2 DEVELOPMENTS IN THE GLOBAL ECONOMY AND FINANCIAL MARKETS

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After suffering the first contraction since World War II in 2009, the global economy staged a strong recovery in 2010, with world GDP growing by 5 percent. However, the pace of activity remained geographically uneven, with employment lagging. Economic performance during 2010 was a tale of two halves. During the first half of the year, the recovery was driven by the rebuilding of depleted inventories, which fostered a sharp rebound in industrial production and trade. Supportive macro-economic policies also played an important role. During the second half, as the inventory cycle leveled off and fiscal consolidation loomed in many advanced economies, fears of a double-dip recession increased. In the end, reduced excess capacity, accommodative policies, and further improvements in confidence and financial conditions bolstered private demand, making the recovery more self-sustaining. Investment was in the lead, though consumption also regained strength.

Left Workers assemble an automobile at a factory in Puebla, Mexico. **Right** New construction in downtown Warsaw, Poland, against the backdrop of the Communism-era Palace of Culture.

AN UNBALANCED RECOVERY

Even as global growth strengthened, the recovery remained unbalanced across the world. In the advanced economies, growth was modest, with average growth of just 3 percent in 2010. Because growth has been slow considering the depth of the recession, output remains far below potential, and unemployment is still very high. Low growth in these countries can be traced to both precrisis excesses and crisis fallout. In many of them—especially the United States—a depressed housing market continues to weigh on investment. The crisis itself has also led to a dramatic increase in public debt, raising worries about fiscal sustainability. In some of the advanced economies, not enough has been done to strengthen banks' capital positions and reduce leverage. This has contributed to sluggish credit growth.

The problems of the European Union (EU) periphery have been particularly acute. These stem from the combined interactions of low growth, fiscal difficulties, and financial pressures. Reestablishing fiscal and financial sustainability in the face of low or negative growth and high sovereign bond and bank credit default swap (CDS) spreads is a daunting challenge. The problems of the EU periphery point to a more general problem faced by many advanced economies: low potential growth and sizable economic slack. This makes the challenge of fiscal adjustment that much greater.

In the emerging and developing economies, economic performance has been much stronger. Overall, these economies enjoyed average growth of over 7¼ percent in 2010. Growth in Asia and Latin America was very buoyant, with most economies in the region operating at or above capacity. Developing economies, particularly in sub-Saharan Africa, have also resumed fast and sustainable growth. In the emerging economies in eastern Europe and the Commonwealth of Independent States that were hit much harder by the crisis, growth has only just begun to turn the corner.

Stronger initial fiscal and financial positions helped many emerging and developing economies recover more quickly from the crisis. These economies are also benefiting from a healthy recovery in exports and strong domestic demand buoyed by accommodative monetary and fiscal policies. Capital outflows during the crisis have turned into capital inflows in the recovery, owing to both better growth prospects and higher interest rates than in the advanced economies. At the same time, a number of emerging economies are experiencing a buildup in inflationary pressures, rapidly expanding credit, and signs of overheating.

Despite the robust global recovery, growth has not been strong enough to make a major dent in aggregate unemployment. As of April 2011, the International Labor Organization estimated that some 205 million people worldwide were still looking for jobs—up by about 30 million since 2007. The increase in unemployment has been especially severe in advanced economies. In many emerging and developing economies, particularly in the Middle East and North Africa, high youth unemployment is a special concern.

Turning to financial conditions, 2010 was a year of improvement—although conditions remain unusually fragile. Global financial stability was bolstered by better macroeconomic performance and continued accommodative macroeconomic policies. However, despite the transfer of risks from the private to the public sector during the crisis, confidence in the banking systems of many advanced economies has not been restored. In some countries, particularly in the euro area, this continues to interact adversely with sovereign risks.

Looking ahead, the global recovery is expected to continue at a moderate pace. The April 2011 *World Economic Outlook* forecast global growth of about 4½ percent in 2011 and 2012, a little slower than in 2010. The multispeed recovery is likely to continue, with growth averaging about 2½ percent in advanced economies and about 6½ percent in emerging and developing economies.

