EXECUTIVE SUMMARY

After a deep global recession, economic growth has turned positive, as wide-ranging public intervention has supported demand and lowered uncertainty and systemic risk in financial markets. The recovery is expected to be slow, as financial systems remain impaired, support from public policies will gradually have to be withdrawn, and households in economies that suffered asset price busts will continue to rebuild savings while struggling with high unemployment. The key policy requirements remain to restore financial sector health while maintaining supportive macroeconomic policies until the recovery is on a firm footing. However, policymakers need to begin preparing for an orderly unwinding of extraordinary levels of public intervention.

Global Recession Is Ending, but a Subdued Recovery Lies Ahead

The global economy appears to be expanding again, pulled up by the strong performance of Asian economies and stabilization or modest recovery elsewhere. In the advanced economies, unprecedented public intervention has stabilized activity and has even fostered a return to modest growth in several economies. Emerging and developing economies are generally further ahead on the road to recovery, led by a resurgence in Asia. The recent rebound in commodity prices and supportive policies are helping many of these economies. Many countries in emerging Europe and the Commonwealth of Independent States have been hit particularly hard by the crisis, and developments in these economies are generally lagging those elsewhere.

The pace of recovery is slow, and activity remains far below precrisis levels. The pickup is being led by a rebound in manufacturing and a turn in the inventory cycle, and there are some signs of gradually stabilizing retail sales, returning consumer confidence, and firmer housing markets. As prospects have improved, commodity prices have staged a comeback from lows reached earlier this year, and world trade is beginning to pick up.

The triggers for this rebound are strong public policies across advanced and many emerging economies that have supported demand and all but eliminated fears of a global depression. These fears contributed to the steepest drop in global activity and trade since World War II. Central banks reacted quickly with exceptionally large interest rate cuts as well as unconventional measures to inject liquidity and sustain credit. Governments launched major fiscal stimulus programs while supporting banks with guarantees and capital injections. Together, these measures reduced uncertainty and increased confidence, fostering an improvement in financial conditions, as evidenced by strong rallies across many markets and a rebound of international capital flows. However, the environment remains very challenging for lower-tier borrowers. More generally, as emphasized in the October 2009 *Global Financial Stability Report* (GFSR), the risk of a reversal is a significant market concern, and a number of financial stress indicators remain elevated.

Looking ahead, the policy forces that are driving the current rebound will gradually lose strength, and real and financial forces, although gradually building, remain weak. Specifically, fiscal stimulus will diminish and inventory rebuilding will gradually lose its influence. Meanwhile, consumption and investment are gaining strength only slowly, as financial conditions remain tight in many economies. Thus, after contracting by about 1 percent in 2009, global activity is forecast to expand by about 3 percent in 2010, which is well below the rates achieved before the crisis. These projections reflect modest upward revisions to those in the July 2009 *WEO Update*.

- Advanced economies are projected to expand sluggishly through much of 2010, with unemployment continuing to rise until later in the year. Annual growth in 2010 is projected to be about 1¼ percent, following a contraction of 3½ percent in 2009. The recovery of activity is more clearly evident on a fourth-quarter-over-fourth-quarter basis: from 2009:Q4 to 2010:Q4, real GDP is expected to rise by about 1¾ percent, up from an expansion of about ½ percent (annualized) during the second half of 2009 and a 2 percent contraction in the first half.
- In emerging economies, real GDP growth is forecast to reach almost 5 percent in 2010, up from 1¾ percent in 2009. The rebound is driven by China, India, and a number of other emerging Asian economies. Other emerging economies are staging modest recoveries, supported by policy stimulus and improving global trade and financial conditions.

Downside risks to growth are receding gradually but remain a concern. The main short-term risk is that the recovery will stall. Premature exit from accommodative monetary and fiscal policies seems a significant risk because the policy-induced rebound might be mistaken for the beginning of a strong recovery in private demand. In general, the fragile global economy still seems vulnerable to a range of shocks, including rising oil prices, a virulent return of H1N1 flu, geopolitical events, or resurgent protectionism.

However, short-term risks are not only on the downside, as evidenced by the recent, more-rapid-than-expected improvement in financial conditions. In particular, the policy-induced reduction in fears about a 1930s-style crash in activity and the accompanying strong rebound in financial market sentiment might induce a larger-than-expected surge in consumption and investment across a number of advanced and emerging economies.

