Towards a Post-Crisis Global Economy:
Not out of the Woods yet, Europe now the Key Risk?

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Key points:

- By the autumn, there must be convincing signs of economic recovery to limit the threat of another round of industry cutbacks and financial market volatility. At present, confusion still reigns over the precise state of the world economy. China is strengthening and the recession may be bottoming out in countries such as the US, UK and France. On the other hand, conditions in some regions - most importantly in most of the Eurozone and emerging Europe - are still deteriorating and creating the risk of further feedback effects.

- Adding to the short-term threat, there is a potential policy vacuum in the Eurozone until elections in Germany are over in September. One reason for the ECB’s recent injection of funds may be the need to ensure stability over the next couple of months – and concerns continue over the performance of the European banks and the need for transparent stress tests.

- Although the unemployment rate has risen more steeply in the US than Europe, if short-term measures to support jobs in the Eurozone (especially in Germany) lapse, this could add another 2-3 million to Europe’s jobless total by the end of 2009.

- The negative effects of the crisis are likely to be even more persistent in Europe than in other regions because of weak internal dynamics and difficulties linked to complex cross-border banking and policy synchronization. This situation is already impacting on social cohesion and voter sentiment, casting a long shadow over both EU integration and potential expansion.

- In general, more attention needs to be paid to a key issue highlighted by this crisis: how global cyclical industries impact on economies, jobs and policy choices. Should the worst affected economies enhance strategies to provision for the impact of downturns or would they be better advised to reduce exposure to cyclical industries? What might this imply for global industrial structures, trade and efficiency? Might this increase Asia’s role?

- Questions must also be addressed regarding persistent large errors in forecasts and analysis and the impact this has had on policy decisions and speed of reaction.
Introduction: further risks and difficult decisions ahead

There is still a strong sense of brinksmanship regarding the state of the global economy and the US and European banking systems. Halfway down the cliff face, are we holding firm, ready to start climbing back up – or not. The outlook for the autumn and the coming year remains highly uncertain.

On the surface, the situation has clearly improved from a few months ago: financial markets are no longer in a state of turmoil and data showing massive losses in trade, output and GDP, having diminished their ability to shock, are now beginning to steady out. Equity markets, commodity prices and sentiment indicators have picked up and other signs of returning confidence include the rally in leading emerging market currencies. Compared with last autumn, there is less talk of the end of the market economy and capitalist system and more focus on recovery prospects and a return to business-as-usual.

However, real economic indicators remain weak and uneven and, at best, probably point not to ‘green shoots’ but to the downturn coming to a halt over the summer. China has seen the most convincing pick-up but, in contrast, the Eurozone economy continued to deteriorate in the second quarter and most of emerging Europe remains mired in financial crisis. Even if a real upturn gradually emerges by the autumn, will this recovery be robust and sustainable or weak and haunted by unresolved tensions, especially in the banking system? What happens if there is no meaningful recovery from current low levels of demand and production – will some sectors never regain previous peaks?

This debate is not just about short-term prospects. Under pressure from the crisis, economic thinking is undergoing a period of uneasy reflection, especially regarding the principles by which economies are managed and expected to grow. This exceptional shock to world trade has jolted even

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1 Including regional disparities and their implications, as demonstrated by the recent IMF briefing on ‘Europe under stress’ (Marek Belka, June 2009) and the Chatham House review ‘From Steady Growth to Sudden Crisis: How Latin America and the Caribbean Are Coping with the Global Recession’ (Working paper, May 2009).
successful exporting nations into re-examining their strategies. However, tradable goods are not the only problem, especially for job prospects. While a pick-up in world trade may revive export-oriented economies, including most of emerging Asia as well as Japan and Germany, this will not resolve the difficulties facing job seekers in countries such as Spain, Ireland and much of emerging Europe. In these cases, there has been a massive rise in unemployment as construction and related service sectors have collapsed and are likely to remain far weaker than past peaks, possibly permanently. Much of emerging Europe has been highly dependent not only on buoyant property markets but also on capital inflow-driven credit growth that has now dried up, exposing another failed growth model. The end of the boom years has revealed the flaws inherent in previous strategies for growth and jobs.

