EXECUTIVE SUMMARY

The global economy is in a dangerous new phase. Global activity has weakened and become more uneven, confidence has fallen sharply recently, and downside risks are growing. Against a backdrop of unresolved structural fragilities, a barrage of shocks hit the international economy this year. Japan was struck by the devastating Great East Japan earthquake and tsunami, and unrest swelled in some oil-producing countries. At the same time, the handover from public to private demand in the U.S. economy stalled, the euro area encountered major financial turbulence, global markets suffered a major sell-off of risky assets, and there are growing signs of spillovers to the real economy. The structural problems facing the crisis-hit advanced economies have proven even more intractable than expected, and the process of devising and implementing reforms even more complicated. The outlook for these economies is thus for a continuing, but weak and bumpy, expansion. Prospects for emerging market economies have become more uncertain again, although growth is expected to remain fairly robust, especially in economies that can counter the effect on output of weaker foreign demand with less policy tightening.

World Economic Outlook (WEO) projections indicate that global growth will moderate to about 4 percent through 2012, from over 5 percent in 2010. Real GDP in the advanced economies is projected to expand at an anemic pace of about 1½ percent in 2011 and 2 percent in 2012, helped by a gradual unwinding of the temporary forces that have held back activity during much of the second quarter of 2011. However, this assumes that European policymakers contain the crisis in the euro area periphery, that U.S. policymakers strike a judicious balance between support for the economy and medium-term fiscal consolidation, and that volatility in global financial markets does not escalate. Moreover, the removal of monetary accommodation in advanced economies is now expected to pause. Under such a scenario, emerging capacity constraints and policy tightening, much of which has already happened, would lower growth rates in emerging and developing economies to a still very solid pace of about 6 percent in 2012.

The risks are clearly to the downside, and two warrant particular attention from policymakers:

- The first is that the crisis in the euro area runs beyond the control of policymakers, notwithstanding the strong policy response agreed at the July 21, 2011, EU summit. Policymakers must swiftly ratify the commitments made at the July summit, and in the meantime, the European Central Bank (ECB) must continue to intervene strongly to maintain orderly conditions in sovereign debt markets. Leaders must stand by their commitments to do whatever it takes to preserve trust in national policies and the euro. Furthermore, given declining inflation pressure and heightened financial and sovereign tensions, the ECB should lower its policy rate if downside risks to growth and inflation persist.
- The second is that activity in the United States, already softening, might suffer further blows—for example, from a political impasse over fiscal consolidation, a weak housing market, rapid increases in household saving rates, or deteriorating financial conditions. Deep political divisions leave the course of U.S. policy highly uncertain. There is a serious risk that hasty fiscal cutbacks will further weaken the outlook without providing the long-term reforms required to reduce debt to more sustainable levels. News from the housing market has been disappointing, with no end in sight to the overhang of excess supply and declining prices, and equity prices have corrected sharply. These or other developments could prompt households to accelerate their pace of deleveraging, by raising their saving rates further. Given growing downside risks to U.S. activity, the Federal Reserve should stand ready to deploy more unconventional support, and the pace of

fiscal consolidation could become more back-loaded provided credible medium-term measures are adopted.

Either one of these eventualities would have severe repercussions for global growth. The renewed stress could undermine financial markets and institutions in advanced economies, which remain unusually vulnerable. Commodity prices and global trade and capital flows would likely decline abruptly, dragging down growth in emerging and developing economies. The extent to which this could lower global growth is illustrated in more detail in a downside scenario—the euro area and the United States could fall back into recession, with activity some 3 percentage points lower in 2012 than envisaged in WEO projections. Damage to other economies would also be significant.

Homegrown risks in emerging and developing economies seem less severe. Signs of overheating still warrant close attention, particularly from the monetary and prudential authorities. Risks related to commodity prices and social and political unrest in some parts of the world continue to loom large.

The uneven nature of the expansion and the many risks that threaten activity are symptomatic of a global economy that continues to struggle to accomplish the two rebalancing acts identified in earlier issues of the *World Economic Outlook.* First, private demand must take over from public demand. On this front, many economies have made considerable progress, but the major advanced economies lag behind. Second, economies with large external surpluses must rely increasingly on domestic demand, whereas those with large deficits must do the opposite. This rebalancing act has gone only halfway.[1] Key advanced and emerging market economies need to strengthen their policies to advance rebalancing and hedge against the many downside risks. Policies must be calibrated to reflect the transformed global environment, including lower potential output in many advanced and crisis-hit emerging market economies, unusually vulnerable financial sectors, high public deficits and debt and more sovereign credit risk differentiation among advanced economies, and the greater economic resilience of many emerging economies.

Rebalancing from public to private demand: Policymakers in crisis-hit economies must resist the temptation to rely mainly on accommodative monetary policy to mend balance sheets and accelerate repair and reform of the financial sector. Fiscal policy must navigate between the twin perils of losing credibility and undercutting recovery. Fiscal adjustment has already started, and progress has been significant in many economies. Strengthening medium-term fiscal plans and implementing entitlement reforms are critical to ensuring credibility and fiscal sustainability and to creating policy room to support balance sheet repair, growth, and job creation. Better short-term real sector prospects, in turn, would help make medium-term adjustment plans more credible. Should the macroeconomic environment deteriorate substantially, countries with more room for fiscal policy maneuvering should allow automatic stabilizers to operate fully and could choose a more back-loaded adjustment profile.

