FOREWORD

The world economy has entered yet another transition. Advanced economies are gradually strengthening. At the same time, growth in emerging market economies has slowed. This confluence is leading to tensions, with emerging market economies facing the dual challenges of slowing growth and tighter global financial conditions.

The U.S. economy remains at the center of events. Private demand continues to be strong, although growth has been hobbled this year by excessive fiscal consolidation. Politics is creating uncertainty about both the nature and the strength of the fiscal adjustment. The sequester is a bad way to consolidate, and conflicts around increasing the debt ceiling could lead to another bout of destabilizing uncertainty and lower growth. Nevertheless, it is time for monetary policy to make plans for an exit from both quantitative easing and zero policy rates. While there are no major conceptual or technical issues involved, the communication problems facing the Federal Reserve are new and delicate. It is reasonable to expect some volatility in long rates as Fed policy shifts.

The recovery in Japan has been spurred by Abenomics, but sustaining it will depend on meeting two major challenges. The first, reflected in the debate about increasing the consumption tax, is setting the right pace for fiscal consolidation: consolidating too slowly will compromise credibility, and moving too fast will kill growth. The second is implementing a credible set of structural reforms to transform what is now a cyclical recovery into sustained growth.

The core economies of Europe show some signs of recovery. This is the result not of recent major policy changes but of a change in mood, which nonetheless could be largely self-fulfilling if consumers and firms decide to increase spending. Southern periphery countries are still struggling, however. Progress on improving competitiveness and increasing exports is not yet strong enough to offset depressed internal demand. In both the core and the periphery, there is lingering uncertainty about bank balance sheets, which should be reduced by the promised review of banks' asset quality. Taking the longer view, just as for Japan, structural reforms are urgently needed to invigorate the anemic potential growth rates that plague the region.

The major news at this time comes from emerging market economies, where growth has declined—often by more than we previously forecast.

The obvious question is whether this slowdown reflects cyclical factors or a decrease in potential output growth. Based on what we know today, the answer is that it reflects both, albeit to different degrees in various countries—more cyclical in Russia and South Africa, more decreased potential in China and India. Unusually favorable world conditions, including high commodity prices and rapid financial market development, increased potential growth in these economies during the 2000s, and in a number of them, there was a cyclical component on top. As commodity prices stabilize and financial conditions tighten, potential growth is lower, leading in some cases to a sharp cyclical adjustment.

Confronted with these changing conditions, governments in emerging market economies face two challenges. The first is to adjust to lower potential growth. While some decrease in growth relative to the 2000s is inevitable, structural reforms can help ease the adjustment and are becoming more urgent. The list is a familiar one, from rebalancing toward consumption in China to removing barriers to investment in Brazil and India. The second challenge is to deal with the cyclical adjustment, and here the standard advice also applies. Countries with large fiscal deficits must consolidate. Countries with inflation running persistently above target must tighten and—often more important—put in place a more credible monetary policy framework.

The potential impact on these economies of an increase in U.S. long rates makes this advice even more relevant. Normalization of interest rates in advanced economies is likely to lead to a partial reversal of previous capital flows. As investors repatriate funds to the United States, countries with weaker fiscal positions or higher inflation are particularly exposed. The right response is twofold. First, where needed, countries must put their macro houses in order by clarifying their monetary policy framework and maintaining fiscal sustainability. Second, they must let the exchange rate depreciate in response to outflows. Foreign currency exposure and balance-sheet effects, which have created adverse effects in the past, are more limited today, and emerging market economies should be able to adjust to the changed environment without a major crisis.

In short, the recovery from the crisis continues, albeit too slowly. The focus at this time is on emerging market economies—specifically, on the combination of slower growth and tighter financial conditions triggered by U.S. monetary policy. But, in the background, other legacies of the crisis still linger and may well come back to the fore. Public debt and, in some cases, private debt remain very high, and fiscal sustainability is not a given. The architecture of the financial system is evolving, and its future shape is still unclear. These issues will continue to shape the evolution of the world economy for many years to come.

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