

EXECUTIVE SUMMARY

The world economy is entering a major downturn in the face of the most dangerous financial shock in mature financial markets since the 1930s. Global growth is projected to slow substantially in 2008, and a modest recovery would only begin later in 2009. Inflation is high, driven by a surge in commodity prices, but is expected to moderate. The situation is exceptionally uncertain and subject to considerable downside risks. The immediate policy challenge is to stabilize financial conditions, while nursing economies through a period of slow activity and keeping inflation under control.

Global Economy under Stress

After years of strong growth, the world economy is decelerating quickly (Chapters 1 and 2). Global activity is being buffeted by an extraordinary financial shock and by still-high energy and other commodity prices. Many advanced economies are close to or moving into recession, while growth in emerging economies is also weakening.

The financial crisis that first erupted with the U.S. subprime mortgage collapse in August 2007 has deepened further in the past six months and entered a tumultuous new phase in September. The impact has been felt across the global financial system, including in emerging markets to an increasing extent. Intensifying solvency concerns have led to emergency resolutions of major U.S. and European financial institutions and have badly shaken confidence. In response, the U.S. and European authorities have taken extraordinary measures aimed at stabilizing markets, including massive liquidity provision, prompt intervention to resolve weak institutions, extension of deposit insurance, and recent U.S. legislation to use public funds to purchase troubled assets from banks. However, the situation remains highly uncertain as this report goes to press.

At the same time, the combination of the surge in food and fuel prices under way since 2004 and tightening capacity constraints has propelled inflation to rates not seen in a decade. As analyzed in Chapter 3, consumer price rises have been particularly strong in emerging and developing economies. This acceleration reflects the high weight of food in consumption baskets, still-quite-rapid growth, and less-well-anchored inflation expectations. Notably, countries that have adopted inflation-targeting regimes have generally fared better. In the advanced economies, oil price increases have pushed up headline inflation, but underlying inflation pressures seem contained.

The recent deterioration of global economic performance follows sustained expansion built on the increasing integration of emerging and developing economies into the global economy. In hindsight, however, lax macroeconomic and regulatory policies may have allowed the global economy to exceed its “speed limit” and may have contributed to a buildup in imbalances across financial, housing, and commodity markets. At the same time, market flaws, together with policy shortcomings, have prevented equilibrating mechanisms from operating effectively and allowed market stresses to build.

Recovery Not Yet in Sight and Likely to Be Gradual When It Comes

Looking ahead, financial conditions are likely to remain very difficult, restraining global growth prospects. The baseline projections assume that actions by the U.S. and European authorities will succeed in stabilizing financial conditions and avoiding further systemic events. Nonetheless, even with successful implementation of the U.S. plan to remove troubled assets from bank balance sheets, counterparty risk is likely to remain at exceptionally high levels for

some time, slowing down the return to more liquid conditions in key financial markets. Furthermore, additional credit losses are very likely as the global economy decelerates. In this setting, financial institutions' ability to raise new capital will remain very challenged. Accordingly, as discussed in the October 2008 *Global Financial Stability Report*, the required deleveraging will continue to be a protracted process, implying that limits on the pace of credit creation—and on activity—will be present at least through 2009.

Nonetheless, several factors are expected to lay the groundwork for a gradual recovery to emerge later in 2009:

- Commodity prices are projected to stabilize, albeit at 20-year highs. The adverse terms-of-trade effects of the more than 50 percent increase in oil prices during 2008 should begin to unwind in 2009, boosting consumption in oil-importing countries.
- The U.S. housing sector is expected to finally reach bottom in the coming year, ending the intense drag on growth that has been present since 2006. The eventual stabilization of house prices should help restrain the financial sector's mortgage-related losses, and the recent intervention in the two government-sponsored enterprises, Fannie Mae and Freddie Mac, should help support the availability of credit to the housing sector. Although the housing cycle and related adjustment might lag in other advanced economies, the overall impact of the financial crisis will be severely felt.
- Notwithstanding cooling of their momentum, emerging economies are still expected to provide a source of resilience, benefiting from strong productivity growth and improved policy frameworks. Of course, the longer the financial crisis lasts, the more they are likely to be affected.