These issues continue to be addressed in a series of Chatham House briefing papers on the recession, its impacts, the post-crisis implications for economic prospects and policy choices, and the risks to the outlook over the longer run. In this paper, we specifically review the current economic situation and prospects for recovery, highlighting risks as well as the opportunities ahead.

**More evidence of recovery essential to maintain confidence**

On the back of a marked rally in confidence surveys and financial markets, supported by leading indicators such as shipping rates and global oil prices, many forecasters have been optimistically announcing that ‘green shoots’ are already emerging and the world economy is poised to pick up and carry on as normal by 2010-2011. This means a return to global growth rates of 3-4% – perhaps even revisiting the ‘golden age’ of 2004-2007, when growth was as high as 5% in PPP terms. While the IMF is typically seen as more cautious than the [general?] consensus over 2009-2010 prospects, it too points to ‘business as usual’ rates of global growth by 2011 – not too bad a crisis after all?

Unfortunately, these scenarios may not be as rosy as growth rates make them seem. Even if activity does pick up moderately, this may still imply that the level of activity remains lower than the 2007-2008 peak for the next couple of years, posing an on-going risk, especially for the weak financial sector, for accelerated industry restructuring and for jobs. Worse than this, the
pessimists quite plausibly argue that hopes for a sustained recovery are naïve and ignore key messages from the crisis. They warn that there will be a very prolonged period of little or no growth for the global economy, which will even rock expectations in seemingly impervious economies such as China. If indeed global production capacity is simply too high in some key industries, then there will be more plant closures and job losses around the world – and they will be permanent. This analysis harks back to the massive industrial restructuring seen in the early 1980s recession. Although it is possible to argue that many developed economies should be more robust today thanks to increases in their services sectors, more flexible working practices and the lower numbers of new labour market entrants (versus the baby boom years of the 1980s), the pessimists dismiss this relatively benign scenario as panglossian, pointing to the ultimate vulnerability of the services sector along with the demise of job creation in construction.

Figure 1: Confidence and financial markets begin to pick up

In addition to the task of coping with the collapse in the financial system and global industries, many pre-crisis problems have not been resolved and may soon resurface: these include global imbalances in savings rates and net trade, instability in global capital flows and currencies, capacity shortages and steeply rising prices in commodity markets and future inflationary pressures. Concern has also grown over public sector finances in the major developed economies and their impact, for example on future tax policy and financial markets. And there are risks of ill-timed and badly managed policy tightening.

2 Such as Stephen Roach (2009).
throwing grit into the system or worse, possibly igniting further instability in the fragile banking system.

These various extremes of opinion regarding the outlook have been characterized rather cutely as an alphabetic medley of shaped recovery scenarios, V, L, W, Z and more, which belies their not-so-cute implications. For example, such diverse views imply a level of uncertainty that will make it even harder for companies and households to take major decisions on spending. Many will simply continue to put off all but essential expenditure. And policy makers are equally uncertain about their next move – for example, when will central bank rates start to rise? Or what, if anything, can be done if the economic situation remains weak?

If the world economy can pick up by the autumn and return to positive growth, this will be a powerful signal regarding its ability to rebound from adversity. Optimism would be justified. This would set the scene for a new wave of investment and wealth creation, especially in the emerging market economies, building on the current upswing in financial markets. However, what reactions will there be if hopes of a sustained recovery are dashed, especially as policy-makers have used up most, if not all, of their fire power? Certainly, by the autumn, companies will find it hard to countenance many more months of dismal business conditions without putting in place further and more permanent downsizing, the impact of which would undoubtedly prolong the recession into 2010-2011. This would have further negative effects on the banking system via rising non-performing loans (NPLs). Policy-makers thus face a race against time to engineer an upturn and stave off the risk of another round of retrenchment.

