EXECUTIVE SUMMARY

Thus far, economic recovery is proceeding broadly as expected, but downside risks remain elevated. Most advanced economies and a few emerging economies still face large adjustments. Their recoveries are proceeding at a sluggish pace, and high unemployment poses major social challenges. By contrast, many emerging and developing economies are again seeing strong growth, because they did not experience major financial excesses just prior to the Great Recession. Sustained, healthy recovery rests on two rebalancing acts: internal rebalancing, with a strengthening of private demand in advanced economies, allowing for fiscal consolidation; and external rebalancing, with an increase in net exports in deficit countries, such as the United States, and a decrease in net exports in surplus countries, notably emerging Asia. The two interact in strong ways. Increased net exports in advanced economies imply higher demand and higher growth, allowing more room for fiscal consolidation. Strengthened domestic demand helps emerging market economies maintain growth in the face of lower exports. A number of policies are required to support these rebalancing acts. In advanced economies, the repair and reform of the financial sector need to accelerate to allow a resumption of healthy credit growth. In addition, fiscal adjustment needs to start in earnest in 2011. Specific plans to cut future budget deficits are urgently needed now to create new room for fiscal policy maneuver. If global growth threatens to slow appreciably more than expected, countries with fiscal room could postpone some of the planned consolidation. Meanwhile, key emerging economies will need to further develop domestic sources of growth, with the support of greater exchange rate flexibility.

Stronger Activity, but Setbacks to Financial Stability

Economic recovery continued to strengthen during the first half of 2010. Global activity expanded at an annual rate of about 5¼ percent—about ½ percent higher than anticipated in the July *World Economic Outlook* (WEO) *Update.* A surge in inventory and, lately, fixed investment accounted for a dramatic rise in manufacturing and global trade. Low consumer confidence and reduced household incomes and wealth are holding consumption down in many advanced economies. Growth in these economies reached only about 3½ percent during the first half of 2010, a low rate considering that they are emerging from the deepest recession since World War II. Their recoveries will remain fragile for as long as improving business investment does not translate into higher employment growth. However, household spending is doing well in many emerging market economies, which expanded by close to 8 percent and where investment is propelling job creation. This heterogeneity in the pace of recovery across advanced and emerging economies is discussed in detail in Chapter 2.

At the same time, financial stability suffered a major setback, as explained in the accompanying October 2010 *Global Financial Stability Report* (GFSR). Market volatility increased and investor confidence dropped. Prices in many stock exchanges fell, led initially by financial stocks and by European markets. Heavy selling of the sovereign debt of vulnerable euro area economies rattled the banking system, triggering a systemic crisis. This added to existing worries about the sustainability of the recovery and caused a broader decline in stocks. Risk premiums on corporate bonds widened, and corporate bond issues slowed to a trickle in May. Issuance in emerging markets also dropped sharply. Since the beginning of the summer, however, financial conditions have improved again. Tail risks have been reduced by unprecedented European policy initiatives—the European Central Bank's Securities Markets Program and euro area governments' European Stabilization Mechanism—and by a front-loading of fiscal adjustment. However, underlying sovereign and banking vulnerabilities remain a significant challenge amid lingering concerns about risks to the global recovery.

Questions about the Pace of Recovery

The global recovery remains fragile, because strong policies to foster internal rebalancing of demand from public to private sources and external rebalancing from deficit to surplus economies are not yet in place. Global activity is forecast to expand by 4.8 percent in 2010 and 4.2 percent in 2011, broadly in line with earlier expectations, and downside risks continue to predominate. WEO projections are that output of emerging and developing economies will expand at rates of 7.1 and 6.4 percent, respectively, in 2010 and 2011. In advanced economies, however, growth is projected at only 2.7 and 2.2 percent, respectively, with some economies slowing noticeably during the second half of 2010 and the first half of 2011, followed by a reacceleration of activity. Slack will remain substantial and unemployment persistently high. Inflation is projected to stay generally low, amid continued excess capacity and high unemployment, with a few exceptions among the emerging economies. Risks to the growth forecasts are mainly to the downside. However, the probability of a sharp global slowdown, including stagnation or contraction in advanced economies, still appears low.

More Proactive Policies Are Needed

Policies need to become more proactive to achieve the required internal and external rebalancing. Most advanced economies and a few emerging economies still face major adjustments, including the need to strengthen household balance sheets, stabilize and subsequently reduce high public debt, and repair and reform their financial sectors. Monetary policy should stay highly supportive in most of the advanced economies and should be the first line of defense against any larger-than-projected weakening of activity as fiscal support diminishes. With policy rates already near zero in the large advanced economies, monetary policymakers may have to resort to further unconventional measures if private demand weakens unexpectedly as fiscal support wanes.

