FOREWORD

The recovery continues, but it has weakened. In advanced economies, growth is now too low to make a substantial dent in unemployment. And in major emerging market economies, growth that had been strong earlier has also decreased. Relative to our April 2012 forecasts, our forecasts for 2013 growth have been revised from 2.0 percent down to 1.5 percent for advanced economies, and from 6.0 percent down to 5.6 percent for emerging market and developing economies.

The forces at work are, for the most part, familiar.

Those forces pulling growth down in advanced economies are fiscal consolidation and a still-weak financial system. In most countries, fiscal consolidation is proceeding according to plan. While this consolidation is needed, there is no question that it is weighing on demand, and the evidence increasingly suggests that, in the current environment, the fiscal multipliers are large. The financial system is still not functioning efficiently. In many countries, banks are still weak, and their positions are made worse by low growth. As a result, many borrowers still face tight borrowing conditions.

The main force pulling growth up is accommodative monetary policy. Central banks continue not only to maintain very low policy rates, but also to experiment with programs aimed at decreasing rates in particular markets, at helping particular categories of borrowers, or at helping financial intermediation in general.

More seems to be at work, however, than these mechanical forces—namely, a general feeling of uncertainty. Assessing the precise nature and effects of this uncertainty is essential, but it is not easy. Essential: If uncertainty could be decreased, the recovery could well turn out to be stronger than currently forecast. But not easy: Explicit indexes of uncertainty, such as the VIX in the United States or the VStoxx in Europe, remain at fairly low levels.[1] Uncertainty appears more diffuse, more Knightian in nature. Worries about the ability of European policymakers to control the euro crisis and worries about the failure to date of U.S. policymakers to agree on a fiscal plan surely play an important role, but one that is hard to nail down.

Low growth and uncertainty in advanced economies are affecting emerging market and developing economies, through both trade and financial channels, adding to homegrown weaknesses. As was the case in 2009, trade channels are surprisingly strong, with, for example, lower exports accounting for most of the decrease in growth in China. Alternative risk-off and risk-on episodes, triggered by progress and regress on policy action, especially in the euro area, are triggering volatile capital flows.

Turning to policy action, the main focus continues to be the euro area. Here, there has been a clear change in attitudes, and a new architecture is being put in place. The lessons of the past few years are now clear. Euro area countries can be hit by strong, country-specific, adverse shocks. Weak banks can considerably amplify the adverse effects of such shocks. And, if it looks like the sovereign itself might be in trouble, sovereign-bank interactions can further worsen the outcome.

Therefore a new architecture must aim at reducing the amplitude of the shocks in the first place—at putting in place a system of transfers to soften the effects of the shocks. That architecture must aim at moving the supervision, the resolution, and the recapitalization processes for banks to the euro area level. It must decrease the probability of default by sovereigns, and were default nevertheless to occur, it must decrease the effects on creditors and on the

[1]VIX = Chicago Board Options Exchange Market Volatility Index; VStoxx = Bloomberg's Euro Stoxx 50 Volatility Index.

financial system. It is good to see these issues being seriously explored and to see some of these mechanisms being slowly put together.

In the short term, however, more immediate measures are needed. Spain and Italy must follow through with adjustment plans that reestablish competitiveness and fiscal balance and maintain growth. To do so, they must be able to recapitalize their banks without adding to their sovereign debt. And they must be able to borrow at reasonable rates. Most of these pieces are falling into place, and if the complex puzzle can be rapidly completed, one can reasonably hope that the worst might be behind us.

If uncertainty is indeed behind the current slowdown, and if the adoption and implementation of these measures decrease uncertainty, things may turn out better than our forecasts, not only in Europe, but also in the rest of the world. I, for once, would be happy if our baseline forecasts turn out to be inaccurate—in this case, too pessimistic.

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