World Faces Serious New Economic Challenges

The global recovery has evolved better than expected. The IMF now forecast global growth to reach 4.2% in 2010, an upward revision of 0.3% from January forecast, and 4.3% in 2011. Alongside growth, global trade has also shown a strong rebound, and so have capital flows. And, financial market conditions and stability have improved. These good global numbers hide however a more complex reality, namely a tepid recovery in many advanced economies, and a much stronger one in most emerging and developing economies.

IMF forecast growth in advanced economies to be 2.3% for 2010 and 2.4% in 2011. This is just not enough to make up for the ground lost during the recession. Output for these countries is now 7% below its pre-crisis trend, and this "output gap" is expected to remain large for many years to come. Associated with this prolonged output gap is persistent high unemployment. IMF forecast the unemployment rate in advanced economies to reach 8.4% in 2010, and to only decline to 8.0% in 2011.

The main factor behind this weak performance and this prolonged output gap is weak private demand. In the **United States**, consumers, who were the drivers of the economy before the crisis, are being more prudent. In **Europe**, where banks play a central role in financial intermediation, the weak banking sector limits credit supply. In **Japan**, deflation has reappeared, leading to higher real interest rates, and putting in danger an already weak recovery.

By contrast, we forecast growth in emerging and developing economies to be much stronger, 6.3% in 2010, and 6.4% in 2011. Developing **Asia** is in the lead, with forecasts of 8.7% for 2010, and 8.6% in 2011. Growth appears not only strong but sustainable. While fiscal policy often played a central role in supporting activity in 2009, private demand is strengthening, and can sustain growth in the future.

Serious new challenges

The asymmetric nature of the recovery creates serious challenges, both for advanced and for developing and emerging market economies. In advanced countries, the main challenge is fiscal consolidation. A year ago, the risk was that private demand would collapse, leading to another Great Depression scenario. The priority was thus to implement fiscal stimulus programs, and avoid this catastrophic scenario. This we did. Thanks in part to the stimulus programs, demand did not collapse, and has indeed started to grow again, if only weakly. One year later however, the risk has shifted location. The loss in fiscal revenues associated with the loss in output is threatening to lead, if not contained, to a debt explosion. In most countries, fiscal consolidation must increasingly be the priority.

Emerging and developing countries face a different set of challenges. One of them is large capital inflows. Higher growth prospects and higher interest rates are attracting large capital inflows. Such inflows, especially when driven by growth prospects, are fundamentally good news, but we have learned from experience that they can also lead to booms and busts. Thus, the main policy issue facing recipient countries is how to best accommodate these flows, how much to let the currency appreciate, how to use macroeconomic policy, how to use macro-prudential tools, reserves, and capital controls, to best avoid excesses and maintain stable growth.

Solutions closely linked

Interestingly, and importantly, the solutions to the challenges facing advanced and emerging countries are closely linked:

In advanced economies, fiscal consolidation is needed, but is likely to have an adverse effect on demand and thus on growth. To offset these adverse effects and maintain growth, advanced countries, as a whole, may need to depreciate their currency so as to increase their net exports.

This, in turn, implies that emerging and developing countries, again as a whole, do the reverse, namely let their currency appreciate, and reduce net exports. It is in their global interest to do so, as this adjustment may be needed to sustain growth in advanced countries, and, by implication, strong growth in the rest of the world. In many countries, it is also clearly in their own, direct, interest to do so.

In **China** for example, a shift away from exports towards domestic consumption—a shift that requires both structural measures to decrease saving, and an appreciation of the currency—appears highly desirable.

New stage of the crisis

To conclude, we find ourselves at an important new stage of the crisis. A global depression has been averted. The world economy is recovering, and recovering better than we had previously thought likely. This is certainly welcome news.

But new—and no less formidable—challenges have presented themselves. Achieving strong, sustained and balanced growth will not be easy. It will require more work—namely fiscal consolidation in advanced countries, exchange rate adjustments, a rebalancing of demand across the world.

Source: IMF