Fiscal adjustment needs to start in 2011. If global growth threatens to slow appreciably more than expected, countries with fiscal room could postpone some of the planned consolidation. One of the most urgent challenges for advanced economies is to legislate plans that help achieve sustainable fiscal positions before the end of the decade. This task is now more pressing than it was six months ago to rebuild room for fiscal policy maneuver in the face of still-volatile sovereign debt markets. Such room could be needed because monetary policy alone might not be able to provide sufficient support to counter the threat of a weakening of activity that is markedly more pronounced than expected.

Fiscal policy tightening will likely prove contractionary in most economies, although the extent is difficult to gauge. The survey of past experience in Chapter 3 suggests that fiscal consolidation in advanced economies typically detracts from short-term growth. The introduction of credible, growth-friendly, medium-term fiscal consolidation plans—currently not on offer in many advanced economies—would help limit the deflationary impact of consolidation on private demand in the short term. Such plans would have to include reforms to rapidly growing spending programs, notably entitlements, and tax reforms that favor production rather than consumption.

Better financial sector policies and practices in advanced economies are critical for strengthening the resilience of the recovery to shocks and sustaining private demand over the medium term. Progress on this front has been very slow. Apparently isolated difficulties in a few spots can have large spillover effects, via complex financial linkages and deterioration of fragile confidence. As the October 2010 GFSR explains, incomplete progress in addressing the legacy problems of the crisis has left systems in advanced economies vulnerable. Failure to rapidly resolve, restructure, or consolidate weak banks and repair wholesale markets raises the need for further fiscal backstopping and low interest rates to support recovery, which can cause other problems, including spillovers to emerging economies. More broadly, policymakers need to continue to clarify and specify regulatory reform, building on the improvements proposed by the Basel Committee on Banking Supervision. This would help financial markets and institutions provide more support, on a sounder basis, for consumption and investment, which is essential for strong, sustainable growth.

Structural policies that strengthen growth over the medium term would also help support the required normalization of macroeconomic policies in advanced economies. While supportive macroeconomic policies and financial sector repair and reform are essential for stronger job creation, in a number of economies, labor market policies could enhance growth and job creation and reduce high unemployment over the medium term. Complementary reforms to product and services markets could strengthen the employment effects by boosting labor demand and real wages through greater competition and lower markups on prices.

Although many emerging economies are seeing high growth again, they continue to rely significantly on demand from advanced economies. Chapter 4 makes clear that demand for imports from the advanced economies will continue to be below precrisis trends, in view of the high share of consumer durables and investment goods in trade. Emerging economies that relied heavily on demand from these economies will therefore have to rebalance growth further toward domestic sources to achieve growth rates similar to those before the crisis, helping the required external rebalancing. In economies with excessive external surpluses, which are mainly in emerging Asia, fiscal tightening should therefore take a backseat to monetary tightening and exchange rate flexibility. Removing distortions that drive high household or corporate saving rates and deter investment in nontradables sectors would facilitate the rebalancing of growth to domestic sources. Such rebalancing will require further deregulation and reform of financial sectors and corporate governance, as well as stronger social safety nets in key Asian economies. In many other emerging economies, fiscal tightening can start immediately, because domestic demand recovery is already well under way or public debt is relatively high. In various emerging economies, rising inflation or high credit growth also signal a need for further monetary tightening.

Many emerging and developing economies have successfully concluded first-generation reforms that improved macroeconomic policy frameworks, strengthening their resilience to macroeconomic shocks. However, to sustain or further raise potential growth and employment, efforts could usefully focus on simplifying product and services market regulation, raising human capital, and building critical infrastructure. Such reforms would also help absorb growing capital inflows in a productive manner, which would accelerate global income convergence and external rebalancing. As Chapter 1 and the October 2010 GFSR underscore, these flows can be expected to grow over the medium term, as the performance of emerging economies improves relative to that of the advanced economies, yields in the advanced economies remain low for some time, and institutional investors in advanced economies continue to diversify their exposures.

Strong, coordinated policy responses by all are essential to limit the fallout of the Great Recession. Historical evidence suggests that countries hit by financial crises typically suffer permanent output losses relative to precrisis trends. However, outcomes after individual crises have varied widely, depending on the policy responses. So far, much progress has been made through coordinated policy responses in alleviating liquidity strains and rebuilding confidence, and this has been essential for activity to rebound. The challenge ahead is for policymakers to put in place, in a coordinated manner, policies that support the fundamental adjustments needed for a return to healthy medium-term growth.