EXECUTIVE SUMMARY

Global Economic Environment

The global expansion is losing speed in the face of a major financial crisis (Chapter 1). The slowdown has been greatest in the advanced economies, particularly in the United States, where the housing market correction continues to exacerbate financial stress. Among the other advanced economies, growth in western Europe has also decelerated, although activity in Japan has been more resilient. The emerging and developing economies have so far been less affected by financial market developments and have continued to grow at a rapid pace, led by China and India, although activity is beginning to slow in some countries.

At the same time, headline inflation has increased around the world, boosted by the continuing buoyancy of food and energy prices. In the advanced economies, core inflation has edged upward in recent months despite slowing growth. In the emerging markets, headline inflation has risen more markedly, reflecting both strong demand growth and the greater weight of energy and particularly food in consumption baskets.

Commodity markets have continued to boom despite slowing global activity. Strong demand from emerging economies, which has accounted for much of the increase in commodity consumption in recent years, has been a driving force in the price run-up, while biofuel-related demand has boosted prices of major food crops. At the same time, supply adjustments to higher prices have lagged, notably for oil, and inventory levels in many markets have declined to medium- to long-term lows (see Appendix 1.2). The recent run-up in commodity prices also seems to have been at least partly due to financial factors, as commodities have increasingly emerged as an alternative asset class.

The financial shock that erupted in August 2007, as the U.S. subprime mortgage market was derailed by the reversal of the housing boom, has spread quickly and unpredictably to inflict extensive damage on markets and institutions at the core of the financial system. The fallout has curtailed liquidity in the interbank market, weakened capital adequacy at major banks, and prompted the repricing of risk across a broad range of instruments, as discussed in more detail in the April 2008 *Global Financial Stability Report*. Liquidity remains seriously impaired despite aggressive responses by major central banks, while concern about credit risks has intensified and extended far beyond the subprime mortgage sector. Equity prices have also retreated as signs of economic weakness have intensified, and equity and currency markets have remained volatile.

These financial dislocations and associated deleveraging are affecting both bank and nonbank channels of credit in the advanced economies, and evidence is gathering of a broad credit squeeze—although not yet a full-blown credit crunch. Bank lending standards in the United States and western Europe are tightening, the issuance of structured securities has been curtailed, and spreads on corporate debt have risen sharply. The impact is most severe in the United States and is contributing to a further deepening of the housing market correction. In western Europe, the main spillovers have been through banks most directly exposed to U.S. subprime securities and disruptions in interbank and structured securities markets.

Recent financial market stress has also had an impact on foreign exchange markets. The real effective exchange rate for the U.S. dollar has declined sharply since mid-2007 as foreign investment in U.S. bonds and equities has been dampened by reduced confidence in both the liquidity of and the returns on such assets, as well as by the weakening of U.S. growth prospects and interest rate cuts. The decline in the value of the U.S. dollar has boosted net exports and helped bring the U.S. current account deficit down to less than 5 percent of GDP by the fourth quarter of 2007, over 1½ percent of GDP lower than its peak in 2006. The main counterpart to the decline of the dollar has been appreciation of the euro, the yen, and other floating currencies such as the Canadian dollar and some emerging economy currencies. However, exchange rate movements have been less marked for a number of countries with large current account surpluses—notably China and oil-exporting countries in the Middle East.

Direct spillovers to emerging and developing economies have been less pronounced than in previous periods of global financial market distress, although capital inflows have moderated in recent months and issuance activity has been subdued. A number of countries that had relied heavily on short-term cross-border borrowing have been affected more substantially. Trade spillovers from the slowdown in the advanced economies have been limited so far and are more visible in economies that trade heavily with the United States. As a result, growth among emerging and developed economies has continued to be generally strong and broadly balanced across regions, with many countries still facing rising inflation rates from buoyant food and fuel prices and strong domestic demand.

Underpinning the resilience of the emerging and developing economies are their increasing integration into the global economy and the broad-based nature of the current commodity price boom, which have boosted exports, foreign direct investment, and domestic investment in commodity-exporting countries to a greater degree than during earlier booms. As explored in Chapter 5, commodity exporters have been able to make progress toward diversifying their export bases, including by increasing manufacturing exports, and the share of trade among the emerging and developing economies themselves has increased. Strengthened macroeconomic frameworks and improved institutional environments have been important factors behind these favorable developments. As a result, the growth performance of emerging and developing economies has become less dependent on the advanced economy business cycle, although spillovers have clearly not been eliminated.