Extending the horizon to the medium term, there are other important risks to sustained recovery, mainly in the major advanced economies. On the financial front, a major concern is that continued public skepticism toward what is perceived as bailouts for the very firms considered responsible for the crisis undercuts public support for financial restructuring, thereby paving the way to a prolonged period of stagnation. On the macroeconomic policy front, the greatest risk revolves around deteriorating fiscal positions, including as a result of measures to support the financial sector.

Beyond 2010: Rebalancing the Global Economy

Achieving sustained healthy growth over the medium term will depend critically on addressing the supply disruptions generated by the crisis and rebalancing the global pattern of demand.

Lower Potential Output

Financial firms will need to be restructured and markets repaired to deliver adequate credit for sustained increases in investment and productivity, while labor will need to be redeployed across sectors. Historical evidence presented in Chapter 4 indicates that there were typically large, permanent hits to output in the aftermath of past financial crises, although the extent is difficult to determine and there have been a wide variety of outcomes. The current medium-term output projections are indeed on a much lower path than before the crisis, consistent with a permanent loss of potential output. Investment has already fallen sharply, especially in the economies hit by financial and real estate crises. Together with rising scrap rates, as corporations go bankrupt or restructure, this is reducing effective capital stocks. In addition, unemployment rates are expected to remain at high levels over the medium term in a number of advanced economies.

Demand-Side Rebalancing

To complement efforts to repair the supply side of economies, there must also be adjustments in the pattern of global demand in order to sustain a strong recovery. Specifically, many economies that have followed export-led growth strategies and have run current account surpluses will need to rely more on domestic demand and imports. This will help offset subdued domestic demand in economies that have typically run current account deficits and have experienced asset price (stock or housing) busts, including the United States, the United Kingdom, parts of the euro area, and many emerging European economies. To accommodate the shifts on the demand side, there will need to be changes on the supply side as well. This will require action on many fronts, including measures to repair financial systems, improve corporate governance and financial intermediation, support public investment, and reform social safety nets to lower precautionary saving. Even with a strong commitment by all countries to reform along these and other lines, however, this process of rebalancing global demand will be a drawn-out process and will need to be supported by greater exchange rate flexibility.

Policy Challenges

The key policy priorities remain to restore the health of the financial sector and to maintain supportive macroeconomic policies until the recovery is on a firm footing, even though policymakers must also begin preparing for an eventual unwinding of extraordinary levels of public intervention. The premature withdrawal of stimulus seems the greater risk in the near term, but developing the medium-term macroeconomic strategy beyond the crisis is key for maintaining confidence in fiscal solvency and for price and financial stability. The challenge is to map a middle course between unwinding public interventions too early, which would jeopardize the progress made in securing financial stability and recovery, and leaving these measures in place too long, which carries the risk of distorting incentives and damaging public balance sheets.

Timing the Tightening of Accommodative Monetary Conditions

The key issues facing monetary policymakers are when to start tightening and how to unwind large central bank balance sheets. The two objectives do not necessarily present major conflicts, because instruments exist to start tightening monetary conditions even while balance sheets remain much larger than usual. The pace at which the buildup in central bank balance sheets should be unwound depends on progress in normalizing market conditions and the types of interventions in place.

Regarding the timing of monetary policy tightening, advanced and emerging economies face different challenges. In advanced economies, central banks can (with few exceptions) afford to maintain accommodative conditions for an extended period because inflation is likely to remain subdued as long as output gaps remain wide. Moreover, monetary policymakers will need to accommodate the impact of the gradual withdrawal of fiscal support. The situation is more varied across emerging economies; in a number of these economies it will likely be appropriate to start removing monetary accommodation sooner than in advanced economies. In some economies, warding off risks for new asset price bubbles may call for greater exchange rate flexibility, to allow monetary policy tightening to avoid importing an excessively easy policy stance from the advanced economies.