In terms of timing, therefore, it is absolutely critical that signs of a credible, sustainable recovery begin to be confirmed by the end of the summer: this will determine whether the autumn sees a surge of confidence in the world’s economic future or disappointment leading to another round of turmoil.
Real upturn not here yet but statistics should improve by late 2009

So far, the data point to nothing more than a very modest improvement in world trade and output, which are still operating at a very low ebb indeed. A real recovery in the world economy is not yet confirmed – there should be no illusions about this. However, signs that the downturn is coming to a halt have been enough to cheer doom-weary news headlines.

Figure 2: World trade and prices beginning to turn around but still very weak

Sources: BEA, ECB, EIU, Japan MoF

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3 The Baltic Dry Index is a daily index of international shipping prices of dry bulk cargo. By measuring shipping demand it serves as a proxy for global trade.

4 Since most commodities including oil are priced in dollars, a weakening of the value of the dollar requires a corresponding increase in the price of the commodity simply to maintain its value. As such, the dollar trade-weighted Effective Exchange Rate and commodity prices are often inversely related.
Global activity should stabilize over the summer, undoubtedly helped by all the policy easing still feeding through the system (the lags involved may be as long as 6-12 months). This will encourage the recent improvement in sentiment and at least a modest revival in household spending in some countries. Indicators such as retail, home and car sales will be the signposts to watch for a real demand recovery. Companies may also help revive demand in the ICT and office equipment sector – this may lead to a pick-up in Asian exports. In addition, by the end of the year, figures will start to be flattered by comparison with the dramatically weaker results in late 2008, making headlines seem less bleak. Such news may be little more than a technical improvement but it almost inevitably encourages sentiment and shifts the focus to looking forward beyond the crisis and on to recovery.

What evidence is there that the drop in demand and activity from late 2008 into the first months of 2009 is beginning to flatten off? Are signals such as shipping rates and commodity prices accurately pointing to the end of the recession or not? And are conditions uniform across the key regions of the global economy – especially in the US, Europe, China and Japan, which together account for over 80% of world GDP and an even larger proportion of consumer spending?

Reviewing the data for the most important parts of the world suggests at best cautious optimism and at worst grounds for heightened concern about the possibility of another high-risk autumn.

**Guarded optimism for the US**

Monthly data suggest the downturn is no longer getting worse in the US. For example, US retail sales, imports and industrial production data all point to conditions beginning to stabilize or improve slightly, while the housing market is mixed, with sales picking up in some sectors but prices still falling. Notably, the gap between housing starts and sales is now almost zero after a savage downsizing in construction. Special factors will also play a role, such as the US adopting a car scrapping subsidy similar to those successfully implemented in Europe, aimed at a temporary boost to sales to tide the sector over the slump.
However, the overall evidence for a consumer upturn remains erratic and this can only be confirmed after several months’ more data. While low inflation, easy monetary policy and benefits from the Obama fiscal package should help to boost households’ purchasing power and incentive to spend, it is quite possible that the economy as a whole will only move sideways for the rest of this year. The savings ratio has already jolted up from around zero to almost 7% of disposable income, which argues that the worst of the adjustment to higher savings may be over. But a return to growth in consumer spending will still depend on rising real incomes to fuel it. The second half of 2009 should provide the right conditions for a pick-up but a return to inflation in 2010 could damp down this recovery.

**Figure 3: US economic indicators**

![Graph showing US economic indicators]

*Source: Federal Reserve, Census Bureau*
It is also expected that some lagging indicators will get worse this year and possibly not improve until 2011. For example, employment and unemployment statistics continue to deteriorate. While the number of jobless claims has fallen slightly from its April peak, and the rate of job losses has slowed down, this latter figure is still heavily negative and there remain risks of further shockwaves from industrial restructuring, which would hit consumer confidence and spending and further delay a pick-up in investment as well.
In the short term, the main hope for a swift rebound in demand and trade seems to be pinned on restocking, backed up by the slight improvement in underlying consumer spending. The US certainly sees inventories playing an important role in the business cycle, as Fed Chairman Ben Bernanke noted in recent testimony before Congress. Although a further fall is possible in the second quarter, US inventories have already dropped sharply. In the first quarter of 2009 alone this cut almost 3 percentage points from GDP, representing nearly half of the overall decline in GDP. Indeed, stock levels have been falling since the start of the recession.

