FOREWORD

The world economy is in the middle of a balancing act. On the one hand, countries must address the legacies of the global financial crisis, ranging from debt overhangs to high unemployment. On the other, they face a cloudy future. Potential growth rates are being revised downward, and these worsened prospects are in turn affecting confidence, demand, and growth today.

The interplay of these two forces—the crisis legacies proving tougher to resolve than expected and potential growth turning lower—has resulted in several downward revisions to the forecast during the past three years. The forecast in this edition of the *World Economic Outlook* is, unfortunately, no exception. World growth is mediocre and a bit worse than forecast in July. At the same time, because these two forces operate to different degrees in various countries, the evolution of the global economy has become more differentiated.

Among advanced economies, the United States and the United Kingdom in particular are leaving the crisis behind and achieving decent growth—though even for those two countries, potential growth is now lower than in the early 2000s. Japan is growing, but high public debt inherited from the past and very low potential growth create major macroeconomic and fiscal challenges. Growth nearly stalled earlier this year in the euro area, even in the core. Although this partly reflects temporary factors, the recovery has been slowed by the crisis legacies, primarily in the south, and by low potential growth nearly everywhere.

In emerging market economies, lower potential growth is the dominating factor. For these economies as a whole, potential growth is now forecast to be 1.5 percent lower than in 2011. Here again, differentiation is the rule. China is sustaining high growth, but slightly lower growth in the future is seen to be a healthy development. India has recovered from its relative slump; thanks in part to effective policies and a renewal of confidence, growth is expected once again to exceed 5 percent. In contrast, uncertain investment prospects in Russia had already lowered growth before the Ukraine crisis, and the crisis has made growth prospects worse. Uncertain prospects and low investment are also weighing on growth in Brazil.

The downside risks are clear.

First, the long period of low interest rates has led to some search for yield, and financial markets may be too complacent about the future. These risks should not be overplayed, but policymakers clearly must be on the lookout. Macroprudential tools are the right instruments to mitigate these risks; whether they are up to the task, however, is an open question.

Second, geopolitical risks have become more relevant. So far, the effects of the Ukraine crisis have not spread beyond the affected countries and their immediate neighbors. And the turmoil in the Middle East has not had much effect on the level or volatility of energy prices. But clearly, this could change in the future, with major implications for the world economy.

Third, there is a risk that the recovery in the euro area could stall, that demand could weaken further, and that low inflation could turn into deflation. This is not our baseline, because we believe euro area fundamentals are slowly improving. But should such a scenario play out, it would be the major issue confronting the world economy.

This takes me to the policy implications.

In advanced economies, policies must deal with both the crisis legacies and low potential growth. A major focus has been on improving bank balance sheets, but debt overhang of firms and households remains a serious legacy issue in a number of countries. To increase potential growth, as long as demand remains weak, monetary accommodation and low interest rates remain of the essence.

The weak recovery in the euro area has triggered a new debate about the stance of fiscal policy. The low spreads on sovereign bonds suggest that the fiscal consolidation undertaken during the past few years has built trust among financial investors that current fiscal paths are sustainable. This credibility, which has been acquired at a high price, should not be threatened. This does not imply that there is no scope to use fiscal policy to help sustain the recovery. As we argue in

Chapter 3, infrastructure investment, for example, even when financed by debt, may be justified and can help spur demand in the short term and supply in the medium term. And should the recovery stall, being ready to do more would be important.

Increasing potential output, let alone potential growth, is a tall order, and expectations should remain realistic. In most countries, specific structural reforms can help, however. The challenge, for both advanced and emerging market economies, is to go beyond the general mantra of "undertaking structural reforms" to identify both the reforms that are most needed and the reforms that are politically feasible. Perhaps more generally, the challenge for policymakers is to reestablish confidence by articulating a clear plan to deal with both the legacies of the crisis and the challenges of low potential growth.

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