After suffering a major setback during 2011, global prospects are gradually strengthening again, but downside risks remain elevated. Improved activity in the United States during the second half of 2011 and better policies in the euro area in response to its deepening economic crisis have reduced the threat of a sharp global slowdown. Accordingly, weak recovery will likely resume in the major advanced economies, and activity is expected to remain relatively solid in most emerging and developing economies. However, the recent improvements are very fragile. Policymakers need to continue to implement the fundamental changes required to achieve healthy growth over the medium term. With large output gaps in advanced economies, they must also calibrate policies with a view to supporting still-weak growth over the near term.

Global growth is projected to drop from about 4 percent in 2011 to about 3½ percent in 2012 because of weak activity during the second half of 2011 and the first half of 2012. The January 2012 WEO Update had already marked down the projections of the September 2011 World Economic Outlook, mainly on account of the damage done by deteriorating sovereign and banking sector developments in the euro area. For most economies, including the euro area, growth is now expected to be modestly stronger than predicted in the January 2012 WEO Update. As discussed in Chapter 1, the reacceleration of activity during the course of 2012 is expected to return global growth to about 4 percent in 2013. The euro area is still projected to go into a mild recession in 2012 as a result of the sovereign debt crisis and a general loss of confidence, the effects of bank deleveraging on the real economy, and the impact of fiscal consolidation in response to market pressures. Because of the problems in Europe, activity will continue to disappoint for the advanced economies as a group, expanding by only about 1½ percent in 2012 and by 2 percent in 2013. Job creation in these economies will likely remain sluggish, and the unemployed will need further income support and help with skills development, retraining, and job searching. Real GDP growth in the emerging and developing economies is projected to slow from 6¼ percent in 2011 to 5¼ percent in 2012 but then to reaccelerate to 6 percent in 2013, helped by easier macroeconomic policies and strengthening foreign demand. The spillovers from the euro area crisis, discussed in Chapter 2, will severely affect the rest of Europe; other economies will likely experience further financial volatility but no major impact on activity unless the euro area crisis intensifies once again.

Policy has played an important role in lowering systemic risk, but there can be no pause. The European Central Bank’s three-year longer-term refinancing operations (LTROs), a stronger European firewall, ambitious fiscal adjustment programs, and the launch of major product and labor market reforms helped stabilize conditions in the euro area, relieving pressure on banks and sovereigns, but concerns linger. Furthermore, the recent extension of U.S. payroll tax relief and unemployment benefits has forestalled abrupt fiscal tightening that would have harmed the U.S. economy. More generally, many advanced economies have made good progress in designing and implementing strong medium-term fiscal consolidation programs. At the same time, emerging and developing economies continue to benefit from past policy improvements. With no further action, however, problems could easily flare up again in the euro area and fiscal policy could tighten very abruptly in the United States in 2013.

Accordingly, downside risks continue to loom large, a recurrent feature in recent issues of the World Economic Outlook. Unfortunately, some risks identified previously have come to pass, and the projections here are only modestly more favorable than those identified in a previous downside scenario.¹ The most immediate concern is still that

¹See the downside scenario in the January 2011 WEO Update.
further escalation of the euro area crisis will trigger a much more generalized flight from risk. This scenario, discussed in depth in this issue, suggests that global and euro area output could decline, respectively, by 2 percent and 3 1/2 percent over a two-year horizon relative to WEO projections. Alternatively, geopolitical uncertainty could trigger a sharp increase in oil prices: an increase in these prices by about 50 percent would lower global output by 1 1/4 percent. The effects on output could be much larger if the tensions were accompanied by significant financial volatility and losses in confidence. Furthermore, excessively tight macroeconomic policies could push another of the major economies into sustained deflation or a prolonged period of very weak activity. Additionally, latent risks include disruption in global bond and currency markets as a result of high budget deficits and debt in Japan and the United States and rapidly slowing activity in some emerging economies. However, growth could also be better than projected if policies improve further, financial conditions continue to ease, and geopolitical tensions recede.

Policies must be strengthened to solidify the weak recovery and contain the many downside risks. In the short term, this will require more efforts to address the euro area crisis, a temperate approach to fiscal restraint in response to weaker activity, a continuation of very accommodative monetary policies, and ample liquidity to the financial sector.

• In the euro area, the recent decision to combine the European Stability Mechanism (ESM) and the European Financial Stability Facility (EFSF) is welcome and, along with other recent European efforts, will strengthen the European crisis mechanism and support the IMF’s efforts to bolster the global firewall. Sufficient fiscal consolidation is taking place but should be structured to avoid an excessive decline in demand in the near term. Given prospects for very low domestic inflation, there is room for further monetary easing; unconventional support (notably LTROs and purchases of government bonds) should continue to ensure orderly conditions in funding markets and thereby facilitate the pass-through of monetary policy to the real economy. In addition, banks must be recapitalized—this may require direct support from a more flexible EFSF/ESM.

