EDITORIAL
STRONGER GROWTH AHEAD, BUT MORE RISKS

The global economy continues to expand at a moderate pace, with some acceleration of growth anticipated in 2014 and 2015. But global growth forecasts have been revised down significantly for this year and 2014, in large part due to weaker prospects in many emerging market economies (EMEs). Downside risks dominate and policy must address them.

Contrary to the situation in the early phases of the recovery when stimulus in EMEs had positive spillovers on growth in advanced economies, the global environment may now act as an amplifier and a transmission mechanism for negative shocks from EMEs.

In recent months, three events already have unsettled confidence and market stability, which accounts for part of the downgrading of our forecasts since the last *Economic Outlook*. First, the reaction to discussion in early summer regarding the tapering of asset purchases by the US Federal Reserve was surprisingly strong. Second, increased concerns about developments in some EMEs added to market tensions and sharp capital outflows. Third, the United States came close to a potentially catastrophic crisis associated with its legislative ceiling on federal government debt.

These events – recognised as risks in the May *Outlook* – underline the prominence of negative scenarios and risks that the recovery could again be derailed. These episodes could easily be replayed, quite possibly in a more virulent form, in the period ahead. Other long-standing risks could return to the fore. Although some acute risks, especially in Europe, have receded, tensions within the euro area could erupt again. In addition, specific risks could interact with one another and magnify the effects. These risks stem from unresolved financial fragilities and imbalances, the cumulated effects of exceptional and prolonged monetary stimulus, and underlying structural weaknesses of growth trends in many countries, partly reflecting the consequences of a deep and long-lasting recession.

A stronger slowdown in EMEs would lower growth in advanced economies, most notably in Europe and Japan. In many EMEs, growth is already decelerating. To a large degree, this is related to demographic trends and the diminishing scope for catch-up growth as the income gap with the advanced countries narrows, but there are also long-standing structural impediments that had been hidden by abundant capital inflows and credit growth but which have been exposed by the tightening of financial conditions. Such conditions could add to fragility within EMEs, particularly those most reliant on short-term capital flows or where credit growth has been very fast, and in those advanced economies that are financially exposed to them. While many EMEs are in a stronger position to withstand shocks than in the past, they must accelerate the pace of reforms to deal with deep-rooted fragilities.

In the United States, monetary policy needs to remain accommodative for some time, balancing uncertainty about the evolution of demand and employment with the costs of postponing exit. When economic growth strengthens, large-scale bond purchases should begin to be phased down and then, in the course of 2015, the Federal Reserve should start to raise policy interest rates towards a more neutral stance.

Brinkmanship over fiscal policy in the United States remains a key risk and uncertainty. As discussed in this *Economic Outlook*, this creates on-going uncertainty and poor policy choices, while hitting the debt ceiling

could knock the US and the global recovery off course. The debt ceiling needs to be scrapped and replaced by a credible long-term budgetary consolidation plan with solid political support.

In the euro area, recovery is lagging and uneven, unemployment – especially among the young – remains very high and inflationary pressures are very subdued. The ECB should consider further policy measures if deflationary risks become more serious. Current account adjustment is advancing in the periphery but price adjustment alone will not work given the impossibility of reconciling deflation, needed to regain competitiveness, and achieving nominal growth to support debt sustainability. Much less adjustment, if any, is taking place in surplus countries. More durable and symmetric adjustment is needed through reforms to labour and product markets, including liberalisation of services in Germany that would strengthen and rebalance demand.

Weakness in the banking system remains a major drag on growth in the euro area. The Asset Quality Review and stress tests in 2014 must be implemented rigorously – and followed up by bank recapitalisation where needed – to restore the transmission of monetary policy, strengthen financial-system stability and get credit moving again to enhance the effectiveness of structural reforms and support growth. Failure to use this opportunity could impair confidence in European banks and sovereigns. There is progress towards banking union but the transition promises to be complex and delicate as the criteria and responsibility for regulation, supervision, and resolution of banks have to be clarified.

In Japan, the initial impact of new monetary, fiscal and structural policies has produced strong export growth, rising consumer spending and a rebound in business investment. The increase in the consumption tax rate to 8% is welcome and should be followed by a further hike as planned in 2015. However, high levels of public debt create risks in the absence of a more detailed and credible fiscal consolidation plan to achieve the target of a primary budget surplus by 2020. Most importantly, bold structural reform measures are needed to boost growth and maintain confidence in the three arrow strategy.

Growth since the global crisis has been uneven and hesitant. Job creation has been even more disappointing. Clear and credible strategies are needed for how jobs and growth will be created, as the public finances continue to be restored and so that exceptional monetary policies are no longer needed to support demand. Such strategies require a strong commitment to structural reforms in advanced and emerging market economies alike.

The gains from structural reform will accumulate over the longer term, but for some measures they can be achieved in a couple of years. And the benefits are larger when macroeconomic and financial conditions are stronger, although paradoxically this can be the time when it is hardest to make the political case for reform. As the recovery takes hold, policy makers need to resist the temptation to back off reforms, and instead take advantage of improved conditions to secure the recovery and move to a stronger trajectory for jobs and growth. More jobs would boost income and confidence, thus providing support for the reform process itself and upside, rather than downside, risks could materialise.

If, however, as the recovery strengthens, governments are complacent, and remain behind the curve, policy action will be too little too late. Policy inaction or mistakes could have much more severe consequences than the turbulence seen to date and jeopardise growth for years to come.

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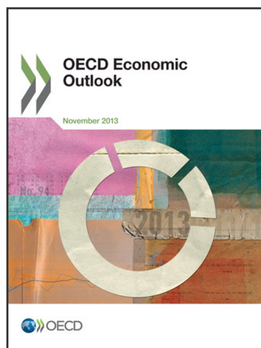

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