

EXECUTIVE SUMMARY

In 2010, world output is expected to rise by about 4¼ percent, following a ½ percent contraction in 2009. Economies that are off to a strong start are likely to remain in the lead, as growth in others is held back by lasting damage to financial sectors and household balance sheets. Activity remains dependent on highly accommodative macroeconomic policies and is subject to downside risks, as fiscal fragilities have come to the fore. In most advanced economies, fiscal and monetary policies should maintain a supportive thrust in 2010 to sustain growth and employment. But many of these economies also need to urgently adopt credible medium-term strategies to contain public debt and later bring it down to more prudent levels. Financial sector repair and reform are additional high-priority requirements. Many emerging economies are again growing rapidly and a number have begun to moderate their accommodative macroeconomic policies in the face of high capital inflows. Given prospects for relatively weak growth in the advanced economies, the challenge for emerging economies is to absorb rising inflows and nurture domestic demand without triggering a new boom-bust cycle.

Recovery Has Proceeded Better than Expected

The global recovery has evolved better than expected, with activity recovering at varying speeds—tepidly in many advanced economies but solidly in most emerging and developing economies. Policy support was essential to jump-start the recovery. Monetary policy has been highly expansionary and supported by unconventional liquidity provision. Fiscal policy provided a major stimulus in response to the deep downturn. Among advanced economies, the United States is off to a better start than Europe and Japan. Among emerging and developing economies, emerging Asia is in the lead. Growth is also solidifying in key Latin American and other emerging and developing economies but continues to lag in many emerging European and various Commonwealth of Independent States (CIS) countries. Sub-Saharan

Africa is weathering the global crisis well, and its recovery is expected to be stronger than following past global downturns.

The recoveries in real and financial activity are mutually supportive, but access to credit remains difficult for some sectors. Money markets have stabilized. Corporate bond and equity markets have rebounded. In advanced economies, the tightening of bank lending standards is ending, and the credit crisis appears to be bottoming out. In many emerging and developing economies, credit growth is reaccelerating. Nevertheless, financial conditions remain more difficult than before the crisis. Especially in advanced economies, bank capital is likely to remain a constraint on growth as banks continue to retrench their balance sheets. Sectors that have only limited access to capital markets—consumers and small and medium-size enterprises—are likely to continue to face tight limits on their borrowing. In a few advanced economies, rising public deficits and debt have contributed to a sharp increase in sovereign risk premiums, posing new risks to the recovery.

Together with real and financial activity, cross-border financial flows from advanced to many emerging economies have also rebounded strongly. Key drivers include rapid growth in emerging economies, large yield differentials in their favor, and a returning appetite for risk. The recovery of cross-border flows has come with some real effective exchange rate changes—depreciation of the U.S. dollar and appreciation of some other floating currencies of advanced and emerging economies. But relative to precrisis levels, changes have been generally limited, and global current account imbalances are forecast to widen again over the medium term.

Multispeed Recovery Will Continue

The world economy is poised for further recovery but at varying speeds across and within regions. Global growth is projected to reach 4¼ percent in 2010 and 2011. Advanced economies are now

expected to expand by 2¼ percent in 2010, and by 2½ percent in 2011, following a decline in output of more than 3 percent in 2009. Growth in emerging and developing economies is projected to be over 6¼ percent during 2010–11, following a modest 2½ percent in 2009. As Chapters 1 and 2 explain, economies that are off to a strong start are likely to continue to lead the recovery, as growth in others is held back by lasting damage to financial sectors and household balance sheets. The recovery under way in the major advanced economies will be relatively sluggish compared with recoveries from previous recessions. Likewise, the recoveries in many economies of emerging Europe and the CIS are likely to be sluggish compared with those expected for many other emerging economies.

The outlook for activity remains unusually uncertain, even though a variety of risks have receded. Risks are generally to the downside, with those related to public debt growth in advanced economies having become sharply more evident. In the near term, a risk is that, if unchecked, market concerns about sovereign liquidity and solvency in Greece could turn into a full-blown and contagious sovereign debt crisis, as explained in the April 2010 *Global Financial Stability Report* (GFSR). More generally, the main concern is that room for policy maneuver in many advanced economies has either been largely exhausted or is much more limited, leaving the fragile recoveries exposed to new shocks. In addition, bank exposures to real estate continue to pose downside risks, mainly in the United States and parts of Europe.

Policies Need to Sustain and Strengthen Recovery

Given the large amount of public debt that has been accumulated during this recession, in many advanced economies exit policies need to emphasize fiscal consolidation and financial sector repair. This will allow monetary policy to remain accommodative without leading to inflation pressure or financial market instabilities. In emerging and developing economies, priorities depend on room available for fiscal policy maneuvers and on current account positions. Spillovers related to fiscal policies are particularly relevant for the major advanced economies, as

large deficits and the lack of well-specified medium-term fiscal consolidation strategies in these economies could adversely affect funding costs of other advanced or emerging economies.

Medium-Term Fiscal Consolidation Strategies Are Urgently Needed

Fiscal policy provided major support in response to the deep downturn. At the same time, the slump in activity and, to a much lesser extent, stimulus measures pushed fiscal deficits in advanced economies to about 9 percent of GDP. Debt-to-GDP ratios in these economies are expected to exceed 100 percent of GDP in 2014 based on current policies, some 35 percentage points of GDP higher than before the crisis.

