

EXECUTIVE SUMMARY

Global economic prospects have improved again but the road to recovery in the advanced economies will remain bumpy. World output growth is forecast to reach 3¼ percent in 2013 and 4 percent in 2014. In advanced economies, activity is expected to gradually accelerate, starting in the second half of 2013. Private demand appears increasingly robust in the United States but still very sluggish in the euro area. In emerging market and developing economies, activity has already picked up steam.

Better, but Bumpy and Divergent, Prospects for Advanced Economies

Over the past six months, advanced economy policymakers have successfully defused two of the biggest short-term threats to the global recovery, the threat of a euro area breakup and a sharp fiscal contraction in the United States caused by a plunge off the “fiscal cliff.” In response, financial markets have rallied on a broad front. Moreover, financial stability has improved, as underscored in the April 2013 *Global Financial Stability Report* (GFSR).

The financial market rally has been helping economic recovery by improving funding conditions and supporting confidence, but growth prospects appear broadly unchanged. While U.S. private demand has been showing strength as credit and housing markets are healing, larger-than-expected fiscal adjustment is projected to keep real GDP growth at about 2 percent in 2013. In the euro area, better conditions for periphery sovereigns are not yet passing through to companies and households, because banks are still hobbled by poor profitability and low capital, constraining the supply of credit. Also, in many economies activity will be held back by continued fiscal adjustment, competitiveness problems, and balance sheet weaknesses. Furthermore, new political and financial risks that could put a damper on the recovery have come to the fore. Accordingly, real GDP is projected to contract relative to 2012, by about ¼

percent of GDP. Japan, by contrast, will see a fiscal- and monetary-stimulus-driven rebound, with real GDP growth reaching 1½ percent.

Overall, the annual growth forecast for advanced economies in 2013—a modest 1¼ percent—is no better than the outcome for 2012. That said, assuming that policymakers avoid setbacks and deliver on their commitments, the projections in this *World Economic Outlook* (WEO) build on continued easing of the brakes on real activity. Consequently, in 2013, after a weak first half, real GDP growth in the advanced economies is projected to rise above 2 percent for the rest of the year and to average 2¼ percent in 2014, spurred by U.S. growth of about 3 percent.

Reaccelerating Activity in Emerging Market and Developing Economies

There was a noticeable slowdown in the emerging market and developing economies during 2012, a reflection of the sharp deceleration in demand from key advanced economies, domestic policy tightening, and the end of investment booms in some of the major emerging market economies. But with consumer demand resilient, macroeconomic policy on hold, and exports reviving, most economies in Asia and sub-Saharan Africa and many economies in Latin America and the Commonwealth of Independent States are now seeing higher growth. The recovery should again gain speed in emerging Europe as demand from advanced Europe slowly picks up. However, economies in the Middle East and North Africa continue to struggle with difficult internal transitions. And a couple of economies in South America are facing high inflation and increasing exchange market pressure.

There is good news emanating from developing economies. Even as estimates of potential growth have been marked down in recent years for some of the larger emerging markets, it has been steadily improving elsewhere. In fact, Chapter 4 underscores that the prospects of many of today’s dynamic low-income

countries appear stronger than those of their peers during the 1960s and 1970s.

More Symmetric Risks

Notwithstanding old dangers and new turbulence, the near-term risk picture has improved as recent policy actions in Europe and the United States have addressed some of the gravest short-term risks. In the euro area, the main short-term dangers now revolve around adjustment fatigue, weak balance sheets, broken credit channels in the periphery, and insufficient progress toward stronger economic and monetary union at the euro area level. In the United States and Japan, risks relate mainly to medium-term fiscal policy. Over the short term, a failure by the U.S. Congress to replace the automatic spending cuts (budget sequester) with back-loaded measures at the end of the current fiscal year would entail somewhat lower-than-projected growth in late 2013 and beyond. Of much greater concern would be a failure to raise the debt ceiling—the risk of such self-destructive inaction, however, appears low. Over the medium term, downside risks revolve around the absence of strong fiscal consolidation plans in the United States and Japan; high private sector debt, limited policy space, and insufficient institutional progress in the euro area, which could lead to a protracted period of low growth; distortions from easy and unconventional monetary policy in many advanced economies; and overinvestment and high asset prices in many emerging market and developing economies. Unless policies address these risks, global activity is likely to suffer periodic setbacks. By the same token, a stronger-than-projected policy response could also foster a stronger recovery in activity.

Policymakers Cannot Afford to Relax Their Efforts

In advanced economies, policy should use all prudent measures to support sluggish demand. However, the risks related to high sovereign debt limit the fiscal policy room to maneuver. There is no silver bullet to address all the concerns about demand and debt. Rather, fiscal adjustment needs to progress gradually, building on measures that limit damage to demand in the short term; monetary policy needs to stay supportive of activity; financial policies need to help

improve the pass-through of monetary policy; and structural and other policies need to spur potential output and global demand rebalancing. Regarding monetary policy, one key finding of Chapter 3 is that inflation expectations have become much better anchored, affording central banks greater leeway to support activity—although they must be mindful of financial stability risks emanating from their policies, as discussed in detail in the April 2013 GFSR.

The critical fiscal policy requirements are persistent but gradual consolidation and, for the United States and Japan, the design and implementation of comprehensive medium-term deficit-reduction plans. These requirements are urgent for Japan, given the significant risks related to the renewal of stimulus in an environment of very high public debt levels. In the United States, it is worrisome that after three years of deliberations, policymakers have not agreed on a credible plan for entitlement and tax reform and that improvement in near-term prospects seems to have come with a decreased sense of urgency for progress. The specific requirements and country details are discussed in the April 2013 *Fiscal Monitor*.

The April 2013 GFSR underscores the need for further financial repair and reform, including restructuring weak banks and, in some cases, offering households and weak corporate debtors avenues other than traditional bankruptcy for dealing with debt overhang. Previous WEO reports also stressed the critical role of structural reforms in rebuilding competitiveness and boosting medium-term growth prospects in many euro area economies.

In emerging market and developing economies, some tightening of policies appears appropriate over the medium term. The tightening should begin with monetary policy and be supported with prudential measures as needed to rein in budding excesses in financial sectors. Eventually, policymakers should also return fiscal balances to levels that afford ample room for policy maneuvering. Some will need to take significant action now; others will need only limited improvements over the medium term.

Policy Spillovers

The bumpy recovery and skewed macroeconomic policy mix in advanced economies are complicating policymaking in emerging market economies. Concerns resurfaced once again recently, when looser monetary

policy in Japan and other factors prompted a large depreciation of the yen. That said, complaints about competitive exchange rate depreciations appear overblown. At this juncture, there seem to be no large deviations of the major currencies from medium-term fundamentals. The U.S. dollar and the euro appear moderately overvalued and the renminbi moderately undervalued. The evidence on valuation of the yen is mixed.

The way to address currency worries is for all economies to pursue policies that foster internal and external balance. In the major advanced economies, this requires more progress with medium- and long-term fiscal adjustment plans, entitlement reform, and balance sheet repair. Short-term fiscal policies could

then be less restrictive, which, together with better balance sheets, would relieve pressure from overburdened monetary policy. Emerging market and developing economies, in turn, face different challenges. Key external surplus economies should allow their exchange rates to be more market determined and should implement structural policies to rebalance the economy toward consumption-driven growth. Other economies need to deploy structural policies to foster the healthy absorption of capital inflows. When these flows threaten to destabilize their economies, they can adopt macroprudential or capital-flow-management measures to avoid the buildup of major internal imbalances.