EXECUTIVE SUMMARY

The recovery has suffered new setbacks, and uncertainty weighs heavily on the outlook. A key reason is that policies in the major advanced economies have not rebuilt confidence in medium-term prospects. Tail risks, such as those relating to the viability of the euro area or major U.S. fiscal policy mistakes, continue to preoccupy investors. The *World Economic Outlook* (WEO) forecast thus sees only a gradual strengthening of activity from the relatively disappointing pace of early 2012. Projected global growth, at 3.3 and 3.6 percent in 2012 and 2013, respectively, is weaker than in the July 2012 *WEO Update,* which was in turn lower than in the April 2012 WEO (Chapter 1). Output is expected to remain sluggish in advanced economies but still relatively solid in many emerging market and developing economies. Unemployment is likely to stay elevated in many parts of the world. And financial conditions will remain fragile, according to the October 2012 *Global Financial Stability Report* (GFSR). Chapter 2 discusses regional developments in detail.

The WEO forecast rests on two crucial policy assumptions. The first is that European policymakers—consistent with the GFSR's *baseline scenario*—will adopt policies that gradually ease financial conditions further in periphery economies. In this regard, the European Central Bank (ECB) has recently done its part. It is now up to national policymakers to move and activate the European Stability Mechanism (ESM), while articulating a credible path and beginning to implement measures to achieve a banking union and greater fiscal integration. The second assumption is that U.S. policymakers will prevent the drastic automatic tax increases and spending cutbacks (the "fiscal cliff") implied by existing budget law, raise the U.S. federal debt ceiling in a timely manner, and make good progress toward a comprehensive plan to restore fiscal sustainability. The WEO forecast could once again be disappointed on both accounts.

More generally, downside risks have increased and are considerable. The IMF staff's fan chart, which uses financial and commodity market data and analyst forecasts to gauge risks—suggests that there is now a 1 in 6 chance of global growth falling below 2 percent, which would be consistent with a recession in advanced economies and low growth in emerging market and developing economies. Ultimately, however, the WEO forecast rests on critical policy action in the euro area and the United States, and it is very difficult to estimate the probability that this action will materialize.

This juncture presents major difficulties for policymakers. In many advanced economies, injections of liquidity are having a positive impact on financial stability and output and employment, but the impact may be diminishing. Many governments have started in earnest to reduce excessive deficits, but because uncertainty is high, confidence is low, and financial sectors are weak, the significant fiscal achievements have been accompanied by disappointing growth or recessions. In emerging market and developing economies, policymakers are conscious of the need to rebuild fiscal and monetary policy space but are wondering how to calibrate policies in the face of major external downside risks.

An effective policy response in the major advanced economies is the key to improving prospects and inspiring more confidence about the future. In the short term, the main tasks are to rule out the tail risk scenarios and adopt concrete plans to bring down public debt over the medium term.

The crisis in the euro area remains the most obvious threat to the global outlook. The ECB has put in place a mechanism to improve the transmission of low policy rates to borrowing costs in the periphery, where investors' fears about the viability of the euro have pushed market rates to very high levels. The periphery economies need to continue to adjust. Governments must meet their commitment to make the euro area firewall more flexible. Specifically, the ESM must intervene in banking

systems and provide support to sovereigns, while national leaders must work toward true economic and monetary union. This requires establishing a banking union with a unified financial stability framework and implementing measures toward fiscal integration, on the principle that more area-wide insurance must come with more area-wide control. Unless more action is taken soon, recent improvements in financial markets could prove fleeting. The WEO forecast may then be disappointed once again, and the euro area could slide into the October 2012 GFSR *weak policies* scenario. If, however, policy actions were to exceed WEO assumptions—for example, if euro area policymakers were to deliver a major down payment on the road to more integration, such as an area-wide bank resolution mechanism with a common fiscal backstop—real GDP growth could well be higher than projected, consistent with the October 2012 GFSR *complete policies* scenario.