Outlook and Risks

Global growth is projected to slow to 3.7 percent in 2008, ½ percentage point lower than at the time of the January *World Economic Outlook Update* and 1¼ percentage points lower than the growth recorded in 2007. Moreover, growth is projected to remain broadly unchanged in 2009. The divergence in growth performance between the advanced and emerging economies is expected to continue, with growth in the advanced economies generally expected to fall well below potential. The U.S. economy will tip into a mild recession in 2008 as the result of mutually reinforcing cycles in the housing and financial markets, before starting a modest recovery in 2009 as balance sheet problems in financial institutions are slowly resolved (Chapter 2). Activity in western Europe is also projected to slow to well below potential, owing to trade spillovers, financial strains, and negative housing cycles in some countries. By contrast, growth in emerging and developing economies is expected to ease modestly but remain robust in both 2008 and 2009. The slowdown reflects efforts to prevent overheating in some countries as well as trade and financial spillovers and some moderation in commodity prices.

The overall balance of risks to the short-term global growth outlook remains tilted to the downside. The IMF staff now sees a 25 percent chance that global growth will drop to 3 percent or less in 2008 and 2009—equivalent to a global recession. The greatest risk comes from the still-unfolding events in financial markets, particularly the potential for deep losses on structured credits related to the U.S. subprime mortgage market and other sectors to seriously impair financial system balance sheets and cause the current credit squeeze to mutate into a full-blown credit crunch. Interaction between negative financial shocks and domestic demand, particularly through the housing market, remains a concern for the United States and to a lesser degree for western Europe and other advanced economies. There is some upside potential from projections for domestic demand in the emerging economies, but these economies remain vulnerable to trade and financial spillovers. At the same time, risks related to inflationary pressures have risen, reflecting the price surge in tight commodity markets and the upward drift of core inflation.

Policy Issues

Policymakers around the world are facing a diverse and fast-moving set of challenges, and although each country's circumstances differ, in an increasingly multipolar world it will be essential to meet these challenges broadly, taking full account of cross-border interactions. In the advanced economies, the pressing tasks are dealing with financial market dislocations and responding to downside risks to growth—but policy choices should also take into account inflation risks and longer-term concerns. Many emerging and developing economies still face the challenge of ensuring that strong current growth does not drive a buildup in inflation or vulnerabilities, but they should be ready to respond to slowing growth and more difficult financing conditions if the external environment deteriorates sharply.

Advanced Economies

Monetary policymakers in the advanced economies face a delicate balancing act between alleviating the downside risks to growth and guarding against a buildup in inflation. In the United States, rising downside risks to output, amid considerable uncertainty about the extent, duration, and impact of financial turbulence and the deterioration in labor market conditions, justifies the Federal Reserve's recent deep interest rate cuts and a continuing bias toward monetary easing until the economy moves to a firmer footing. In the euro area, although current inflation is uncomfortably high, prospects point to its falling back below 2 percent during 2009, in the context of an increasingly negative outlook for activity. Accordingly, the European Central Bank can afford some easing of the policy stance. In Japan, there is merit in keeping interest rates on hold, although there would be some limited scope to reduce interest rates from already-low levels if there were a substantial deterioration in growth prospects.

Beyond these immediate concerns, recent financial developments have fueled the continuing debate about the degree to which central banks should take asset prices into account in setting monetary policy. In this context, Chapter 3 looks at connections between housing cycles and monetary policy. It concludes that recent experience seems to support giving greater weight to house price movements in monetary policy decisions, especially in economies with more developed mortgage markets where "financial accelerator" effects have become more pronounced. This could be achieved within a risk-management framework for monetary policy by "leaning against the wind" when house prices move rapidly or when prices have moved out of normal valuation ranges, although it would not be feasible or desirable for monetary policy to adopt specific house price objectives.

Fiscal policy can play a useful stabilizing role in advanced economies in the event of a downturn in economic activity, although it should not jeopardize efforts aimed at consolidating fiscal positions over the medium term. In the first place, there are automatic stabilizers that should provide timely fiscal support, without jeopardizing progress toward medium-term objectives. In addition, there may be justification for additional discretionary stimulus in some countries, given present concern about the strength of recessionary forces and concern that financial dislocations may have weakened the normal monetary policy transmission mechanism, but any such stimulus must be timely, well targeted, and quickly unwound. In the United States, where automatic stabilizers are relatively small, the recent legislation to provide additional stimulus for an economy under stress seems fully justified, and room may need to be found for some additional public support for housing and financial markets. In the euro area, automatic stabilizers are more extensive and should be allowed to play out fully around a deficit path that is consistent with steady advancement toward medium-term objectives. Countries whose medium-term objectives are well in hand can provide some additional discretionary stimulus if needed. However, in other countries, the ability to allow even automatic stabilizers to operate in full may be limited by high levels of public debt and current adjustment plans that are insufficient for medium-term sustainability. In Japan, net public debt is projected to remain at high levels despite recent consolidation efforts. In the context of an economic downturn, automatic stabilizers could be allowed to operate, but their impact on domestic demand would be small, and there would be little scope for additional discretionary action.