- In the euro area, the adverse feedback loop between weak sovereign and financial institutions needs to be broken. Fragile financial institutions must be asked to raise more capital, preferably through private solutions. If these are not available, they will have to accept injections of public capital or support from the EFSF, or be restructured or closed. Medium-term plans for fiscal consolidation are appropriately ambitious. In the economies of the periphery, a major task will be to find the right balance between fiscal consolidation and structural reform on the one hand and external support on the other, so as to ensure that adjustment in these economies can be sustained.
- The top priorities in the United States include devising a medium-term fiscal consolidation plan to put public debt on a sustainable path and to implement policies to sustain the recovery, including by easing the adjustment in the housing and labor markets. The American Job Act would provide needed short-term support to the

[1]See Blanchard, Oliver, and Gian Maria Milesi-Ferretti, 2011, "(Why) Should Current Account Balances Be Reduced?" IMF Staff Discussion Note No. 11/03 (Washington: International Monetary Fund); and Lane, Philip, and Gian Maria Milesi-Ferretti, 2011, "External Adjustment and the Global Crisis," IMF Working Paper No. 11/197 (Washington: International Monetary Fund), for further discussion of this challenge.

economy, but it must be flanked with a strong medium-term fiscal plan that raises revenues and contains the growth of entitlement spending.

- In Japan, the government should pursue more ambitious measures to deal with the very high level of public debt while attending to the immediate need for reconstruction and development in the areas hit by the earthquake and tsunami.

In all these economies, major progress with respect to entitlement and tax reform would create more room to adapt the pace of near-term fiscal consolidation to the strength of domestic demand and thereby limit further weakening of the recovery.

Rebalancing from external to domestic demand: Progress on this front has become even more important to sustain global growth. Some emerging market economies are contributing more domestic demand than is desirable (for example, several economies in Latin America); others are not contributing enough (for example, key economies in emerging Asia). The first set needs to restrain strong domestic demand by considerably reducing structural fiscal deficits and, in some cases, by further removing monetary accommodation. The second set of economies needs significant currency appreciation alongside structural reforms to reduce high surpluses of savings over investment. Such policies would help improve their resilience to shocks originating in the advanced economies as well as their medium-term growth potential.

The Great Recession amplified a number of real-sector problems, especially in advanced economies. The United States could be facing a very sluggish recovery of employment. Although unemployment is below post–World War II highs, job losses during the crisis were unprecedented and came on top of lackluster employment performance during the preceding decade. Households are more worried about future income prospects than at any time since the early 1980s. Priorities include easing adjustment in the housing market and strengthening active labor market policies. In many ways, however, the problem is so large that it warrants a drastic change in macroeconomic policy: major entitlement and tax reform with a view to creating more room for fiscal policy to sustain the recovery in the short term. In the euro area, abstracting from the large problems posed by the financial turbulence, the situation is more mixed. Households generally seem less concerned than in the United States, and job destruction has been much less severe, except in the crisis-hit economies of the periphery. The key structural challenge is for the economies in the periphery to adopt reforms that improve their capacity to rebuild and maintain their competitiveness.

Structural challenges elsewhere in the world vary widely. Large capital inflows in some emerging market economies underscore the need to improve their absorptive capacity by further opening product and services markets to foreign capital and strengthening financial stability frameworks. In addition, high food prices underscore the need for many emerging and developing economies to develop well-targeted social safety nets.

In view of the slow pace of global demand rebalancing, high commodity prices, and the modest growth outlook for advanced economies, long-term interest rates for key sovereigns are likely to stay low. This may foster risk taking in other economies—previous episodes of money recycling on a massive scale have rarely been without financial accidents. Symptoms of excessive risk taking are in fact evident in a few advanced and a number of emerging market economies: very high credit growth, booming real estate markets, and large flows into financial markets. More generally, the financial crisis brought to the fore the extraordinary vulnerability of the global financial system to disruptions in wholesale funding markets. At the national level, central banks have responded by putting in place temporary mechanisms that inject liquidity if wholesale funding threatens to dry up. There are, however, no such mechanisms at the international level. In general, the latest financial crisis illustrates the urgent need to beef up the size and scope of international risk-sharing mechanisms, which have fallen far behind the size of international financial markets.

To ensure that trade remains supportive of the global recovery, policymakers must continue to resist protectionist pressures. Just as important, with negotiations on the long-running World Trade Organization (WTO) Doha Round of trade talks at a pivotal juncture, political leaders need to muster the will and high-level attention to devise a credible plan to move the negotiations forward, including by strongly communicating the benefits to the public. Failure of the round could lead to fragmentation of the global trading system and a weakening of the WTO and multilateralism.

Unless policies are strengthened, especially in advanced economies, nothing beyond a weak and bumpy recovery is in the cards. There are potential major benefits to a stronger, collaborative policy response. As explained in a separate IMF report for the G20 Mutual Assessment Program, adopting growth-friendly medium-term fiscal consolidation programs in advanced economies, policies to rebalance demand in emerging market surplus economies, and structural reforms to boost potential growth everywhere could provide a considerable fillip to global GDP.[2] Perhaps even more important, together with measures to facilitate balance sheet adjustment by households and banks, such policies would forestall a lost decade of growth in advanced economies, which would be very detrimental for all. However, achieving this will require that policymakers tackle difficult political economy challenges at home and resuscitate the strong collaborative spirit that prevailed at the height of the crisis.

[2]See Group of Twenty, 2010, "G20 Mutual Assessment Process—Alternative Policy Scenarios," report prepared by staff of the International Monetary Fund for the G20 Mutual Assessment Process, G-20 Toronto Summit, Toronto, Canada, June 26–27 (Washington: International Monetary Fund). www.imf.org/external/np/g20/pdf/062710a.pdf.