Other countries have also highlighted this factor, as cuts in production in the new year helped limit increases in unsold inventories, while heavy discounting and special deals (such as the aforementioned car scrapping schemes) have encouraged a reduction in existing stock. Depleted stocks have been cited as the motivation for some companies reactivating production in the second quarter in order to meet demand (especially in the Japanese car industry).

It is also important to remember that the effects of policy easing are continuing to feed through around the world, improving the outlook for at least moderate, sustained gains in consumer spending in the US and elsewhere. Low interest rates have global impacts even in countries that have not expanded fiscal policy. While it may be important for rebalancing the world economy that savings rates in the US and UK stay higher than the near zero levels seen in recent years, limiting their upside potential for growth in consumer demand, there should be lower savings rates in surplus countries.
such as China and Germany. The global rise in savings in 2009 has been excessive and needs to drop to end the recession. Global consumer spending will be a key factor to watch over the summer months as without some revival in this sector, there will be little hope of a real and meaningful recovery. Restocking alone will only provide a temporary boost.

**European economies still deteriorating**

Compared with tempered but growing optimism in the US (and, as discussed below, signs of revival in Asia), there are grounds not just for caution but for concern over conditions elsewhere. The deep recession in the OECD, especially in Europe, is quite typically lagging the US and global cycle but, more unusually, it will probably take much longer to turn around this downturn, based on the multiple constraints limiting demand growth. And many developing countries are still grappling with the substantial impacts and aftershocks of the last six months’ turmoil that are still feeding through. In emerging Europe, fortunately, some risks have been contained thanks to the increase in IMF financial resources agreed at the G20 meeting in March, but many countries still face financial difficulties and severe adjustment problems in spite of IMF assistance. The scale of the problems in the most troubled parts of Eastern Europe is also illustrated by the first quarter GDP figures, which show a fall in the 10-20% range for the hardest hit countries such as the Baltic States and Ukraine.

As we have highlighted in previous Chatham House briefings, forecasters took a long time to catch up with the actual rate of change in economic prospects over the last year and, even now, some countries may not have digested the full implications of this recession and the radical (and probably persistent) change in financial conditions.

Examining the short-term indicators for Europe and the US, it appears that the continents are decoupling. Unlike in the US, where a number of indicators point to the possibility of an incipient recovery, in Europe the data have actually worsened. In addition, some negative effects (such as job losses in Germany) may have been only temporarily held back, adding to the risks that may emerge in the autumn. There was surprise at the depth of the loss in German GDP in the first quarter of 2009 as well as the continuing steep slide
in Eurozone industrial production in the second quarter. In early June, the ECB warned that forecasts may be downgraded again, with the drop in Eurozone GDP possibly exceeding 5% this year. Reviews suggest that the Euro area will remain in recession during the whole of 2009 and possibly into 2010 as well.

Further complications arise owing to the heterogeneity of Europe’s economic problems: to some extent, this explains why previous forecasts failed to adequately predict the scale of the damage as the crisis moved from the financial sector to the real economy. For example, the UK (like the US) was widely expected to be hit harder than other EU economies given its large financial services sector and the fact that it was at the centre of the financial storm. Yet the UK may actually suffer a less severe recession than many of its European partners, in part because the economy is weighted more heavily towards non-cyclical sectors and flexible working practices. France also has less cyclical exposure, and has a relatively large number of protected jobs in government and state sector industries.

**Figure 6: European economic indicators**

![Diagram showing European economic indicators](image)

*Source: Eurostat*
EU countries have been hit hard not just by the slump in exports (Germany) but also by the collapse of the construction sector (e.g. Spain). They face a steep and prolonged downturn. Housing bubbles that incorporated both steep price rises and excessive new build, such as those seen in Spain, Ireland and parts of Eastern Europe, have caused the most widespread damage when they burst. Excess stock takes time to absorb and job losses are significant and slow to reverse.

