I. Breaking the vicious cycles

The world is now five years on from the outbreak of the financial crisis, yet the global economy is still unbalanced and seemingly becoming more so as interacting weaknesses continue to amplify each other. The goals of balanced growth, balanced economic policies and a safe financial system still elude us. In advanced economies at the centre of the financial crisis, high debt loads continue to drag down recovery; monetary and fiscal policies still lack a comprehensive solution to short-term needs and long-term dangers; and despite the international progress on regulation, the condition of the financial sector still poses a threat to stability. From time to time, encouraging signs raise hopes – but they are quickly dashed, delivering another blow to the confidence of consumers and investors.

As many advanced economies have been struggling, emerging market economies have been rising, in some cases fuelled by rapid credit expansion or a vast wave of export-led growth. This two-speed recovery generates large and potentially destabilising current account imbalances and volatile gross capital flows. The export boom in many emerging markets has crowded out the development of more durable internal sources of growth, leaving countries more vulnerable as growth begins to slow down. As the economic developments of the past year (see Chapter II) have demonstrated, a self-sustaining recovery in the advanced economies and a rebalancing of global growth remain elusive.

In short, vicious cycles are distorting both advanced and emerging economies. How can these vicious cycles be turned into virtuous ones? The ongoing challenges of *structural adjustment*, *monetary* and *fiscal* policy risks, and *financial reform* encompass the broad global threats that are still with us. These four topics, and the steps needed to set the global economy firmly on the path to sustainable long-term growth, are the focus of Chapters III–VI in this Report. In the remainder of this chapter, we highlight the policy recommendations for the global economy. And, before concluding, we also discuss the particularly vicious cycles currently bedevilling Europe, where the monetary union faces the above challenges plus those of an incomplete institutional setup.

Structural challenges persist

The global economy remains unbalanced, as activity in many advanced economies continues to falter while economies elsewhere are expanding, in some cases rapidly (Chapter III). This is unlikely to be sustainable.

Economies that were at the centre of the financial crisis must face their crisis legacies of debt and misallocated resources head-on. The leverage-driven real estate boom left an enormous overhang of debt after the inevitable implosion. The necessary deleveraging process for households is far from complete and has been slow by historical standards. Household debt remains close to 100% of GDP in some countries, including Ireland, Spain and the United Kingdom; in others, including France and Italy, household and corporate debt have both increased relative to GDP since 2008.

An important factor slowing the deleveraging process among households is the simultaneous need for balance sheet repair and deleveraging in the financial and government sectors. Unusually slow deleveraging in every major sector of activity partly explains why the recovery in the advanced economies has been so weak. And given the ongoing need to improve balance sheets, any effects from stimulative fiscal policy will be limited by overindebted agents using additional income to repay debt rather than spend more. As a result, weak growth is likely to continue.

Persistent imbalances across industries are also impeding recovery. Because labour and capital do not easily shift across industries, the misallocation of resources during the boom tends to work against recovery in the aftermath of a crisis. Hence, countries where the sectoral imbalances were most apparent are facing higher and more protracted unemployment as their industrial structure only slowly adjusts.

Meanwhile, countries that are growing rapidly confront the problems of identifying and reacting to the emergence of financial booms and, in many cases, of shifting away from a reliance on exports. Evidence of overshooting in some emerging markets is not hard to find. In several cases, prices for real estate and other assets have been surging while private indebtedness and debt service costs relative to income have been rising far above long-term trends. The lessons from the hardships now being endured in the advanced economies in the wake of similar experiences are not lost on today's emerging market policymakers, especially given recent signs of a slowdown in emerging market economies. But with the prospect of continued slow growth in much of the world, countries whose success has depended on exports would do well to speed their efforts to build capacity for internal growth.

Overburdened central banks face risks

Over the past year, central banks in the advanced economies have continued or even expanded their purchases of government bonds and their support of liquidity in the banking system. At $18 trillion and counting, the aggregate assets of all central banks now stand at roughly 30% of global GDP, double the ratio of a decade ago. And real policy interest rates – nominal rates minus headline inflation – remain substantially negative in most major advanced economies. The global economy is certainly better off today because central banks moved forcefully after the 2008 collapse of Lehman Brothers and in the years since. One of the latest examples of such action was the European Central Bank's offer of three-year loans to banks in late 2011 and again in early 2012. That €1 trillion programme, which increased the Eurosystem central bank balance sheet by roughly €500 billion, was perhaps the single most important factor halting the freeze in banks' funding markets and, indirectly, supporting some euro area government bond markets.

