

## FOREWORD

The world economic recovery continues, more or less as predicted. Indeed, our growth forecasts are nearly unchanged since the January 2011 *WEO Update* and can be summarized in three numbers: We expect the world economy to grow at about 4½ percent a year in both 2011 and 2012, but with advanced economies growing at only 2½ percent while emerging and developing economies grow at a much higher 6½ percent.

Earlier fears of a double-dip recession—which we did not share—have not materialized. The main worry was that in advanced economies, after an initial recovery driven by the inventory cycle and fiscal stimulus, growth would fizzle. The inventory cycle is now largely over and fiscal stimulus has turned to fiscal consolidation, but private demand has, for the most part, taken the baton.

Fears have turned to commodity prices. Commodity prices have increased more than expected, reflecting a combination of strong demand growth and supply shocks. Although these increases conjure up the specter of 1970s-style stagflation, they appear unlikely to derail the recovery. In advanced economies, the decreasing share of oil, the disappearance of wage indexation, and the anchoring of inflation expectations all combine to suggest there will be only small effects on growth and core inflation. The challenge will be stronger however in emerging and developing economies, where the consumption share of food and fuel is larger and the credibility of monetary policy is often weaker. Inflation may well be higher for some time but, as our forecasts suggest, we do not expect a major adverse effect on growth. However, risks to the recovery from additional disruptions to oil supply are a concern.

The recovery, however, remains unbalanced.

In most advanced economies, output is still far below potential. Unemployment is high, and low growth implies that it will remain so for many years

to come. The source of low growth can be traced to both precrisis excesses and crisis wounds: In many countries, especially the United States, the housing market is still depressed, leading to anemic housing investment. The crisis itself has led to a dramatic deterioration in fiscal positions, forcing a shift to fiscal consolidation while not eliminating market worries about fiscal sustainability. And in many countries banks are struggling to achieve higher capital ratios in the face of increasing nonperforming loans.

The problems of the European Union periphery, stemming from the combined interactions of low growth, fiscal woes, and financial pressures, are particularly acute. Reestablishing fiscal and financial sustainability in the face of low or negative growth and high interest rates is a substantial challenge. And, while extreme, the problems of the EU periphery point to a more general problem: an underlying low rate of growth of potential output. Adjustment is very hard when growth is very low.

The policy advice to advanced economies remains largely the same as in the October 2010 *World Economic Outlook*, and so far has been only partly heeded: increased clarity on banks' balance sheet exposures and ready recapitalization plans if needed; smart fiscal consolidation that is neither too fast, which could kill growth, nor too slow, which would kill credibility; the redesign of financial regulation and supervision; and, especially in Europe, an increased focus on reforms to increase potential growth.

In emerging market economies, by contrast, the crisis left no lasting wounds. Their initial fiscal and financial positions were typically stronger, and the adverse effects of the crisis were more muted. High underlying growth and low interest rates are making fiscal adjustment much easier. Exports have largely recovered, and whatever shortfall in external demand they experienced has typically been made up through increases in domestic demand. Capital

outflows have turned into capital inflows, due to both better growth prospects and higher interest rates than in the advanced economies.

The challenge for most emerging market economies is thus quite different from that of the advanced economies—namely, how to avoid overheating in the face of closing output gaps and higher capital flows. Their response should be twofold: first, to rely on a combination of fiscal consolidation and higher interest rates to maintain output at potential and, second, to use macroprudential tools—including, where needed, capital controls—to avoid increases in systemic risk stemming from inflows. Countries are often tempted to resist the exchange rate appreciation that is likely to come with higher interest rates and higher inflows. But appreciation increases real income, is part of the desirable adjustment, and should not be resisted.

Overall, the macro policy agenda for the world economy remains the same but, with the passage of time, more urgent. For the recovery to be sustained, advanced economies must achieve fiscal consolidation. To do this and to maintain growth, they need to rely more on external demand. Symmetrically, emerging market economies must rely less on external demand and more on domestic demand. Appreciation of emerging market economies' currencies relative to those of advanced economies is an important key to this global adjustment. The need for careful design at the national level and coordination at the global level may be as important today as at the peak of the crisis two years ago.

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