Policymakers need to continue strong efforts to deal with financial market turmoil in order to avoid a full-blown crisis of confidence or a credit crunch. The immediate priorities, explored in more detail in the April 2008 *Global Financial Stability Report*, are to rebuild counterparty confidence, reinforce the capital and financial soundness of institutions, and ease liquidity strains. Additional initiatives to help support the U.S. housing market, including possible use of the public sector balance sheet, could help to reduce uncertainties about the evolution of the financial system, although care would be needed to avoid inducing undue moral hazard. Longer-term reforms include improving mortgage market regulation, promoting the independence of rating agencies, broadening supervision, strengthening the framework of supervisory cooperation, and improving crisis resolution mechanisms.

Emerging and Developing Economies

Emerging and developing economies face the challenges of controlling inflation while being alert to downside risks from the slowdown in the advanced economies and the increased stress in financial markets. In some countries, further monetary policy tightening may be needed to keep inflation under control. With a flexible exchange rate regime, currency appreciation will tend to provide useful support for monetary tightening. Countries whose exchange rates are heavily managed vis-à-vis the U.S. dollar have less room to respond because rising interest rates may encourage heavier capital inflows. China and other countries that have diversified economies would benefit from moving toward more flexible regimes that would provide greater scope for monetary policy. For many Middle Eastern oil exporters, the exchange rate peg to the U.S. dollar constrains monetary policy, and it will be important that the current buildup in fiscal spending be calibrated to account for the cyclical position of these economies and that priority be given to spending aimed at alleviating supply bottlenecks.

Fiscal and financial policies can also play useful roles in preventing overheating and related problems. Expenditure restraint can help moderate domestic demand, lessen the need for monetary tightening, and ease pressures from short-term capital inflows. Vigilant financial supervision—promoting appropriately tight lending standards and strong risk management in domestic financial institutions—can pay dividends both by moderating the demand impulse from rapid credit growth and by reducing the buildup of balance sheet vulnerabilities.

At the same time, policymakers should be ready to respond to a more negative external environment, which could undercut trade performance and stifle capital inflows. In many countries, strengthened policy frameworks and public sector balance sheets will allow for more use than in the past of countercyclical monetary and fiscal policies. In China, the consolidation of the past few years provides ample room to support the economy through fiscal policy, such as by accelerating public investment plans and advancing the pace of reforms to strengthen social safety nets, health care, and education. In many Latin American countries, well-established inflation-targeting frameworks would provide the basis for monetary easing in the event of both a downturn in activity and an alleviation of inflation pressures. Automatic fiscal stabilizers could be allowed to operate, although there would be little room for discretionary fiscal stimulus, given still-high public debt levels. Some emerging and developing economies that have large current account deficits or other vulnerabilities and are reliant on capital inflows may need to respond by tightening policies promptly to maintain confidence.

Multilateral Initiatives and Policies

Broadly based efforts to deal with global challenges have become indispensable. In the event of a severe global downturn, there would be a case for providing temporary fiscal support in a range of countries that have made good progress in recent years in securing sound fiscal positions. Providing fiscal stimulus across a broad group of countries that would benefit from stronger aggregate demand could prove much more effective than isolated efforts, given the inevitable cross-border leakages from added spending in open economies. It is still early to launch such an approach, but it would be prudent for countries to start contingency planning to ensure a timely response in the event that such support becomes necessary.

Reducing risks associated with global current account imbalances remains an important task. It is encouraging that some progress is being made in implementing the strategy endorsed by the International Monetary and Financial Committee and the more detailed policy plans laid out by participants in the IMF-sponsored Multilateral Consultation on Global Imbalances aimed at rebalancing domestic demand across countries, with supportive movements in real exchange rates (see Box 1.3). This road map remains relevant but should be used flexibly to take account of the changing global context. Reducing trade barriers also remains an important priority, but the slow progress toward completing the Doha Round has been disappointing. Rising trade has been a key source of the recent strong performance of the global economy—and the recent progress toward global poverty reduction—and a renewed push in this area remains essential.

Recent commitments to developing a post-Kyoto framework for joint action to address climate change are very welcome. As discussed in Chapter 4, efforts to adapt to and mitigate the buildup of greenhouse gases have important macroeconomic consequences. The chapter finds that these macroeconomic consequences can be contained, provided efforts to limit emissions are based on effective carbon pricing that reflects the damages emissions inflict. Such carbon pricing should be applied across countries to maximize the efficiency of abatement, should be flexible to avoid volatility, and should be equitable so as not to put undue burdens on the countries least able to bear them.