The extraordinary persistence of loose monetary policy is largely the result of insufficient action by governments in addressing structural problems. Simply put: central banks are being cornered into prolonging monetary stimulus as governments drag their feet and adjustment is delayed. As we discuss in Chapter IV, any positive effects of such central bank efforts may be shrinking, whereas the negative side effects may be growing. Both conventionally and unconventionally accommodative monetary policies are palliatives and have their limits. It would be a mistake to think that central bankers can use their balance sheets to solve every economic and financial problem: they cannot induce deleveraging, they cannot correct sectoral imbalances, and they cannot address solvency problems. In fact, near zero policy rates, combined with abundant and nearly unconditional liquidity support, weaken incentives for the private sector to repair balance sheets and for fiscal authorities to limit their borrowing requirements. They distort the financial system and in turn place added burdens on supervisors.

With nominal interest rates staying as low as they can go and central bank balance sheets continuing to expand, risks are surely building up. To a large extent they are the risks of unintended consequences, and they must be anticipated and managed. These consequences could include the wasteful support of effectively insolvent borrowers and banks – a phenomenon that haunted Japan in the 1990s – and artificially inflated asset prices that generate risks to financial stability down the road. One message of the crisis was that central banks could do much to avert a collapse. An even more important lesson is that underlying structural problems must be corrected during the recovery or we risk creating conditions that will lead rapidly to the next crisis.

In addition, central banks face the risk that, once the time comes to tighten monetary policy, the sheer size and scale of their unconventional measures will prevent a timely exit from monetary stimulus, thereby jeopardising price stability. The result would be a decisive loss of central bank credibility and possibly even independence.

Although central banks in many advanced economies may have no choice but to keep monetary policy relatively accommodative for now, they should use every opportunity to raise the pressure for deleveraging, balance sheet repair and structural adjustment by other means. They should also be doubly watchful for the build-up of new imbalances in asset markets.

Fast-growing economies are in a different situation. But there too, central banks are under pressure. The threats to monetary and financial stability in many emerging market economies have, as noted above, been in evidence for some time. Monetary policymakers there will need to continue to search for the right balance, but the task is being made even more difficult by recent signs of faltering growth combined with extraordinarily accommodative policies in the advanced economies.

The abysmal fiscal outlook

Since 2007 – the year the financial crisis began – government debt in the advanced economies has increased on average from about 75% of GDP to more than 110%. And average government deficits have ballooned from 1.5% to 6.5% of GDP. One could be forgiven for thinking that, without the financial crisis, government fiscal foundations today would be fairly sound. But the seemingly endless growth of tax receipts during the boom years only temporarily shored up those foundations. By pushing down tax receipts and driving up the government's social safety net costs, the financial crisis created an explosion of deficits and debt that directed the authorities' attention with new force to the underlying menace that no longer seemed so far away: the gross underfunding of governments' health care and pension obligations and an unmanageably large public sector.

In some countries, staggeringly large support programmes for the financial sector wreaked havoc on government finances. The feedback between the financial and the government sectors thus made a key contribution to accelerating fiscal decay; and the connection between banking stress and market pressures on sovereign credit has tightened considerably in the past couple of years, especially in Europe.

As we discuss in Chapter V, the fiscal maelstrom has toppled many sovereigns from their unique perch where the market considered them to be essentially free of credit risk and, in that sense, riskless. The loss is particularly worrisome given weak economic conditions and a global banking system still largely dependent on government support. The shrinking supply of safe assets is harming the functioning of financial markets and driving up funding costs for the private sector. And it is helping push banks into risky practices, such as rehypothecation – that is, the use of the same collateral for multiple obligations.

Over the past year, much of the world has focused on Europe, where sovereign debt crises have been erupting at an alarming rate. But, as recently underscored by credit downgrades of the United States and Japan and rating agency warnings on the United Kingdom, underlying long-term fiscal imbalances extend far beyond the euro area.

Although debt in emerging markets has on average remained fairly stable relative to GDP, governments there should take heed: credit and asset price booms in many cases have been masking underlying weaknesses in their fiscal accounts, much as they did in advanced economies before the financial crisis. If recent signs of a slowdown persist, the fiscal horizon of emerging market economies could darken quickly.

