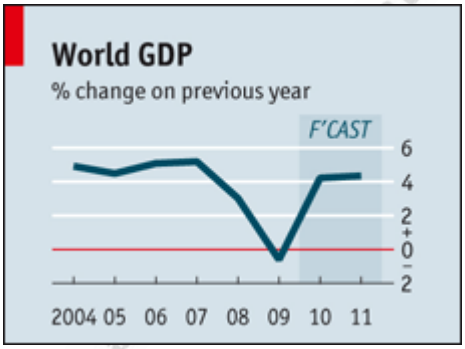
Curb your enthusiasm

A welcome recovery—but an uneven one, with dangers both for sluggish Europe and bubbly emerging economies.

THERE is a whiff of exuberance around the world economy these days. Financial markets are buoyant, business confidence is rising and global growth seems increasingly robust. In its latest forecasts, released on April 21st, the IMF predicts that global output will grow by 4.2% this year on a purchasing-power basis, a full percentage point more than it foresaw six months ago. Other seers are even more optimistic, predicting growth of more than 4.5%—or close to the average pace of the boom years before the recession. The level of global output is now back to where it was before the downturn. And given the scale of the financial crisis, the recovery is surprisingly brisk. With global business investment accelerating and consumer spending strong, there is growing optimism that the recovery is becoming self-sustaining.

Some of this optimism is justified. Just as financial stress worsened the recession, so healthier financial markets are now reinforcing the recovery. Higher asset prices have propped up consumer spending and narrower corporate bond spreads have eased firms' borrowing costs. Economic recovery, in turn, has helped ease financial pain. The IMF has reduced its estimate of banks' total losses from the crisis by $500 billion, to $2.3 trillion, two-thirds of which has already been written off.



The trouble is that the good fortune has not been shared equally. The healthy pace of global growth belies differences between regions that are big and are getting bigger. Historically, deeper recessions are followed by stronger recoveries. But this time around countries that were least affected by the recession (primarily the largest emerging economies) are seeing the fastest acceleration. China's economy is now growing at double-digit rates. The IMF expects India's GDP to increase by almost 9% this year. Some forecasters reckon that Brazil's growth rate could reach 7%, which would be its fastest pace in a quarter of a century. In contrast, countries where the downturn was deepest have the weakest recoveries. Output fell further in Britain and the euro area than it did in America. Yet the IMF expects output growth of only 1% in the euro zone and 1.3% in Britain this year, compared with more than 3% in America.

One reason for this multi-speed recovery is that the financial crisis was largely confined to the rich world, and recoveries after such crises tend to be slow. But the gap between American and European growth rates means that this cannot be the only explanation. The structure of finance matters (Europe is more dependent on banks), as does an economy's flexibility (productivity has soared in America, but it has slumped in Europe). Another factor is differences in the scope for, and effectiveness of, policy stimulus. Thanks to their low debt levels, many big emerging economies used fiscal and monetary stimulus vigorously and effectively. In America the Federal Reserve opened the spigots, and the dollar's reserve-currency status gives the country unusual fiscal latitude. In the euro zone, in contrast,

individual countries lack an independent monetary policy. And with high debt levels, many are running out of fiscal room even as their economies remain weak.

The dangers of getting too excited

The danger is that these growth gaps will widen rather than narrow. In Europe output could slow as sovereign debt fears spread beyond Greece, forcing the likes of Portugal (see article) to tighten fiscal policy faster. Big emerging economies, which have little or no spare capacity and which are growing at a faster pace than is sustainable, could easily overheat, risking inflation and asset bubbles. A multi-speed global recovery is, unfortunately, less stable than a synchronised one, not least because the policy combination that makes sense for the rich world—gradually tighter fiscal policy and a prolonged period of cheap money—will encourage more capital to flow to emerging economies in search of higher yields, and add to their risk of overheating. Nonetheless, both sets of policymakers can do more to prevent the more extreme outcomes.

Rich economies where public debt burdens are soaring urgently need bold and credible plans for medium-term deficit-reduction. They also need supply-side measures that boost economic growth, from tax reform (in America) to freer job markets (in Europe). To prevent bubbles forming as a result of lopsided global growth, emerging economies need to use deft monetary and fiscal tightening, flexible exchange rates and prudential tools such as reserve requirements and capital inflow controls. The urgency is especially great in Asia. China needs to allow the yuan to strengthen soon. India's recent interest-rate hikes have failed to keep up with inflation. For now, booming growth in emerging economies explains the rosiness of the global recovery. But its sustainability will depend, in large part, on how that prosperity is controlled.

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