The global recovery is proceeding better than expected but at varying speeds—trepidly in many advanced economies and solidly in most emerging and developing economies. World growth is now expected to be 4¼ percent. Among the advanced economies, the United States is off to a better start than Europe and Japan. Among emerging and developing economies, emerging Asia is leading the recovery, while many emerging European and some Commonwealth of Independent States economies are lagging behind. This multispeed recovery is expected to continue.

As the recovery has gained traction, risks to global financial stability have eased, but stability is not yet assured. Our estimates of banking system write-downs in the economies hit hardest from the onset of the crisis through 2010 have been reduced to $2.3 trillion from $2.8 trillion in the October 2009 Global Financial Stability Report. However, the aggregate picture masks considerable differentiation within segments of banking systems, and there remain pockets that are characterized by shortages of capital, high risks of further asset deterioration, and chronically weak profitability. Deleveraging has so far been driven mainly by deteriorating assets that have hit both earnings and capital. Going forward, however, pressures on the funding or liability side of bank balance sheets are likely to play a greater role, as banks reduce leverage and raise capital and liquidity buffers. Hence, the recovery of private sector credit is likely to be subdued, especially in advanced economies.

At the same time, better growth prospects in many emerging economies and low interest rates in major economies have triggered a welcome resurgence of capital flows to some emerging economies. These capital flows however come with the attendant risk of inflation pressure and asset bubbles. So far, there is no systemwide evidence of bubbles, although there are a few hot spots, and risks could build up over a longer-term horizon. The recovery of cross-border financial flows has brought some real effective exchange rate changes—depreciation of the U.S. dollar and appreciation of other floating currencies of advanced and emerging economies. But these changes have been limited, and global current account imbalances are forecast to widen once again.

The outlook for activity remains unusually uncertain, and downside risks stemming from fiscal fragilities have come to the fore. A key concern is that room for policy maneuvers in many advanced economies has either been exhausted or become much more limited. Moreover, sovereign risks in advanced economies could undermine financial stability gains and extend the crisis. The rapid increase in public debt and deterioration of fiscal balance sheets could be transmitted back to banking systems or across borders.

This underscores the need for policy action to sustain the recovery of the global economy and financial system. The policy agenda should include several important elements.

The key task ahead is to reduce sovereign vulnerabilities. In many advanced economies, there is a pressing need to design and communicate credible medium-term fiscal consolidation strategies. These should include clear time frames to bring down gross debt-to-GDP ratios over the medium term as well as contingency measures if the deterioration in public finances is greater than expected. If macroeconomic developments proceed as expected, most advanced economies should embark on fiscal consolidation in 2011. Meanwhile, given the still-fragile recovery, the fiscal stimulus planned for 2010 should be fully implemented, except in economies that face large increases in risk premiums, where the urgency is greater and consolidation needs to begin now. Entitlement reforms that do not detract from demand in the short term—for example, raising the statutory retirement age or lowering the cost of health care—should be implemented without delay.

Other policy challenges relate to unwinding monetary accommodation across the globe and
managing capital flows to emerging economies. In major advanced economies, insofar as inflation expectations remain well anchored, monetary policy can continue being accommodative as fiscal consolidation progresses, even as central banks begin to withdraw the emergency support provided to financial sectors. Major emerging and some advanced economies will continue to lead the tightening cycle, since they are experiencing faster recoveries and renewed capital flows. Although there is only limited evidence of inflation pressures and asset price bubbles, current conditions warrant close scrutiny and early action. In emerging economies with relatively balanced external positions, the defense against excessive currency appreciation should include a combination of macroeconomic and prudential policies, which are discussed in detail in the *World Economic Outlook* and *Global Financial Stability Report*.

Combating unemployment is yet another policy challenge. As high unemployment persists in advanced economies, a major concern is that temporary joblessness will turn into long-term unemployment. Beyond pursuing macroeconomic policies that support recovery in the near term and financial sector policies that restore banking sector health (and credit supply to employment-intensive sectors), specific labor market policies could also help limit damage to the labor market. In particular, adequate unemployment benefits are essential to support confidence among households and to avoid large increases in poverty, and education and training can help reintegrate the unemployed into the labor force.

Policies also need to buttress lasting financial stability, so that the next stage of the deleveraging process unfolds smoothly and results in a safer, competitive, and vital financial system. Swift resolution of nonviable institutions and restructuring of those with a commercial future is key. Care will be needed to ensure that too-important-to-fail institutions in all jurisdictions do not use the funding advantages their systemic importance gives them to consolidate their positions even further. Starting securitization on a safer basis is also essential to support credit, particularly for households and small and medium-size enterprises.

Looking further ahead, there must be agreement on the regulatory reform agenda. The direction of reform is clear—higher quantity and quality of capital and better liquidity risk management—but the magnitude is not. In addition, uncertainty surrounding reforms to address too-important-to-fail institutions and systemic risks make it difficult for financial institutions to plan. Policymakers must strike the right balance between promoting the safety of the financial system and keeping it innovative and efficient. Specific proposals for making the financial system safer and for strengthening its infrastructure—for example, in the over-the-counter derivatives market—are discussed in the *Global Financial Stability Report*.

Finally, the world’s ability to sustain high growth over the medium term depends on rebalancing global demand. This means that economies that had excessive external deficits before the crisis need to consolidate their public finances in ways that limit damage to growth and demand. Concurrently, economies that ran excessive current account surpluses will need to further increase domestic demand to sustain growth, as excessive deficit economies scale back their demand. As the currencies of economies with excessive deficits depreciate, those of surplus economies must logically appreciate. Rebalancing also needs to be supported with financial sector reform and growth-enhancing structural policies in both surplus and deficit economies.

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