Risks to the outlook remain on the downside. In advanced economies, weak sovereign and financial sector balance sheets and still-moribund real estate markets continue to present major concerns. Financial risks are also on the downside as a result of the high funding requirements of banks and sovereigns, especially in certain euro area economies.

New downside risks have also been building. These include commodity prices—notably for oil—and related geopolitical uncertainty. Overheating and booming asset markets in emerging market economies are another source of downside risks. However, there is also the potential for upside surprises in regard to growth in the short term, owing to strong corporate balance sheets in advanced economies and buoyant demand in emerging and developing economies.

A combination of strong demand growth and supply shocks has driven commodity prices up faster than anticipated, raising downside risks to the recovery. However, in advanced economies, the falling share of oil in energy consumption, the disappearance of wage indexation, and the anchoring of inflation expectations suggest that the effects on growth and core inflation will be minor. In emerging and developing economies, however, sharply higher food and commodity prices pose a threat to poor households. They also present a greater risk in regard to inflation, given that spending on food and fuel accounts for a much larger share of the consumer basket in these countries. And because the credibility of monetary policy is less well established, it may be more difficult to keep inflation expectations in check. However, growth prospects are good in most low-income countries despite these downside risks.

OLD AND NEW CHALLENGES

In the year ahead, policymakers will still be dealing with challenges stemming from the crisis, even as new ones come to the fore. In advanced economies, the challenge is how best to sustain the recovery while pressing ahead with critical fiscal adjustment and financial sector repair and reform. Monetary policy should remain accommodative as long as output remains below potential and inflation expectations are well anchored. Countries also should adopt "smart" or growth-friendly fiscal consolidation: neither too fast, which could stop growth, nor too slow, which would undermine credibility. The focus should be on reforms to promote growth that place public debt on a sustainable track over the medium term. In the financial sphere, the redesign of financial regulation and supervision remains a pressing issue, as does increasing clarity on banks' balance sheet exposures and preparing recapitalization plans, if needed. Finally, an increased focus on reforms to boost potential growth is required in many advanced economies, but especially in Europe.

Action is also needed to bring down high unemployment, which poses risks to social cohesion. Accelerating bank restructuring and recapitalization to relaunch credit to small and medium-sized firms, which account for the bulk of employment, would help. Temporary employment subsidies targeted at these firms might also be useful to support job creation. Where unemployment has increased for structural reasons or was high even before the crisis, broader labor and product market reforms are essential to create more jobs.

For most emerging market economies, the challenge is how to avoid overheating in the face of closing output gaps and higher capital flows. Macroeconomic policies are appropriate tools to deal with surging capital inflows—namely, allowing the currency to appreciate, accumulating more reserves, and adjusting monetary and fiscal policy to maintain output at potential. Capital flow management measures—which encompass a range of taxes, certain prudential measures, and capital controls—are also part of the toolkit. But such measures should not be a substitute for necessary macroeconomic policy adjustment. 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 and is part of the desirable adjustment in countries with large current account surpluses, and should not be resisted.

Securing robust and sustainable global growth will require continued policy cooperation across the world. In the advanced economies, fiscal consolidation must be achieved. To do this *and* to maintain growth, these economies 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, as is increasing the pace of structural reforms to boost the role of domestic consumption and investment. 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.

Advancing the financial sector reform agenda remains crucial to sustaining the recovery. Countries in which banking systems are still struggling will need to enhance transparency (including through more consistent, rigorous, and realistic stress tests) and recapitalize, restructure, and (if necessary) close weak institutions. Addressing risks posed by systemically important financial institutions will remain an ongoing concern. And as countries transition to a new and more-demanding regulatory regime, banks will need larger capital buffers and strengthened balance sheets. Without these longer-term financial sector reforms, short-term funding difficulties will continue to present serious risks of another systemic liquidity event.