JOINT FOREWORD TO *WORLD ECONOMIC OUTLOOK* AND *GLOBAL FINANCIAL STABILITY REPORT*

The Recovery Has Started, and the Challenge Is to Sustain It

The global economy is expanding again, and financial conditions have improved markedly. It will still take some time, however, until the outlook for employment improves significantly.

Emerging and developing economies are further ahead on the road to recovery, led by a resurgence in Asia—in general, emerging economies have withstood the financial turmoil much better than expected based on past experience, which reflects improved policy frameworks. However, gains in activity are now being seen more broadly, including in the major advanced economies. Financial market sentiment and risk appetite have rebounded, banks have raised capital and wholesale funding markets have reopened, and emerging market risks have eased.

The triggers for this rebound are strong public policies across advanced and emerging economies that, together with measures deployed by the IMF at the international level, have allayed concerns about systemic financial collapse, supported demand, and all but eliminated fears of a global depression. These fears had contributed to the steepest drop in global activity and trade since World War II. Central banks reacted quickly with exceptionally large interest rate cuts as well as unconventional measures to inject liquidity and sustain credit. Governments launched major fiscal stimulus programs, while assessing their banks with stress tests and supporting them with guarantees and capital injections. And the IMF made use of its enhanced lending capacity and more flexible facilities to help emerging and developing economies cope with the risks associated with the crisis. Together, these measures reduced uncertainty and increased confidence.

But complacency must be avoided. Despite these advances, the pace of recovery is expected to be slow and, for quite some time, insufficient to decrease unemployment. Also, poverty could increase significantly in a number of developing economies where real GDP per capita is contracting in 2009 for the first time in a decade. Activity may pick up quickly in the short term. Yet the forces that are driving the current rebound are partly temporary in nature, including major fiscal stimulus, central banks' support for credit markets, and restocking following exceptionally large cutbacks in production and drawdowns of inventories. These forces will diminish during the course of 2010.

A further key constraint on the pace of recovery will be limits on credit availability. Bank deleveraging will constrain the supply of bank credit for the remainder of 2009 and into 2010 in both the United States and Europe, where credit supply is even more bank-dependent. Bank balance sheets have benefited from capital-raising efforts and positive earnings reports but will remain under pressure as a result of continuing credit deterioration. Our analysis suggests that U.S. banks have recognized somewhat more than half their projected losses from impaired assets through 2010. In Europe, loss recognition is less advanced, reflecting differences in the economic cycle. Although stronger bank earnings are supporting capital levels, they are not expected to fully offset write-downs over the next 18 months. Moreover, steady-state earnings are likely to be lower in the postcrisis environment, and reforms under way to bank regulation are expected to reduce net revenues and result in more costly self-insurance through higher capital and liquidity requirements. Projections for emerging economies assume that capital flows, which took a major hit over the past year, will stabilize or grow moderately. Credit growth will continue to fall or stay at very low levels, and this will hold back investment, with the notable exception of China. Significant credit contraction is generally unlikely, except in parts of emerging Europe and the Commonwealth of Independent States.

Meanwhile, consumption and investment are gaining strength only slowly, held back by the need for balance sheet repair, high excess capacity as well as financing constraints, and rising unemployment, which is expected to peak at over 10 percent of the labor force in advanced economies. Consumption will be particularly weak in advanced economies, especially those that experienced credit booms, housing bubbles, and large current account deficits, such as the United States and the United Kingdom, and in a number of other (especially emerging) European economies. U.S. consumers, in particular, are likely to maintain substantially higher saving rates than before the crisis.

Accordingly, the *World Economic Outlook* projects activity contracting by about 1 percent in 2009 and expanding by about 3 percent in 2010, which is still well below rates achieved before the crisis.

Downside risks remain a concern. The main risk is that private demand in advanced economies remains very weak. If so, policymakers may be confronted with the difficult choice of either maintaining fiscal stimulus, raising issues of debt sustainability, or phasing out the fiscal stimulus, raising the danger of adverse interactions between real activity, the health of the financial sector, and the fiscal situation. However, there is also potential for positive surprises. Specifically, reduced fears about a 1930s-style crash in activity and an accompanying strong rebound in financial market sentiment could drive a larger-than-projected short-term increase in consumption and investment.

Policy Challenges

It is still too early for policymakers to relax their efforts to restore financial sector health and support demand with expansionary macroeconomic policies. The challenge is to ensure that continued short-term support does not distort incentives and endanger public balance sheets, with damaging consequences for the medium term. Furthermore, policies must begin to address key medium-term challenges, including the need for reforming financial systems, boosting potential growth, and rebalancing the patterns of global demand.