Against this backdrop, the baseline growth projections have been marked down significantly relative to the July 2008 *World Economic Outlook Update*. On an average annual basis, global growth is expected to moderate from 5.0 percent in 2007 to 3.9 percent in 2008 and

3.0 percent in 2009, its slowest pace since 2002. The advanced economies would be in or close to recession in the second half of 2008 and early 2009, and the anticipated recovery later in 2009 will be exceptionally gradual by past standards. Growth in most emerging and developing economies would decelerate below trend. On the inflation front, the combination of rising slack and stabilizing commodity prices is expected to contain the pace of price increases, bringing inflation back below 2 percent in 2009 in advanced economies. In emerging and developing economies, inflation would ebb more gradually, as recent commodity price increases continue to feed through to consumers.

There are substantial downside risks to this baseline forecast. The principal risk revolves around two related financial concerns: that financial stress could remain very high and that credit constraints from deleveraging could be deeper and more protracted than envisaged in the baseline. In addition, the U.S. housing market deterioration could be deeper and more prolonged than forecast, while European housing markets could weaken more broadly. Inflation risks to growth are now more balanced because commodity prices have retreated as the global economy slows. At the same time, potential disruptions to capital flows and the risks of rising protectionism represent additional risks to the recovery.

The connections between financial stress and economic downturns are explored in Chapter 4, which compares recent experience to earlier episodes. The analysis indicates that financial stress that is rooted in the banking sector typically has more adverse economic effects than stress in stock markets or exchange rates and that the shift toward more-arm's-length financial intermediation may have increased the impact. Initial conditions appear to affect the outcomes. Thus, the relatively healthy nonfinancial corporate balance sheets in the United States and western Europe at the beginning of the current downturn provide a source of resilience, but would be at risk from a sustained period of financial stress.

Chapter 6 raises concerns about countries with sustained large current account deficits. These concerns may be particularly relevant as global deleveraging reduces the availability of external financing for emerging economies. The analysis seeks to explain large divergences in current account behavior across the emerging world and relates the large deficits in emerging Europe to capital account liberalization, financial reform, and opportunities created by European economic convergence. However, sustained large deficits can end abruptly, and rigid exchange regimes heighten such risks. In fact, many economies with large current account deficits have already experienced a much greater impact from the financial market turmoil than those with small current account deficits or surpluses.

Policymakers between a Rock and a Hard Place

Policymakers around the world today face the daunting task of stabilizing financial conditions while simultaneously nursing their economies through a period of slower growth and containing inflation. Multilateral efforts take on particular importance in current circumstances, including policy initiatives to remedy the financial turmoil, alleviate the tightness in commodity markets, and support low-income economies burdened by high food import bills.

Country authorities are actively pursuing policies intended to stabilize financial conditions. Achieving this daunting task will require comprehensive responses that address the systemic problems—dealing with troubled assets, fostering the rebuilding of bank capital, and restoring liquid conditions in funding markets—while being mindful of taxpayer interests and moral hazard considerations. Approaches at the national level should be internationally coordinated to deal with joint problems and to avoid creating adverse, cross-border incentives.

The U.S. initiative to purchase real-estate-related assets should help over time to reduce

the pressure on banks from distressed assets, and thus support a return of stable funding sources and confidence. However, public funds are also likely to be needed to help banks rebuild their capital bases. In western Europe, restoring confidence now requires a decisive commitment to concerted and coordinated action to facilitate timely recognition of troubled assets and bank recapitalization. A key task will be to develop cooperative agreements, adapted to a broad range of circumstances, including for resolving stress in large cross-border institutions and ensuring consistency in approaches to expanding deposit insurance.

Macroeconomic policies in the advanced economies should aim at supporting activity, thus helping to break the negative feedback loop between real and financial conditions, while not losing sight of inflation risks.

- Rapidly slowing activity and rising output gaps should help contain inflation. Moderating inflation pressure and the deteriorating economic outlook already provide scope for monetary easing in some cases, notably in the euro area and the United Kingdom, where short-term interest rates are quite high.
- Regarding fiscal policy, automatic stabilizers play a useful role in buffering shocks to activity and should be left to operate freely, provided that adjustment paths are consistent with long-term sustainability. Discretionary fiscal stimulus can provide support to growth in the event that downside risks materialize, provided the stimulus is delivered in a timely manner, is well targeted, and does not undermine fiscal sustainability. In the current circumstances, available fiscal room should be focused on supporting stabilization of the financial and housing sectors as needed, rather than for more broad-brush stimulus. In due course, offsetting adjustments to fiscal policies will be needed to safeguard medium-term consolidation objectives.

Macroeconomic policy priorities vary considerably across emerging and developing economies, as policymakers balance growth and inflation risks.

