Balancing Act

After first stabilizing, hopeful signs have emerged that global growth has entered the initial recovery phase. However, consumers are not yet ready to step up their spending. Where we go from here therefore depends critically on the political resolve to provide continued stimulus, while preparing the groundwork for an orderly exit strategy.

Indeed, the global economy is beginning to pull out of a recession unprecedented in the post–World War II era, based on the latest IMF World Economic Outlook. Following a disappointing first quarter, during which the global economy contracted almost as fast as during the fourth quarter of 2008, high-frequency data point to a return to modest growth at the global level.

Financial conditions have improved more than expected and recent data suggest that the rate of decline in economic activity is moderating, although to varying degrees among regions and partly reflecting more volatile factors such as inventory accumulation. Equity markets have been on a roll, credit spreads and the cost of protection against defaults have declined to almost pre-crisis levels, and there has been a faster than-expected turnaround in international capital flows reflecting subsiding risk aversion.

Growth projections in emerging Asia have been revised upward as well to 5.5 percent in 2009 and 7.0 percent in 2010. The upgrade owes to improved prospects in China and India, which unfortunately is unlikely to yield significant direct positive spillover effects to the rest of Asia as fiscal stimulus and rapid credit growth have fueled higher public investment by state-owned enterprises, with a high domestic content. Indeed, the IMF's latest Regional Economic outlook presented evidence that recoveries in Asia tend to be weak, and have to await a firm recovery in exports. As such, for the regional outlook, the ball remains firmly in the court of the advanced economies.

As for the prospects of the G3 (the U.S., euro area, and Japan), before we get too excited, the global recession is not over, and the recovery is still expected to be slow, as financial systems remain impaired, support from public policies will gradually diminish, and households in countries that suffered asset price busts will rebuild savings.

Regarding the financial system, bank debt and interbank markets have resumed functioning and concerns regarding liquidity and counterparty risks in the banking sector have declined. Although corporate bond markets have reopened, growth in bank credit to the private sector continues to slow in mature economies, hindering growth, particularly in those countries where firms typically rely more heavily on bank financing. Securitization markets outside those supported by the public sector remain impaired, and lower-quality borrowers continue to have limited access to capital market funding.

Banks repairing their balance sheets have also led to cross-border deleveraging, leading to an unwinding of the rapid financial globalization that occurred over the past decade. This trend will likely continue, placing additional pressure on those banking systems that are heavily

reliant on cross-border funding, such as those in parts of Eastern Europe. In short, the financial sector continues to be dependent on significant public support, resulting in an unparalleled transfer of risk from the private to the public sector. Although unavoidable, this has created a concomitant increase in public sector risks and a mounting burden on fiscal sustainability.

Regarding households, there are several reasons why the consumer in mature economies has yet to play its part in the economic recovery. Many housing markets have yet to bottom out. At the same time, commodity prices have rebounded ahead of the recovery. With growth in 2010 still short of potential until late in the year in advanced economies, unemployment will continue to increase. The crisis has also reduced the potential growth rate in advanced economies, leading to a reduction in consumers' expectations of future income. Furthermore, compared to past recessions, it is likely that consumers' risk aversion will remain elevated, as the experience of foreclosures, wealth destruction, and job losses will leave enduring memories. In short, it is unlikely that the consumer would be willing, have the means, or the access to financing to increase its spending, opting to reduce indebtedness instead.

At the same time, however, work will need to begin on exit strategies from the various financial, monetary, and fiscal support policies in order to address market uncertainty. This is no easy task. Removing stimulus too soon or too fast could jeopardize the recovery. Removing stimulus too late or too slow could unsettle inflation expectations and cause concerns about fiscal sustainability, particularly in those countries with looming fiscal costs from aging populations.

On balance, the current economic landscape as sketched above implies that it is too soon to withdraw stimulus and leaving the recovery in the, still shaky, hands of the market. The overarching policy priority remains improving financial sector health, in a multilaterally consistent manner, through recapitalization and restructuring of financial institutions where needed. This requires raising private capital and maintaining an expanded central bank balance sheet. Monetary and fiscal policy should also remain supportive until growth resumes and deflationary risks in countries that experienced a collapse in asset prices dissipate.

The formulation of exit strategies, and their communication to the markets, also highlights that upside risks to growth are modest: if growth picks up faster than expected, an exit from fiscal, monetary, and financial support need to begin sooner, dampening the recovery. Medium-term policies need to ensure that steps taken to normalize policies and markets are consistent with establishing a lasting framework of sound financial (self-)regulation, sustainable fiscal balances, and the maintenance of price stability.