Regarding the near term, given the fragile recovery, fiscal stimulus planned for 2010 should be fully implemented, except in countries that are suffering large increases in risk premiums—these countries need to begin fiscal consolidation now. Looking further ahead, if macroeconomic developments proceed as expected, most advanced economies should embark on significant fiscal consolidation in 2011. Countries urgently need to design and implement credible fiscal adjustment strategies, emphasizing measures that support potential growth. These should include clear timelines to bring down gross debt-to-GDP ratios over the medium term. Also needed are reforms to entitlement spending that lower spending in the future but do not depress demand today.

The fiscal challenges are different in a number of emerging economies, with some important exceptions. The public debt problem in these economies is more localized—as a group, these economies' public debt ratios are at about 30 to 40 percent of GDP and, given their high growth, are expected to soon be back on a declining path. Many emerging Asian economies entered the crisis with relatively low public debt levels and can afford to maintain an expansionary fiscal stance. This will help rebalance the mix between externally and domestically driven growth. But these economies will need to be alert to growing price pressures and emerging financial instability and to allow their currencies to appreciate to combat overheating. Other major

emerging economies, however, have less fiscal room to maneuver and should withdraw support as the recovery gains more traction. Fiscal policy in low-income economies will also need to be redirected toward medium-term considerations as private and external demand recovers.

Monetary Accommodation Needs to Be Unwound Cautiously and Capital Inflows Managed

Still-low levels of capacity utilization and well-anchored inflation expectations are expected to keep inflation in check in most economies. Significant upside risks to inflation are confined to emerging economies that have a history of unstable price levels or have limited economic slack. In major advanced economies, monetary policy can remain accommodative as fiscal consolidation progresses, provided inflation pressure remains subdued. This can be achieved even as central banks begin to withdraw the emergency support provided to financial sectors. In major emerging and some advanced economies that are experiencing faster recoveries, central banks have already begun to reduce the degree of monetary accommodation or are expected by the markets to do so over the coming year. These economies will probably continue to lead the tightening cycle, as they are expected to recover faster than major advanced economies. In some emerging economies, overcapacity in some sectors and deteriorating credit quality also point to the need to tighten credit.

In emerging economies with excessive surpluses, monetary tightening should be supported with nominal effective exchange rate appreciation as excess demand pressures build, including in response to continued fiscal support to facilitate demand rebalancing or capital inflows. In others, monetary tightening may be complicated: it could attract more capital inflows, lead to exchange rate appreciation, and thereby undermine competitiveness. If exchange rate overshooting becomes a concern, countries should consider fiscal tightening to ease pressure on interest rates; some buildup of reserves; and possibly stricter controls on capital inflows—mindful of the potential to create new distortions—or looser controls on outflows.

Financial Sectors Must Be Repaired and Reformed

Together with fiscal adjustment, more progress with financial sector repair and reform is the top priority for a number of advanced economies to sustain recovery. Moreover, financial market inefficiencies and regulatory and supervisory failures played a major role in the crisis and need to be remedied to build a stronger financial system. For advanced economies, the April 2010 GFSR has lowered its estimate of actual and prospective bank write-downs and loan loss provisions during 2007–10 from \$2.8 trillion to \$2.3 trillion, two-thirds of which had been recognized by the end of 2009. Progress in remedying financial inefficiencies and reforming prudential policies and frameworks will increase the effectiveness of monetary policy and reduce the risk of the ample supply of liquidity finding an outlet in renewed speculative distortions. At the same time, emerging economies will need to continue to strengthen their prudential policies and frameworks in anticipation of growing capital inflows.

Policies to Support the Unemployed and Foster Employment Are Essential

High unemployment poses major social problems. In advanced economies, unemployment is projected to stay close to 9 percent through 2011 and then to decline only slowly. Chapter 3 explains that unemployment responses have been markedly different across advanced economies because of differences in output declines, labor market institutions, and factors such as financial stress and house price busts. Moreover, in many countries problems are larger than the headline unemployment rate statistics suggest because many individuals are underemployed or have dropped out of the labor force. In this setting, a major concern is the potential for temporary joblessness to turn into long-term unemployment and to lower potential output growth. To limit damage to the labor market, macroeconomic policies need to be appropriately supportive of the recovery where possible. At the same time, policies need to foster wage flexibility and provide adequate support for the jobless.

Rebalancing Global Demand Is Key to Buoy and Sustain Growth

For the world economy to sustain a high-growth trajectory, the economies that had excessive external deficits before the crisis need to consolidate their public finances in ways that limit damage to potential growth and demand. Concurrently, economies that ran excessive current account surpluses will need to further increase domestic demand to sustain growth, as excessive-deficit economies scale back their demand (and imports) in response to lower expectations about future income. As the currencies of economies with excessive deficits depreciate, then

logically those of surplus economies must appreciate. Rebalancing needs to be supported with financial sector reform and structural policies in both surplus and deficit economies. Policymakers will need to exploit policy synergies, especially between fiscal policy and structural reform.

Global demand rebalancing is not a new issue. Chapter 4 reviews the historical experience of economies with large current account surpluses. It finds that reversing current account surpluses has typically not been associated with losses in economic growth, with a variety of macroeconomic and structural policies playing an important role in countering output losses from real exchange rate appreciation.