• In the United States and Japan, sufficient fiscal adjustment is planned over the near term but there is still an urgent need for strong, sustainable fiscal consolidation paths over the medium term. Also, given very low domestic inflation pressure, further monetary easing may be needed in Japan to ensure that it achieves its inflation objective over the medium term. More easing would also be needed in the United States if activity threatens to disappoint.

• More generally, given the weak growth prospects in the major economies, those with room for fiscal policy maneuvering, in terms of the strength of their fiscal accounts and credibility with markets, can reconsider the pace of consolidation. Others should let automatic stabilizers operate freely for as long as they can readily finance higher deficits.

Looking further ahead, the challenge is to improve the weak medium-term growth outlook for the major advanced economies. The most important priorities remain fundamental reform of the financial sector; more progress with fiscal consolidation, including ambitious reform of entitlement programs; and structural reforms to boost potential output. In addition to implementing new consensus regulations (such as Basel III) at the national level, financial sector reform must address many weaknesses brought to light by the financial crisis, including the problems related to institutions considered too big or too complex to fail, the shadow banking system, and cross-border collaboration between bank supervisors. Reforms to aging-related spending are crucial because they can greatly reduce future spending without significantly harming demand today. Such measures can demonstrate policymakers’ ability to act decisively and thereby help rebuild market confidence in the sustainability of public finances. This, in turn, can create more room for fiscal and monetary policy to support financial repair and demand without raising the specter of inflationary government deficit financing. Structural reforms must be deployed on many fronts—for example, in the euro area, to improve economies’ capacity to adjust to competitiveness shocks, and in Japan, to boost labor force participation.
Policies directed at real estate markets can accelerate the improvement of household balance sheets and thus support otherwise anemic consumption. Countries that have adopted such policies, such as Iceland, have seen major benefits, as discussed in Chapter 3. In the United States, the administration has tried various programs but, given their limited success, is now proposing a more forceful approach. Elsewhere, the authorities have left it to banks and households to sort out the problems. In general, fears about moral hazard—by letting individuals who made excessively risky or speculative housing investments off the hook—have stood in the way of progress. These issues are similar to those that are making it so difficult to address the euro area crisis, although in Europe the moral hazard argument is being applied to countries rather than individuals. But in both cases, the use of targeted interventions to support demand can be more effective than much more costly macroeconomic programs. And the moral hazard dimension can be addressed in part through better regulation and supervision.

Emerging and developing economies continue to reap the benefits of strong macroeconomic and structural policies, but domestic vulnerabilities have been gradually building. Many of these economies have had an unusually good run over the past decade, supported by rapid credit growth or high commodity prices. To the extent that credit growth is a manifestation of financial deepening, this has been positive for growth. But in most economies, credit cannot continue to expand at its present pace without raising serious concerns about the quality of bank lending. Another consideration is that commodity prices are unlikely to grow at the elevated pace witnessed over the past decade, notwithstanding short-term spikes related to geopolitical tensions. This means that fiscal and other policies may well have to adapt to lower potential output growth, an issue discussed in Chapter 4.

The key near-term challenge for emerging and developing economies is how to appropriately calibrate macroeconomic policies to address the significant downside risks from advanced economies while keeping in check overheating pressures from strong activity, high credit growth, volatile capital flows, still-elevated commodity prices, and renewed risks to inflation and fiscal positions from energy prices. The appropriate response will vary. For economies that have largely normalized macroeconomic policies, the near-term focus should be on responding to lower external demand from advanced economies. At the same time, these economies must be prepared to cope with adverse spillovers and volatile capital flows. Other economies should continue to rebuild macroeconomic policy room and strengthen prudential policies and frameworks. Monetary policymakers need to be vigilant that oil price hikes do not translate into broader inflation pressure, and fiscal policy must contain damage to public sector balance sheets by targeting subsidies only to the most vulnerable households.

The latest developments suggest that global current account imbalances are no longer expected to widen again, following their sharp reduction during the Great Recession. This is largely because the excessive consumption growth that characterized economies that ran large external deficits prior to the crisis has been wrung out and has not been offset by stronger consumption in surplus economies. Accordingly, the global economy has experienced a loss of demand and growth in all regions relative to the boom years just before the crisis. Rebalancing activity in key surplus economies toward higher consumption, supported by more market-determined exchange rates, would help strengthen their prospects as well as those of the rest of the world.

Austerity alone cannot treat the economic malaise in the major advanced economies. Policies must also ease the adjustments and better target the fundamental problems—weak households in the United States and weak sovereigns in the euro area—by drawing on resources from stronger peers. Policymakers must guard against overplaying the risks related to unconventional monetary support and thereby limiting central banks’ room for policy maneuvering. While unconventional policies cannot substitute for fundamental reform, they can limit the risk of another major economy falling into a debt-deflation trap, which could seriously hurt prospects for better policies and higher global growth.