Global Economic Prospects

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Crisis, Finance, and Growth

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Foreword

THIS YEAR, *Global Economic Prospects* is being released at a critical juncture for the world economy. A recovery from the financial crisis that rocked the world in the fall of 2008 is under way, but many challenges remain and much uncertainty continues to cloud the outlook.

In many respects, recent economic news has been encouraging. Industrial production and trade, after falling by unprecedented amounts worldwide, are growing briskly; financial markets have recovered much of the steep losses they incurred in late 2008 and early 2009; and developing countries are once again attracting the interest of international investors. However, the depth of the recession has left the global economy seriously wounded. Even as profitability returns to many of the firms that were at the heart of the crisis, industrial production and trade levels have yet to regain their pre-crisis levels, and unemployment has reached double digits in many countries and continues to rise.

Given the depth of the crisis and the continued need for restructuring in the global banking system, the recovery is expected to be relatively weak. As a result, unemployment and significant spare capacity are likely to continue to characterize the economic landscape for years to come. This poses a real challenge for policy makers, who must cut back on unsustainably high fiscal deficits without choking off the recovery. Similarly, the extraordinary monetary stimulus needs to be scaled back to avoid the creation of new bubbles. The medium-term strength of the recovery will depend both on how well these challenges are met and on the extent to which private-sector demand picks up. If policies are adjusted too slowly, inflationary pressures and additional bubbles could develop; too quick of an adjustment could stall the recovery.

Whatever the relative strength of the recovery in the next few months, the human costs of this recession are already high. Globally, and notwithstanding upward revisions to growth projections for 2010, the number of people living on $1.25 per day or less is still expected to increase by some 64 million as compared with a no-crisis scenario. The recession has cut sharply into the revenues of governments in poor countries. Unless donors step in to fill the gap, authorities in these countries may be forced to cut back on social and humanitarian assistance precisely when it is most required.

In addition to analyzing the immediate challenges for developing countries posed by the crisis, this year's *Global Economic Prospects* describes some of the longer-term implications of tighter financial conditions for developing-country finance and economic growth. While necessary and desirable, tighter regulation in high-income countries will result in less abundant capital (both globally and domestically) and increased borrowing costs for developing countries. As a result, just as the very loose conditions of the first half of this decade contributed to an investment boom and an acceleration in developing-country growth, so too will higher capital costs in coming years serve to slow growth in developing countries and provoke a decline in potential output.

Countries should not respond passively. Efforts to strengthen domestic financial systems and expand regional cooperation (including regional self-insurance schemes) can help to reduce the sensitivity of domestic economies to international shocks and counteract some of the longer-term negative effects of tighter international financial conditions. Such initiatives are most likely to benefit middle-income countries that already have reasonably well-developed regulatory and competitive environments and healthy financial sectors. Finally, both low- and middle-income countries should strengthen domestic financial regulations. Over time, such steps can improve domestic financial-sector efficiency and reduce borrowing costs—more than offsetting any negative impacts from tighter international conditions.

Overall, these are challenging times. The depth of the recession means that even though growth has returned, countries and individuals will continue to feel the pain of the crisis for years to come. Policy can help mitigate the worst symptoms of this crisis. However, there are no silver bullets, and achieving higher growth rates will require concerted efforts to increase domestic productivity and lower the domestic cost of finance.

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Abbreviations

ASEAN	Association of Southeast Asian Nations
BIS	Bank for International Settlements
CDOs	collateralized debt obligations
CDSs	credit default swaps
CPI	consumer price index
DECPG	Development Economics Prospects Group (World Bank)
ECB	European Central Bank
EMBI	Emerging Markets Bond Index
EMBI+	Emerging Markets Bond Index Plus
FDI	foreign direct investment
GCC	Gulf Cooperation Council
GDP	gross domestic product
GIDD	Global Income Distribution Dynamics model
GNFS	goods and nonfactor services
GNI	gross national income
IBRD	International Bank for Reconstruction and Development
IDA	International Development Association
IMF	International Monetary Fund
IPO	initial public equity offering
Lao PDR	Lao People's Democratic Republic
LCU	local currency unit
LIBOR-OIS	London Interbank Offered Rate-Overnight Indexed Swap rate
M&A	mergers and acquisitions
MDG	Millennium Development Goal
MSCI	Morgan-Stanley Composite Index
NIEs	newly industrializing economies
ODA	official development assistance
OECD	Organisation for Economic Co-operation and Development
OPEC	Organization of the Petroleum-Exporting Countries
PPP	purchasing power parity
saar	seasonally adjusted annualized rate
T-bill	Treasury bill (U.S.)
TFP	total factor productivity
UAE	United Arab Emirates