FOREWORD

Achieving a "strong, balanced, and sustained world recovery"—to quote from the goal set in Pittsburgh by the G20—was never going to be easy. It requires much more than just going back to business as usual. It requires two fundamental and difficult economic rebalancing acts.

First, internal rebalancing: When private demand collapsed, fiscal stimulus helped alleviate the fall in output. But fiscal stimulus has to eventually give way to fiscal consolidation, and private demand must be strong enough to take the lead and sustain growth.

Second, external rebalancing: Many advanced economies, most notably the United States, which relied excessively on domestic demand, must now rely more on net exports. Many emerging market economies, most notably China, which relied excessively on net exports, must now rely more on domestic demand.

These two rebalancing acts are taking place too slowly.

Private domestic demand remains weak in advanced economies. This weakness reflects both a correction of precrisis excesses and the scars of the crisis. U.S. consumers who had overborrowed before the crisis are now saving more and consuming less, and while this is good for the long term, it is a drag on demand in the short term. Housing booms have given way to housing slumps, and housing investment will remain depressed for some time. And weaknesses in the financial system are still constraining credit.

External rebalancing remains limited. Net exports are not contributing to growth in advanced economies, and the U.S. trade deficit remains large. Many emerging market economies continue to run large current account surpluses and to respond to capital inflows primarily through reserve accumulation rather than exchange rate appreciation. International reserves are higher than they have ever been and continue to increase.

The result is a recovery that is neither strong nor balanced and runs the risk of not being sustained. For the past year or so, inventory accumulation and fiscal stimulus were driving the recovery. The first is coming to an end. The second is slowly being phased out. Consumption and investment now have to take the lead. But in most advanced economies, weak consumption and investment, together with little improvement in net exports, are leading to low growth. Unemployment is high and barely decreasing. By contrast, in many emerging market economies, where excesses were limited and the scars are few, consumption, investment, and net exports are all contributing to strong growth, and output is once again close to potential.

What can be done to improve things?

First, and wherever private demand is weak, central banks should continue with accommodative monetary policy. However, one should be realistic. Not much more can be done, and one should not expect too much from further quantitative or credit easing. While there is no evidence yet that sustained low interest rates are leading to excessive risk taking, should such risks materialize, they should be addressed through macroprudential measures, not through increases in policy rates.

Second, and wherever needed, governments must continue both financial repair and financial reform. Many banks remain undercapitalized, and tight credit is constraining segments of demand. Securitization, which must play an important role in any future intermediation system, is still moribund. Financial reform is proceeding, but questions remain about "too-big-to-fail" institutions, the perimeter of regulation, and cross-border issues. The faster reform uncertainty is reduced, the more the financial system will support demand and growth.

Third, and again wherever needed, governments must address fiscal consolidation. What is essential is not so much phasing out fiscal stimulus now, but offering credible medium-term plans for debt stabilization and, eventually, debt reduction. Such credible plans may involve fiscal rules, the creation of independent fiscal agencies, and phased-in entitlement reforms. They have not been offered in most countries, but they are essential and, once in place, will give governments more fiscal flexibility to sustain growth in the short term.

Fourth, emerging market economies with large current account surpluses must accelerate rebalancing. This is not only in the world economy's interest, but also in their own. In many countries, distortions have led to too low a level of consumption or too little investment. Removing these distortions and thus allowing consumption and investment to increase is desirable. To a large extent, market forces in the form of large capital inflows are pushing these countries in the right direction. Unless offset by reserve accumulation, capital inflows will lead to exchange rate appreciation. With the help of macroprudential measures and capital controls, these flows can help reallocate production toward domestic goods. Finally, to the extent that countries remain worried about sudden stops, better provision of global liquidity can play an important role and limit the accumulation of reserves.

All these pieces are interconnected. Unless advanced economies can count on stronger private demand, both domestic and foreign, they will find it difficult to achieve fiscal consolidation. And worries about sovereign risk can easily derail growth. If growth stops in advanced economies, emerging market economies will have a hard time decoupling. The need for careful design at the national level, and coordination at the global level, may be even more important today than at the peak of the crisis, a year and a half ago.

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