So, governments across the globe need to tackle their fiscal predicaments. In most advanced economies, the fiscal budget excluding interest payments would need 20 consecutive years of surpluses exceeding 2% of GDP – starting now – just to bring the debt-to-GDP ratio back to its pre-crisis level. And every additional year that budgets continue in deficit makes the recovery period longer. The question is not whether governments must adjust, but how? Some say that governments should focus exclusively on resolving the long term, ignoring the short term. Others say that the only credible consolidation plan is the one that starts now – anything else risks pushing sovereign creditworthiness off the cliff.

In choosing some position between these two extremes, a few points are clear from the outset. The main priority should be forceful and credible long-term measures, even when it means making painful choices now. Governments in the advanced economies will have to convincingly show that they will adequately manage the costs for pensions and health care as their populations grow older. Spending cuts and revenue increases may be necessary in the near term as well. Countries in the deepest trouble will need to do much more, quickly pushing through significant reform of their public sectors. In many countries, ongoing deleveraging in the private sector weakens near-term aggregate demand and hampers fiscal reform. In those cases, authorities should create sufficient room for manoeuvre to support balance sheet repair in the private sector, including by recapitalising banks as they recognise losses.

But trust lost is never easily regained. The road back to risk-free status for sovereigns is a long one. Some countries have already run out of options and will have no choice but to take immediate steps to restore fiscal balance. Others will need to strike the right balance between long- and short-term measures to be successful. A key challenge for governments as they strive for that balance is to avoid losing the confidence of investors.

Economies less affected by the financial crisis should view their current position of relative strength as an opportunity to put their government finances on a sustainable long-term path. Doing so sooner rather than later will give them the flexibility to react when the next crisis inevitably hits. In addition, all countries will need to stem adverse feedback between the financial sector and the sovereign. To this end, countries should move swiftly to make their banks more resilient and make sure that, as conditions improve, they build fiscal buffers.

The changing financial sphere

While financial institutions struggle to overcome the effects of the crisis, they also confront a changed market environment and new regulations. In some places they have made significant progress on recapitalisation but, as we discuss in Chapter VI, their adjustment to the new conditions has a long way to go and needs to be pushed ahead. The magnitude of this unfinished business is clear from investors' continued distrust of banks: the cost of buying compensation for a bank default (the spread on bank credit default swaps) is as high now as it was at the peak of the crisis, and bank equities continue to lose ground relative to the broad market.

Despite the progress on recapitalisation, many banks remain highly leveraged, including those that appear well capitalised but in fact have outsize derivatives positions. Big banks continue to have an interest in driving up their leverage without enough regard for the consequences of failure: because of their systemic weight, they expect the public sector to cover the downside. Another worrying sign is that trading, after a brief crisis-induced squeeze, has again become a major source of income for large banks.

These conditions are moving the financial sector towards the same high-risk profile it had before the crisis. Recent heavy losses related to derivatives trading are a reminder of the dangers associated with such a development. Surely, fundamental progress on the structure of the financial system will be marked when its largest institutions can fail without the taxpayer having to respond, and when the overall size of the sector relative to the rest of the economy stays within tighter limits.

Some mechanisms can help align market participants' interests with those of the public. One is the reform of remuneration policies at banks. Another involves bank bondholders, who together with the public sector are at risk of picking up the tab if a financial intermediary's net worth turns negative. The incentives of bond investors will be better aligned with the public interest if the investors see more clearly that they will bear losses if banks get into trouble. This will require some combination of *bail-in bonds* – in which bondholders' losses in resolution are known with some certainty beforehand – and improved resolution powers. Making risks to investors clearer and ending crisis-related support for banks, including government guarantees on their bonds, will push investors to better scrutinise the financial health of banks before investing in them. Greater transparency has a pivotal role to play here: it will increase bondholders' ability to monitor the banks because the risks the institutions are taking will be more visible.

In short, public policy must move banks to adopt business models that are less risky, more sustainable and more clearly in the public interest. Governments can give the banking sector a healthy push in this direction if officials make sure that newly agreed regulations are implemented universally and without delay. Apart from enhancing transparency, this would also ensure a level playing field for internationally active banks. Most importantly, authorities should continue forcing banks to bring leverage down – and keep it there by preventing them from deploying new instruments and tactics that would push it back up. But such efforts should not stop with traditional banks. Prudential authorities everywhere still face the challenge of putting in place robust regulations that extend to the shadow banking sector.

What now for European monetary union?

