hat was until now a two-speed recovery, strong in emerging market and developing economies but weaker in advanced economies, is becoming a three-speed recovery. Emerging market and developing economies are still going strong, but in advanced economies, there appears to be a growing bifurcation between the United States on one hand and the euro area on the other.

This is reflected in our forecasts. Growth in emerging market and developing economies is forecast to reach 5.3 percent in 2013 and 5.7 percent in 2014. Growth in the United States is forecast to be 1.9 percent in 2013 and 3.0 percent in 2014. In contrast, growth in the euro area is forecast to be –0.3 percent in 2013 and 1.1 percent in 2014.

The growth figure for the United States for 2013 may not seem very high, and indeed it is insufficient to make a large dent in the still-high unemployment rate. But it will be achieved in the face of a very strong, indeed overly strong, fiscal consolidation of about 1.8 percent of GDP. Underlying private demand is actually strong, spurred in part by the anticipation of low policy rates under the Federal Reserve’s “forward guidance” and by pent-up demand for housing and durables.

The forecast for negative growth in the euro area reflects not only weakness in the periphery but also some weakness in the core. Germany’s growth is strengthening but is still forecast to be less than 1 percent in 2013. France’s growth is forecast to be negative in 2013, reflecting a combination of fiscal consolidation, poor export performance, and low confidence. This may call into question the ability of the core to help the periphery, if and when needed. Most euro area periphery countries, notably Italy and Spain, are expected to have substantial contractions in 2013. The process of internal devaluation is slowly taking place, and most of these countries are slowly becoming more competitive. External demand, however, is just not strong enough to compensate for weak internal demand. Adverse feedback loops between weak banks, weak sovereigns, and low activity are still reinforcing each other.

Japan is forging a path of its own. After many years of deflation, and little or no growth, the new government has announced a new policy, based on aggressive quantitative easing, a positive inflation target, fiscal stimulus, and structural reforms. This policy will boost growth in the short term, and this is reflected in our forecast of 1.6 percent growth for 2013. Given the high level of public debt, however, embarking on a fiscal stimulus in the absence of a medium-term fiscal consolidation plan is risky; it increases the probability that investors will require a risk premium, and that this will lead in turn to debt unsustainability.

In contrast to this mixed picture for the advanced economies, emerging market economies are doing well. In the past, the conditions that prevail today—high commodity prices, low interest rates, large capital inflows—would often have led to credit booms and overheating. This time, however, policymakers have generally succeeded in keeping aggregate demand in line with potential. At the same time, potential growth has itself apparently declined in a number of major emerging market economies, relative to precrisis trends. Although circumstances vary across countries, the evidence suggests that some of this decline has its source in policy-induced distortions, and those should be addressed.

Turning to policies:

In the United States, the focus should be on defining the right path of consolidation. While the sequester has decreased worries about debt sustainability, it is the wrong way to proceed. There should be both less and better fiscal consolidation now and a commitment to more fiscal consolidation in the future.

In the euro area, institutional progress has been made over the past year, in particular on creating a
road map for a banking union. The Outright Monetary Transactions program offered by the European Central Bank, even if not yet taken up, has reduced tail risks. Yet this is not enough. The interest rates facing borrowers in periphery countries are still too high to secure the recovery, and there is a need for further and urgent measures to strengthen banks, without weakening the sovereigns. The weakness of private demand also suggests that countries that have scope to do so should allow automatic stabilizers to operate, and some countries with fiscal space should go even beyond this.

Emerging market economies face different challenges, one of which is handling capital flows. Fundamentally attractive prospects in emerging market economies, together with low interest rates in advanced economies, are likely to lead to continuing net capital inflows and exchange rate pressure in many emerging market economies. This is a desirable process and part of the global rebalancing that must take place if the world economy is to get back to health. At the same time, as we have seen, capital flows can be volatile, making macroeconomic management more difficult. The challenge for recipient countries is to accommodate the underlying trends while reducing the volatility of the flows when they threaten macro or financial stability.

In short, recent good news about the United States has come with renewed worries about the euro area. Given the strong interconnections between countries, an uneven recovery is also a dangerous one. Some tail risks have decreased, but it is not time for policymakers to relax.

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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 surfaced once again recently, when looser monetary