However, exports may also be slow to recover, even if global demand revives, because intra-EU trade still seems to be deteriorating as the result of second and third round shocks continuing to reverberate on internal demand across the EU economies. In addition, there are further risks if mounting unemployment erodes confidence and growth potential over the short to medium term, pointing to the need for policies aimed at job creation as well as encouraging recovery in GDP. However, attempts to stimulate job-intensive sectors will be hampered by the slump in construction, which may never return to its pre-crisis peak in some countries (e.g. Spain), and lack of public funds for job creation in infrastructure and the public sector (which has already been responsible for many of the new jobs created in Europe over the last decade).

In addition to losses linked to construction and trade, those countries which have suffered the most severe financial crises (e.g. Ireland as well as most of Eastern Europe) will find it this yet another handicap to recovery. Many of these economies have depended on external financial assistance (e.g. the

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Sources: US Census Bureau, UK CLG, Spain INE, Ireland DoEnv, France INSEE
IMF or ECB) to stave off national bankruptcy and defaults. Moreover, the health of West European banks is closely associated with such developments given the large investments accumulated over the last decade. As a testament to this dependency, in the midst of attempts to rescue the Baltic States, the ECB recently assisted Sweden in providing liquidity to its banking system. The fragility as well as the complexity of the European cross-border financial system indicates that all future projections must remain cautious.

In this context, the recent ECB provision of more than 440 billion euro in short-term funds, even larger than the injection seen in late 2007, could be as much a cause for concern (about underlying conditions) as a reason for optimism about the ECB providing a boost for recovery. Although there has been a drop in market spreads, this is explained not by confidence returning but by central banks aiming to drive it down – masking the continued malfunctioning of the interbank market. Many believe that the ECB must urgently conduct and publish stress tests across the European banks in order to improve credibility and clear the air. And perhaps, as some analysts argue, there should be a ‘bad bank’ set up as well. But the ECB has probably done enough to tide over the system until decisions can be made after the German elections.

Certainly Germany will need to come back to addressing a number of critical issues this autumn. Across the major EU economies, it is notably not the UK but Germany that has suffered the steepest decline in GDP. This is due to its exceptionally high dependence on exports (an astonishing 47% of GDP) and on industrial production (30% of GDP), both much higher than the average for large developed countries. Growth in Germany has been driven almost entirely by external demand in recent years as domestic consumer spending has remained virtually flat. Indeed, much of the rise in Germany’s exports was accounted for by Eastern Europe, while Western Europe effectively financed the resulting trade deficits by capital flows, often in the form of bank credit. Notably, intra-EU trade actually began to slow almost two years ago, associated with the incipient weakening in EU domestic demand. But in late 2008, both intra- and extra-EU trade collapsed and export sales are currently over 20% below their levels of a year ago. In fact, German exports were down by as much as 29% in April.

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5 Notably Posen and Véron (2009).
China picking up, leading the world recovery

Around the world, there are few bright spots and economic conditions will remain fragile without the support of consumers in the advanced economies. Even in China the latest trade figures show exports remaining at the low levels reached in early 2009, with April-May seeing a fall of around 24% in the dollar value of exports relative to the same period in 2008, although June improved, partly because of a weaker performance a year ago. However, in contrast to most of the hard-hit exporters, China, at least, has continued to see positive developments in manufacturing output and, in particular, its economy has been able to maintain much of its vibrancy in terms of growth in consumer spending (e.g. retail sales up by around 15% in the year to date) and investment (above 32%, higher than 2008, thanks to the boost from bank lending and the government).

Figure 7: Chinese economic indicators

This strength is epitomized by continued growth in vehicle production and sales (up by around 25% in the first half of the year, relative to the previous year), in contrast to virtually every other market in the world (excluding one-off impacts of subsidized scrapping schemes in some countries). With the US
market severely depressed, China’s unit car sales are now the highest in the world, hitting new peaks of more than 1.1 million vehicles per month during the March-May period. This is an important signal of the resilience of domestic consumption and investment. In spite of a steep drop in exports, which could take as much as 4-5 percentage points off GDP in 2009, China may be one of the few countries to register positive growth this year (probably in the 6-7% range) and might even see forecasts upgraded slightly as it pulls out of a very weak first quarter.

