Relative to our previous World Economic Outlook last April, the economic recovery has become much more uncertain. The world economy suffers from the confluence of two adverse developments. The first is a much slower recovery in advanced economies since the beginning of the year, a development we largely failed to perceive as it was happening. The second is a large increase in fiscal and financial uncertainty, which has been particularly pronounced since August. Each of these developments is worrisome—their combination and their interactions more so. Strong policies are urgently needed to improve the outlook and reduce the risks.

Growth, which had been strong in 2010, decreased in 2011. This slowdown did not initially cause too much worry. We had forecast some slowdown, due to the end of the inventory cycle and fiscal consolidation. One-time events, from the earthquake and tsunami in Japan to shocks to the supply of oil, offered plausible explanations for a further slowdown. And the initial U.S. data understated the size of the slowdown itself. Now that the numbers are in, it is clear that more was going on.

What was going on was the stalling of the two rebalancing acts, which we have argued in many previous issues of the World Economic Outlook are needed to deliver “strong, balanced, and sustainable growth.”

Take first internal rebalancing: What is needed is a shift from fiscal stimulus to private demand. Fiscal consolidation is indeed taking place in most advanced economies (although not in Japan). But private demand is not taking the relay. The reasons vary, depending on the country. But tight bank lending, the legacy of the housing boom, and high leverage for many households all turn out to be putting stronger brakes on the recovery than we anticipated.

Turn to external rebalancing: Advanced economies with current account deficits, most notably the United States, need to compensate for low domestic demand through an increase in foreign demand. This implies a symmetric shift away from foreign demand toward domestic demand in emerging market economies with current account surpluses, most notably China. This rebalancing act is not taking place. While imbalances decreased during the crisis, this was due more to a large decrease in output in advanced relative to emerging market economies than to structural adjustment in these economies. Looking forward, the forecast is for an increase rather than a decrease in imbalances.

Now turn to the second adverse development, increased fiscal and financial uncertainty: Markets have clearly become more skeptical about the ability of many countries to stabilize their public debt. For some time, their worries were mostly limited to a few small countries on the periphery of Europe. As time has passed, and as growth prospects have dimmed, their worries have extended to more European countries and to countries beyond Europe—from Japan to the United States. Worries about sovereigns have translated into worries about the banks holding these sovereign bonds, mainly in Europe. These worries have led to a partial freeze of financial flows, with banks keeping high levels of liquidity and tightening lending. Fear of the unknown is high. Stock prices have fallen. These will adversely affect spending in the months to come. Indeed, August numbers indicate that this is already happening.

Low underlying growth and fiscal and financial linkages may well feed back on each other, and this is where the risks are. Low growth makes it more difficult to achieve debt sustainability and leads markets to worry even more about fiscal stability. Low growth also leads to more nonperforming loans and weakens banks. Front-loaded fiscal consolidation in turn may lead to even lower growth. Weak banks and tight bank lending may have the same effect. Weak banks and the potential need for
more capital lead to more worry about fiscal stability. Downside risks are very real.

I have been focusing so far on advanced economies. The reason is that, until now, emerging market economies have been largely immune to these adverse developments. They have had to deal with volatile capital flows, but in general have continued to sustain high growth. Indeed, some are close to overheating, although prospects are more uncertain again for many others. Under the risk scenarios, they may well suffer more adverse export conditions and even more volatile capital flows. Low exports and, perhaps, lower commodity prices will also create challenges for low-income countries.

In light of the weak baseline and high downside risks, strong policy action is of the essence. It must rely on three main legs.

The first leg is fiscal policy. Fiscal consolidation cannot be too fast or it will kill growth. It cannot be too slow or it will kill credibility. The speed must depend on individual country circumstances, but the key continues to be credible medium-term consolidation. Some countries need substantial outside help to succeed. Going beyond fiscal policy, measures to prop up domestic demand, ranging from continued low interest rates, to increased bank lending, to resolution programs for housing, are also of the essence.

The second leg is financial measures. Fiscal uncertainty will not go away overnight. And even under the most optimistic assumptions, growth in advanced economies will remain low for some time. During that time, banks have to be made stronger, not only to increase bank lending and baseline growth, but also—and more important—to reduce risks of vicious feedback loops. For a number of banks, especially in Europe, this is likely to require additional capital buffers, either from private or from public sources.

The third leg is external rebalancing. It is hard to see how, even with the policy measures listed above, domestic demand in the United States and other economies hit by the crisis can, by itself, ensure sufficient growth. Thus, exports from the United States and crisis-hit economies must increase, and, by implication, net exports from the rest of the world must decrease. A number of Asian economies, in particular China, have large current account surpluses and have indicated plans to rebalance from foreign to domestic demand. These plans cannot be implemented overnight. But they must be implemented as fast as possible. Only with this global rebalancing can we hope for stronger growth in advanced economies and, by implication, for the rest of the world.

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