The world is watching the crisis gripping the euro area with trepidation for the spillovers it may have. But at its root the European crisis is a potential harbinger, a virulent and advanced convergence of the problems to be expected elsewhere if policy fails to break the vicious cycles generated by the global weaknesses we describe in this Report – sectoral imbalances, excess leverage, public overindebtedness and overburdened central banks.

For now, the destructive feedback created by these problems is concentrated in the euro area, where the fiscal authorities in some countries, forced to consolidate, can no longer support either their banks or their economies. The rapid loss of investor confidence in these countries has caused an equally rapid fragmentation of euro area financial markets. In this environment, how can the common currency regain its credibility so that Europe can return to prosperity and continue on the road to further integration?

In part, the euro area crisis involves underlying problems that were revealed by the financial crisis and are common to many advanced economies. Likewise, resolving it will require, in part, corrections that are also common:

private sector balance sheet adjustment, sectoral rebalancing, fiscal consolidation and banking recapitalisation. Europe has made progress on this agenda: reforming labour markets and social insurance systems and, through adoption of the fiscal compact, requiring countries to have general government budgets in balance or in surplus.

But full resolution of the euro area crisis also requires strengthening the institutional foundations of the currency union itself. To understand the importance of this issue, recall that the European monetary union integrated financial markets and created a centralised monetary authority so that capital could flow freely and easily across the common currency area. Yet while the region's borders have become irrelevant for finance and for central banking, authorities in one country still have only limited responsibilities for actions that a financial intermediary takes in another country. Hence, the public in one country of the currency union cannot be expected to financially backstop actions taken elsewhere in the union. The conclusion is hard to escape that a pan-European financial market and a pan-European central bank require a pan-European banking system. Put slightly differently, a currency union that centralises the lender of last resort for banks must unify its banking system. Banks in Europe must become European banks.

Recent promising suggestions for movement on the banking front offer quick progress because they would operate within the existing terms of the currency union. First, they would unify banking rules now fragmented along national boundaries. Second, common banking rules would centralise responsibility in a common regulator, supervisor, deposit insurer and resolution authority.

If adopted, these measures will break the adverse feedback between the banks and the sovereign and other destructive links that are making the crisis so severe. They will revive interbank lending and sovereign access to funding markets. They will allow the Eurosystem to withdraw from its unconventional and undesirable role as an intermediary. And they will restore confidence in the single currency so that both institutional and retail depositors return to the banks in their local markets. With day-to-day normality attained through a unified currency *and* banking system, leaders will have the time they need to finish building the broader institutional framework that the monetary union needs for its long-term viability.