Reducing the risks to the medium-term outlook presaged by the public debt overhang in the major advanced economies will require supportive monetary policies and appropriate structural reforms (Chapter 3), as well as careful fiscal policy. Good progress has already been made and planned fiscal consolidation is sizable for the near term, as discussed in the October 2012 *Fiscal Monitor*. U.S. legislators must soon remove the threat of the fiscal cliff and raise the debt ceiling—if they fail to do so, the U.S. economy could fall back into recession, with deleterious spillovers to the rest of the world. Furthermore, policymakers in the United States urgently need to specify strong medium-term fiscal plans. Those in Japan need to persevere with planned adjustments and specify new measures to halt and soon reverse the increase in the public-debt-to-GDP ratio.

More generally, policymakers need to specify realistic fiscal objectives and develop plans for contingencies. This means adopting structural or cyclically adjusted targets, or anchoring plans on measures and their estimated yields, rather than on nominal targets. Automatic stabilizers should be allowed to play freely. Also, should growth fall significantly short of WEO projections, countries with room to maneuver should smooth their planned adjustment over 2013 and beyond. At the same time, declining inflation rates, growing slack, and sizable fiscal adjustment in the advanced economies argue for maintaining very accommodative monetary conditions, including unconventional measures because interest rates are near the zero lower bound.

So far, policymakers' record in meeting structural challenges has been mixed; therefore, further efforts are needed. Programs to relieve chronic household debt burdens, where these have been tried, have not been commensurate with the scale of the problem. Efforts to strengthen the regulatory framework for financial institutions and markets have been patchy, according to Chapter 3 of the October 2012 GFSR, with some success in rebuilding capital but less in lowering reliance on wholesale funding and containing incentives for excessive risk taking and regulatory arbitrage. In addition, in the euro area, the restructuring or resolution of weak financial institutions has advanced slowly and only in response to major market pressure—a more proactive, area-wide approach is urgently needed. Increases in statutory retirement ages have reduced the long-term path of pension outlays, but as health care spending continues to increase quickly, more measures will be needed to contain the growth of entitlements to a sustainable rate. Some countries, notably the economies of the euro area periphery, have introduced reforms to make labor markets more flexible. However, many economies need to take stronger action to help the long-term unemployed, including through improvements to job-search support and training.

In emerging market and developing economies, activity has been slowed by policy tightening in response to capacity constraints, weaker demand from advanced economies, and country-specific factors. Policy improvements have raised their resilience to shocks (Chapter 4). Since the crisis erupted in 2008, expansionary policies have buffered the negative impact of the weakness in advanced economy markets: fiscal deficits have typically been above precrisis levels, whereas real interest rates have been lower. Domestic credit has grown rapidly. Over the medium term, policymakers will need to ensure that they retain the ability to respond flexibly to shocks by maintaining a sound fiscal position and by keeping inflation and

credit growth at moderate rates. In this respect, the policy tightening during 2011 was appropriate. Given the growing downside risks to external demand, central banks have appropriately paused or reversed some of the monetary policy tightening. Many have scope to do more to support demand if external downside risks threaten to materialize.

Global imbalances, and the associated vulnerabilities, have diminished, but there is still a need for more decisive policy action to address them. Within the euro area, current account imbalances—the large surpluses in Germany and the Netherlands and the deficits in most periphery economies—need to adjust further. At the global level, the current account positions of the United States, the euro area as a whole, and Japan are weaker than they would be with more sustainable fiscal policies—and the real effective exchange rates of the dollar, euro, and yen are stronger. In contrast, the current account positions of many Asian economies are undesirably strong and their exchange rates undesirably weak. In part, this reflects distortions that hold back consumption. But it also reflects the effect of large-scale official accumulation of foreign exchange.

In general, the policies required to lower current account imbalances and related vulnerabilities suit the interests of the economies concerned. More adjustment in external-deficit economies and more internal demand in external-surplus economies would contribute not only to a safer global economy but also to stronger growth for all. Many external-deficit economies need further fiscal adjustment and strengthened financial sector supervision and regulation. These efforts need to be complemented with structural measures, the details of which differ widely across the external-deficit advanced and emerging market economies but include labor and product market reform, improvements to governance and the business environment, and measures to boost private saving for retirement. The structural measures needed in external-surplus economies with undervalued exchange rates also vary by country but include boosting investment in Germany, reforming the social safety net in China to encourage consumption, and reducing the accumulation of official reserves in many emerging market economies, which would also help rein in high credit and asset price growth.