Apart from China, there are few upward revisions in forecasts. South Korea has also shown a significant response to large fiscal and monetary stimulus packages (although it remains very vulnerable to the slump in trade and industry) and a number of other Asian economies, including India and Indonesia, have shown greater resilience than expected. For example, India reported surprisingly high GDP growth of 5.8% in the first quarter of the calendar year (arguably somewhat inflated) and manufacturing also returned to positive growth by April, when car sales were up more than 4% on a year before (to over 102,000 units). Meanwhile, Japan is still struggling owing to the sharp deterioration in exports and industrial activity, conditions which are similar to those affecting Germany. As a result, Japan’s contraction in GDP for 2009 (-14% annualized during the first quarter) is expected to be the most pronounced among G7 economies despite the relatively good health of its large banking sector and the relatively intact post-crisis wealth of Japanese savers (in contrast to very large losses in the US). In the Gulf, although more attention tends to be paid to the problems of property projects and the financial sector, especially in Dubai, the regional economy will benefit from the partial recovery in oil prices. Qatar is actually seeing higher, double-digit growth in 2009 thanks to specific energy-related projects coming on stream (and its small population). However, none of these economies carries the punch of China in the global economy – this will remain the focus for both real economic power and sentiment.

In contrast, there remain grounds for concern over the forecasts for Latin America and the Caribbean, which could see further downgrades (as examined in a recent Chatham House working paper ‘From Steady Growth to Sudden Crisis: How Latin America and the Caribbean Are Coping with the Global Recession’). In particular, the deteriorating situation in Mexico, the region’s second-largest economy, may cause a near double-digit drop in GDP
this year. Brazil saw a smaller-than-expected decline in GDP during the first quarter as surprisingly strong consumer demand offset industrial and export losses; however, consumers may not be able to maintain this performance through the rest of the year.

**Risks to recovery?**

In summary, Table 1 illustrates past and current IMF forecasts (broadly similar to consensus) along with own estimates of the risks for 2009.

How can we characterize the key assumptions behind these 2009 forecasts? Do they anticipate a recovery or not? The projections are roughly based on the view that the year-on-year rates of change in GDP (and underlying demand components) in the second and third quarters will be very similar to the figure reported for the first quarter, while the fourth quarter will be close to zero, that is close to the same level of activity as late 2008. This means that the average for the year should be about a percentage point stronger than the weak first quarter. Effectively, this assumes a sharp, L-shaped, drop in the level of GDP from the last quarter of 2008, which will be prolonged through 2009.

The optimists expect this ‘L’ to gradually turn up into a ‘U’ shaped recovery by late 2009, with year-on-year GDP growth just about edging up into positive territory. But the pessimists see weakness continuing and even a risk of a further drop in the level of GDP in 2010: this is doubly dangerous as it may lead to permanent downward revisions to estimates of potential output as well, with implications for future policy setting. Worryingly, the Eurozone already seems to be moving in this direction.
Table 1: Downgrades in regional growth estimates

<table>
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Sources: IMF, own estimates of alternative risk scenario

Clearly ‘post-crisis’ does not mean an end to risk. As indicated above, the world economy will continue to be haunted by a multitude of threats that could destabilize what will be a fragile recovery.

Key issues highlighted include the risks inherent in an uneven recovery (especially given potential feedback effects from a weak Europe), the still dubious health of the financial sector and banks (with no stress tests yet available for the European banks), the build up of public sector deficits and debt and, along with this, the risk of premature policy tightening. In addition, there may be a re-emergence of old risks, such as global imbalances, commodity price inflation and unemployment.

The longer-term risks identified will be discussed more fully in a forthcoming paper in this series on “Towards a post-crisis global economy”. The world will remain in a precarious position on the cliff face for some time to come – but of most immediate concern is the prospective re-intensification of risk this autumn, especially within Europe.
References


Roach, Stephen, various lectures in 2009 including to the Rafael del Pino Foundation in Madrid (June 22) and articles including ‘Whither Capitalism?’ published in Handelsblatt (February 23, 2009).