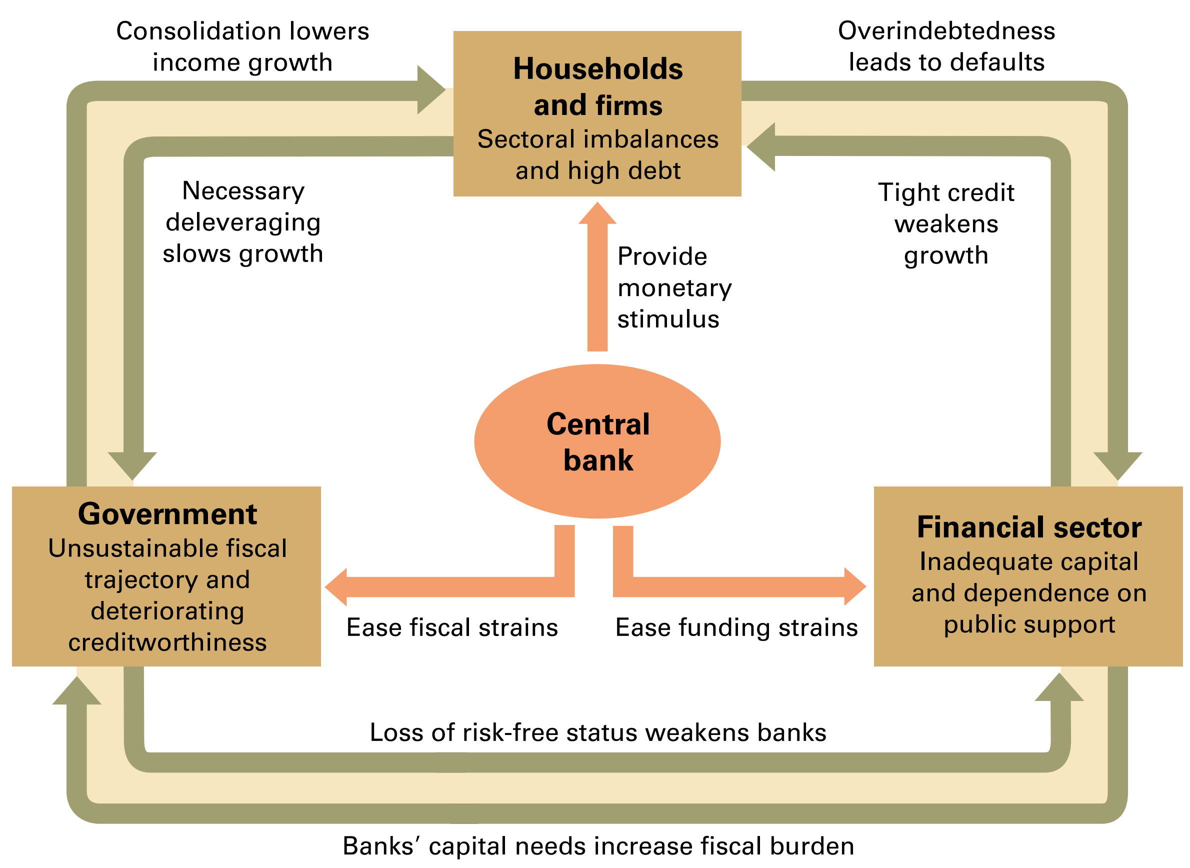
Summing up

Moving the global economy to a path of balanced, self-sustaining growth remains a difficult and unfinished task. As we argue in this Report, a number of interacting structural weaknesses are hindering the reforms required in advanced and emerging market economies. Those hoping for quick fixes will continue to be disappointed – there are none. And central banks – already overburdened – cannot repair these weaknesses. All of this is understood by advanced economy consumers who are reducing debts and are reluctant to spend; it is understood by firms postponing investment and hiring; and it is understood by investors wary of the weak and risky outlook – why else would they accept negative real interest rates on government bonds in many advanced economies?

A look at the economy as a whole shows that three groups need to adjust (Graph I.1): the financial sector needs to recognise losses and recapitalise; governments must put fiscal trajectories on a sustainable path; and households and firms need to deleverage. As things stand, each sector's burdens and efforts to adjust are worsening the position of the other two. The financial sector is putting pressure on the government as well as slowing deleveraging by households and firms. Governments, with their deteriorating creditworthiness and need for fiscal consolidation, are hurting the ability of the other sectors to right themselves. And as households and firms work to reduce their debt levels, they hamper the recovery of governments and banks. All of these linkages are creating a variety of vicious cycles.

Central banks find themselves in the middle of all of this, pushed to use what power they have to contain the damage: pushed to directly fund the financial sector and pushed to maintain extraordinarily low interest rates to ease the strains on fiscal authorities, households and firms. This intense pressure puts at risk the central banks' price stability objective, their credibility and, ultimately, their independence.

Vicious cycles and the burden on central banks



Graph I.1

Breaking these vicious cycles, and thereby reducing the pressure on central banks, is critical. Reaching this goal requires cleaning up and strengthening banks at the same time as the size and riskiness of the financial sector are brought under control. As we have urged in previous Reports, banks must adjust balance sheets to accurately reflect the value of assets; they have made progress on this score, but policymakers should move them along more quickly. As they do, they must ensure speedy recapitalisation and see that banks build capital buffers as conditions improve. More broadly, authorities must implement agreed financial reforms, extend them to shadow banking activities, and limit the size and significance of the financial sector so that the failure of an institution does not ignite a crisis.

In the euro area, the noxious effects of the vicious cycles have reached an advanced stage that reflects not only weaknesses seen elsewhere but also the incomplete nature of financial integration in the currency union. Europe will overcome this crisis if it can address both issues: attain structural adjustment, fiscal consolidation and bank recapitalisation; and unify the framework for bank regulation, supervision, deposit insurance and resolution. That approach will decisively break the damaging feedback between weak sovereigns and weak banks, delivering the financial normality that will allow time for further development of the euro area's institutional framework.

Overall, in Europe and elsewhere, the revitalisation of banks and the moderation of the financial industry will end their destructive interaction with the other sectors and clear the way for the next steps – fiscal consolidation and the deleveraging of the private non-financial parts of the economy. Only then, when balance sheets across all sectors are repaired, can we hope to move back to a balanced growth path. Only then will virtuous cycles replace the vicious ones now gripping the global economy.