Notwithstanding already large deficits and rising public debt in many countries, fiscal stimulus needs to be sustained until the recovery is on a firmer footing and may even need to be amplified or extended beyond current plans if downside risks to growth materialize. However, fiscal policy is likely to become increasingly less effective in supporting demand in the absence of reassurances to investors and taxpayers that deficits and debt will eventually be rolled back. This is likely to require major efforts to constrain spending by initiating entitlement reforms and by committing to large reductions in deficits once the recovery is on a solid footing. The credibility of such reductions could usefully be supported with more robust fiscal frameworks, including suitable fiscal rules and strong enforcement mechanisms that help rein in spending pressures when good times return.

The key issues facing monetary policymakers are when to start tightening and how to unwind large central bank balance sheets. Advanced and emerging economies face different challenges. In advanced economies, central banks can (with few exceptions) afford to maintain accommodative conditions for an extended period because inflation is likely to remain subdued as long as output gaps remain wide. Moreover, monetary policy will need to accommodate the impact of the gradual withdrawal of fiscal support. If and when necessary, instruments exist to start tightening monetary conditions even while central bank balance sheets remain much larger than usual. The pace at which the buildup in central bank balance sheets should be unwound depends on progress in normalizing market conditions and the types of interventions in place. Supported by appropriate pricing, short-term liquidity operations are already unwinding naturally as market conditions improve. However, it could take much longer to unwind the buildup in illiquid assets on some central bank balance sheets.

The situation is more varied across emerging economies, but the moment for starting to remove monetary accommodation is likely to materialize sooner than in advanced economies. In some countries, warding off risks for new asset price bubbles may call for greater exchange rate flexibility, to allow monetary policy tightening relative to easy stances in advanced economies.

Policymakers face two major financial sector challenges. The first is to ensure that markets and banks can support economic recovery. This calls especially for renewed efforts to increase bank capital and repair bank balance sheets. So far, only very partial progress has been made on this front. Official stress tests are important instruments through which the condition of banks can be diagnosed in order to design appropriate strategies for the recapitalization and restructuring of viable banks and for the careful resolution of nonviable banks. In addition, exit strategies from public support need to be clearly articulated to help guide markets. Programs need to be phased out gradually, using market-based incentives to encourage reduced reliance on public support. Moreover, clarity on new capital regulation, liquidity risk requirements, provisioning, and accounting standards and, where possible, agreement on resolution strategies are essential for banks to be able to determine how to deploy their resources and which business lines are likely to be profitable in the future.

The second challenge is to put in place financial reforms that forestall a similar crisis in the future. This will require a major overhaul of prudential policies, which must not be jeopardized by growing confidence that the greatest crisis dangers are past, or fears that national competitive advantages might be lost, or concerns that first-best solutions are beyond reach for technical reasons. Four issues deserve particular attention. First, the perimeter of regulation needs to be broadened and made more flexible, covering all systemically important institutions alongside incentives to preclude further buildups of institutions currently considered "too big or too connected to fail." Second, effective market discipline needs to be encouraged through greater transparency and disclosure and reform of governance in financial institutions. Third, macroprudential frameworks must induce banks to build more buffers—by raising capital and making provisions in good times that can be used in bad times. And, fourth, international collaboration and coordination need to be improved to adequately cope with the challenges posed by cross-border institutions. Looking forward, to avoid a similar crisis, there is a need not just for better rules—through enhanced regulation—but also for adequate enforcement of the rules—through effective supervision—and for prudent behavior by financial institutions—through suitable internal risk-management processes.

Rebalancing Global Demand

Achieving sustained healthy growth over the medium term also depends critically on rebalancing the pattern of global demand. Specifically, many current account surplus economies that have followed export-led growth strategies will need to rely more on domestic demand growth to offset likely subdued domestic demand in deficit economies that have undergone asset price (stock and housing) busts. By the same token, many external deficit countries will need to rely less on domestic demand and more on external demand. This will require significant structural reforms, many of which are also necessary to boost potential output, which has taken a hit as a result of the crisis. Key are measures to repair financial systems, improve corporate governance and financial intermediation, support public investment, and improve social safety nets.

With respect to social policies, rising unemployment will present a major challenge in many advanced economies that must be met with support for incomes, retraining for the jobless, and measures that facilitate wage adjustment in response to shocks. The crisis has also been a setback to poverty-alleviation efforts in many low-income economies, and continued strong donor support will be necessary to safeguard the major progress these countries have made in stabilizing their economies.

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