The recovery is gaining strength, but unemployment remains high in advanced economies, and new macroeconomic risks are building in emerging market economies. In advanced economies, the handoff from public to private demand is advancing, reducing concerns that diminishing fiscal policy support might cause a “double-dip” recession. Financial conditions continue to improve, although they remain unusually fragile. In many emerging market economies, demand is robust and overheating is a growing policy concern. Developing economies, particularly in sub-Saharan Africa, have also resumed fast and sustainable growth. Rising food and commodity prices pose a threat to poor households, adding to social and economic tensions, notably in the Middle East and North Africa. Oil price increases since January 2011 and information on supply, including on spare capacity, suggest that the disruptions so far would have only mild effects on economic activity. An earthquake in Japan has exacted a terrible human toll. Its macroeconomic impact is projected to be limited, although uncertainty remains elevated. Overall, with the recovery stronger on the one hand but oil supply growth lower on the other, projections for global real GDP growth in 2011–12 are little changed from the January 2011 WEO Update. But downside risks have risen.

World real GDP growth is forecast to be about 4½ percent in 2011 and 2012, down modestly from 5 percent in 2010. Real GDP in advanced economies and emerging and developing economies is expected to expand by about 2½ percent and 6½ percent, respectively. Downside risks continue to outweigh upside risks. In advanced economies, weak sovereign balance sheets and still-moribund real estate markets continue to present major concerns, especially in certain euro area economies; financial risks are also to the downside as a result of the high funding requirements of banks and sovereigns. New downside risks are building on account of commodity prices, notably for oil, and, relatedly, geopolitical uncertainty, as well as overheating and booming asset markets in emerging market economies. However, there is also the potential for upside surprises to growth in the short term, owing to strong corporate balance sheets in advanced economies and buoyant demand in emerging and developing economies.

Many old policy challenges remain unaddressed even as new ones come to the fore. In advanced economies, strengthening the recovery will require keeping monetary policy accommodative as long as wage pressures are subdued, inflation expectations are well anchored, and bank credit is sluggish. At the same time, fiscal positions need to be placed on sustainable medium-term paths by implementing fiscal consolidation plans and entitlement reforms supported by stronger fiscal rules and institutions. This need is particularly urgent in the United States to stem the risk of globally destabilizing changes in bond markets. The U.S. policy plans for 2011 have actually switched back from consolidation to expansion. Efforts should be made to reduce the projected deficit for fiscal year 2011. Measures to trim discretionary spending are a move in this direction. However, to make a sizable dent in the projected medium-term deficits, broader measures such as Social Security and tax reforms will be essential. In Japan, the immediate fiscal priority is to support reconstruction. Once reconstruction efforts are underway and the size of the damage is better understood, attention should turn to linking reconstruction spending to a clear fiscal strategy for bringing down the public debt ratio over the medium term. In the euro area, despite significant progress, markets remain apprehensive about the prospects of countries under market pressure. For them what is needed at the euro area level is sufficient, low-cost, and flexible funding to support strong fiscal adjustment, bank restructuring, and reforms to promote competitiveness and growth. More generally, greater trust needs to be reestablished in euro area banks through ambitious stress tests and restructuring and recapitalization...
programs. Moreover, reform of the global financial system remains very much a work in progress.

The challenge for many emerging and some developing economies is to ensure that present boom-like conditions do not develop into overheating over the coming year. Inflation pressure is likely to build further as growing production comes up against capacity constraints, with large food and energy price increases, which weigh heavily in consumption baskets, motivating demands for higher wages. Real interest rates are still low and fiscal policies appreciably more accommodative than before the crisis. Appropriate action differs across economies, depending on their cyclical and external conditions. However, a tightening of macroeconomic policies is needed in many emerging market economies.

• For external surplus economies, many of which manage their currencies and do not face fiscal problems, removal of monetary accommodation and appreciation of the exchange rate are necessary to maintain internal balance—reining in inflation pressure and excessive credit growth—and assist in global demand rebalancing.

• Many external deficit economies need to tighten fiscal and monetary policies, possibly tolerating some overshooting of the exchange rate in the short term.

• For some surplus and deficit economies, rapid credit and asset price growth warn of a threat to financial stability. Policymakers in these economies will need to act soon to safeguard stability and build more resilient financial systems.

• Many emerging and developing economies will need to provide well-targeted support for poor households that struggle with high food prices. Capital flows to emerging market economies resumed remarkably quickly after the crisis. However, as policy rates in advanced economies rise from their unusually low levels, volatile flows may again exit the emerging market economies. Depending on country-specific circumstances, and assuming appropriate macroeconomic and prudential policies are in place, measures designed to curb capital inflows can play a role in dampening the impact of their excessive volatility on the real economy. However, such measures are not a substitute for macroeconomic tightening.

Greater progress in advancing global demand rebalancing is essential to put the recovery on a stronger footing over the medium term. This will require action by many countries, notably fiscal adjustment in key external deficit economies and greater exchange rate flexibility and structural reforms that eliminate distortions that boost savings in key surplus economies.

There is broad agreement on the contours of the policy responses sketched here. However, with the peak of the crisis now past, the imperative for action and willingness to cooperate among policymakers is diminishing. It would be a mistake for advanced economies to delay fiscal adjustment in the face of a difficult political economy at home. Additionally, while the removal of distortions that boost saving in key external surplus economies would support growth and help achieve fiscal consolidation in key advanced economies, insufficient progress on one front should not serve as an excuse for inaction on the other front. It would also be a mistake for emerging market economies to delay exchange rate adjustment in the face of rising inflation pressure. Many emerging market economies cannot afford to delay additional policy tightening until the advanced economies undertake such tightening themselves. The task facing policymakers is to convince their national constituencies that these policy responses are in their best economic interests, regardless of the actions others are taking.