capacity utilization is still low. But in major emerging markets and in some advanced economies that are at the forefront of the recovery, central banks have already begun to reduce the degree of monetary accommodation. In some emerging markets, overcapacity in some sectors and deteriorating credit quality signal the need to tighten credit.

The uneven nature of the global recovery is complicating the policy environment, as different countries and different regions face different obstacles to restoring strong, balanced, and sustainable growth. A key issue is that countries that are recovering more quickly are tightening policy, while interest rates in advanced economies need to stay low for some time. This lack of synchronization is leading to some unintended side effects, one of them being a heavy influx of capital flows to emerging markets. These flows are a welcome recovery from the crisis and reflect the strong growth prospects of these economies. However, policymakers need to be mindful that surges in inflows could lead to exchange rate overshooting, asset price bubbles, and financial instability. So far, there is no system-wide evidence of bubbles, although there are a few hot spots, and risks could build up.

In emerging markets with excessively large current account surpluses, it makes sense for monetary tightening to go hand in hand with nominal effective exchange rate appreciation as excess demand pressures build. But in other emerging markets, monetary tightening could be complicated, as it would attract more capital inflows. As well as leading to exchange rate appreciation and undermining competitiveness, this could encourage a buildup of asset bubbles and undermine financial stability. Countries have a number of tools for addressing excess capital inflows—fiscal tightening, some buildup of reserves, macroprudential measures, and controls on capital flows if deemed necessary under certain circumstances.

Lingering high unemployment remains a core policy challenge. It is difficult to declare an end to the crisis when so many people in so many countries cannot find jobs. In advanced economies, unemployment is expected to stay close to 9 percent through 2011, and then only to decline slowly. Unemployment also remains endemic across many developing countries. Aside from its macroeconomic implications, high unemployment poses major social problems. A leading concern is that temporary joblessness will be transformed into structural unemployment. Sustained high unemployment may also raise the threat of increased trade protectionism. Specific labor market policies could help limit the damage—adequate unemployment benefits are key to supporting household confidence, protecting household incomes, and avoiding large increases in poverty. Education and training programs can help reintegrate the unemployed into the labor force and boost their human capital.

Financial reform must also be high on the policy agenda, especially since financial sector inefficiencies and regulatory and supervisory failure played a major role in this crisis. To support financial stability, swift resolution of nonviable financial institutions and restructuring of those with a commercial future is imperative. The continued existence of too-important-to-fail institutions represents a risk, as these institutions could use their funding advantage to consolidate their positions even further.

The contours of regulatory reform are clear: higher quantity and quality of capital and better liquidity risk management, a toolkit to address systemic risk in general and in too-important-to-fail institutions in particular, and a practical framework to facilitate resolution of cross-border issues. Policymakers must strike the right balance between seeking the safety of the financial system and keeping it innovative and efficient. Failure to act could undermine the recovery, perpetuate moral hazard, and increase the risk of countries going their own way rather than seeking a cooperative solution. Since implementation matters as much as regulation itself, supervision needs to be strengthened by making it more proactive. If regulatory reform does not go hand in hand with stronger supervision, it will not be effective.

To restore and sustain robust global growth, global demand needs to be rebalanced. Countries that ran excessively high external deficits before the crisis need to consolidate their public finances in ways that limit damage to potential growth and demand. The onus then falls on those countries that ran excessive current account surpluses to power global demand. As the deficit countries increase savings in response to lower expectations about future income, the surplus countries will need to shift from export-propelled growth toward domestic demand. They can boost internal demand by spending on social safety nets and improving infrastructure. As the currencies of economies with excessive deficits depreciate, then it follows that those of surplus countries must appreciate. Rebalancing should be supported by financial sector reform and appropriate structural policies in both surplus and deficit countries.