As the October 2009 GFSR emphasizes, continued central bank support will likely be needed through at least next year in many economies, and it could take much longer to unwind the buildup in illiquid assets on some central bank balance sheets. In the meantime, central banks have tools available to absorb reserves as needed to tighten monetary conditions. Looking beyond the short-term challenges, what are some lessons of the crisis for conducting monetary policy? Historical evidence suggests that relatively stable inflation and output growth offer little protection against major shocks to the economy from bursting asset price bubbles: output and inflation are poor predictors of asset price busts. Chapter 3 shows that other variables, notably credit growth and the current account balance, are better predictors and may deserve more attention from monetary policymakers. Thus, if concerns mount about domestic demand and asset prices, monetary policymakers should consider tightening more than required purely for the purpose of keeping inflation under control over the coming year or two. The chapter also argues that policymakers should consider complementing inflation targeting with the introduction of macroprudential tools to help stabilize economies. Macroprudential tools have the advantage of working directly to lean against credit cycles and can therefore be helpful in complementing the role of interest rates in stabilizing economies. Expectations of what can be achieved, however, need to be realistic.

Maintaining Fiscal Support while Safeguarding Fiscal Sustainability

Notwithstanding already large deficits and rising public debt in many countries, fiscal stimulus needs to be sustained until the recovery is on a firm footing and may need to be amplified or extended beyond current plans if downside risks to growth materialize. Governments should thus stand ready to roll out new initiatives as necessary. At the same time, they need to commit to large reductions in deficits once the recovery is on a solid footing and must start addressing long-term fiscal challenges by advancing reforms to put public finances on a more sustainable path. The achievement of such reductions could usefully be supported with more robust fiscal frameworks, including suitable fiscal rules and strong enforcement mechanisms. Such frameworks and rules can play helpful roles in reining in spending pressures when good times return, thereby providing a degree of reassurance to investors that deficits and debt eventually will be rolled back. This is essential to again create significant room for countercyclical policy and rebuild public support for financial markets, both of which will be needed to respond to future shocks.

Healing Financial Sectors while Reforming Prudential Frameworks

Completing financial sector repair and reforming prudential frameworks are indispensable for a return to sustained growth. Restructuring financial firms' activities is key to a resumption of normal lending. As explained in more depth in the October 2009 GFSR, this will require balance sheet cleansing, recapitalization, and new business plans that are consistent with new funding models and new prudential frameworks. So far, there has been only very limited progress in removing impaired assets from bank balance sheets. The main challenge now is ongoing deterioration of asset quality. In this regard, official stress tests are important instruments through which the condition of banks can be diagnosed in order to design appropriate strategies for the recapitalization and restructuring of viable banks and for the careful resolution of nonviable banks. On this front, progress across countries has been uneven, and it is a source of concern that support for recapitalization faces political obstacles. Exit strategies need to be clearly articulated to help guide markets. Banks face a "wall of maturities" in the next two years, increasing rollover risks. In this setting, programs need to be phased out very gradually, using market-based incentives to encourage reduced reliance on public support.

Regarding fundamental reform, the achievement of a major overhaul must not be jeopardized by growing confidence that the greatest crisis dangers are past, fears that national competitive advantages might be lost, or concerns that first-best solutions are out of reach for technical reasons. As the October 2009 GFSR emphasizes, four challenges deserve particular attention. First, the perimeter of regulation needs to be broadened and made more flexible, covering all systemically important institutions alongside incentives to preclude further buildup of institutions currently considered "too big or too connected to fail." Second, effective market discipline needs to be encouraged through greater transparency and disclosure and reform of governance in financial institutions. Third, macroprudential frameworks must induce banks to build more buffers—by raising capital and making provisions in good times that can be used in bad times. And, fourth, international collaboration and coordination need to be improved to adequately cope with the challenges posed by cross-border institutions.

Structural and Social Policy Challenges

Rising unemployment will present a major challenge in many advanced economies, and poverty will continue to challenge many developing economies. The evidence in Chapter 4 suggests that unemployment rates typically tend to rise significantly and remain higher for many years after financial shocks. Limiting the extent of job destruction will require slower wage growth or even wage cuts for many workers. The impact of the necessary adjustments on poorer segments of the labor force could be cushioned with earned income tax credits or similar programs that limit the social repercussions of wage adjustment. In addition, better job matching and education and training can help limit job and wage losses. Poverty could increase significantly in a number of developing economies, notably in sub-Saharan Africa, where real GDP per capita is contracting in 2009 for the first time in a decade. Continued donor support from advanced economies will be crucial if these economies are to sustain hard-won macroeconomic stability gains.