- In an increasing number of economies, the balance of risks has now shifted toward concern about slowing activity as external conditions deteriorate and headline inflation starts to moderate. This shift would justify a halt to the monetary policy tightening cycle, particularly where second-round effects on inflation from commodity prices have been limited, and a turn to easing would be called for if the outlook continues to deteriorate. In the face of sharp capital outflows, countries will need to respond quickly to ensure adequate liquidity, while using the exchange rate to absorb some of the pressure. Furthermore, they should step up efforts to improve capabilities to prevent, manage, and resolve financial stress, including through contingency planning.
- However, in a number of other countries, inflation pressures are still a concern because of sharp food price increases, continued strong growth, tightening supply constraints, and accelerating wages, notably in the public sector. Although the recent moderation in international commodity prices may ease some of the pressure, the gains in reducing inflation in recent years are being jeopardized; once credibility is eroded, rebuilding it will be a costly and lengthy process. In these countries, additional monetary policy tightening may still be called for.
- Countries with heavily managed exchange rate regimes are facing significant challenges. More flexible exchange rates would help contain inflation pressures by providing greater scope for monetary adjustment and provide more room for maneuver in the face of capital outflows. Of course, other considerations feed into choices of exchange rate regimes, including, for example, the degree of financial development and the diversity of the export base.
- Fiscal policy can play a supportive role in macroeconomic management. Greater restraint in public spending would help ease inflation pressures in a number of countries still facing overheating concerns. This is particularly important for current account deficit

countries with pegged exchange rates. In the oil-exporting economies with currencies pegged to the U.S. dollar, spending can be focused on relieving supply bottlenecks. While emerging economies have greater scope than in the past to use countercyclical fiscal policy should their economic outlook deteriorate, the analysis in Chapter 5 cautions that this is unlikely to be effective unless confidence in sustainability has been firmly established and measures are timely and well targeted. More broadly, general food and fuel subsidies have become increasingly costly and are inherently inefficient. Targeted programs that help poor families meet rising living expenses are a preferred option.

Policy Frameworks in Need of Reform

The deteriorating performance of the global economy has raised concerns about the choice of macroeconomic policy frameworks and the appropriateness of policies affecting financial and commodity markets.

Operationalizing “Leaning against the Wind”

The current exceptional environment has heightened interest in developing policies that would be better geared toward avoiding asset price booms and busts, including through stronger policy responses in boom times. A promising approach would be to introduce a macroprudential element into the regulatory framework to weigh against the inherent procyclicality of credit creation. Consideration could also be given to extending monetary policy frameworks to provide for “leaning against the wind” of asset price movements, especially when these are rapid or seem to be moving prices seriously out of line with fundamentals, although this raises complex issues.

Moreover, interest has increased in making fiscal policy frameworks more credible and thus making fiscal policy more effective as a countercyclical tool. The Achilles heel of an active fiscal policy remains political economy settings that

foster short-term decision-making. As a result, many countries fail during good times to build room for effective discretionary stimulus during downturns, or are struggling with addressing long-term fiscal sustainability challenges. Chapter 5 suggests that the shift toward more rules-based policy frameworks—analogue to constrained discretion in monetary policy—and the stronger fiscal governance mechanisms that can be observed in a growing number of countries could boost the effectiveness of fiscal policy in combating downturns.

Plugging Gaps in Regulatory and Supervisory Infrastructures

As well as dealing with the immediate systemic threats, determined efforts are being marshaled to address the manifold weaknesses revealed by the current financial turbulence. As laid out in the October 2008 *Global Financial Stability Report*, a central objective is to ensure more effective and resilient risk management by individual institutions, including by setting more robust regulatory capital requirements and insisting on stronger liquidity management practices and improved disclosure of on- and off-balance-sheet risk. Another important task is to strengthen crisis resolution frameworks.

Moreover, the financial turmoil has revealed that national financial stability frameworks have failed to keep up with financial market innovation and globalization, at the price of deleterious cross-border spillovers. Greater cross-border coordination and collaboration among national prudential authorities are needed, particularly for the purposes of preventing, managing, and resolving financial stress both in markets and in major financial institutions.

Fostering Energy Conservation and Greater Oil and Food Supply

The recent decline in commodity prices should not detract from efforts to relieve strains in commodity markets. There is little concrete evidence that rising investor interest in com-

modities as an alternative asset—or outright speculation—had a systematic or lasting impact on prices. However, the combination of unusual swings in market sentiment and greater financial market liquidity may have contributed to short-term price dynamics in some circumstances. Accordingly, the focus should be on policies to encourage better balance between supply and demand in the longer term and to avoid measures that could exacerbate market tightness in the short term. This could include greater pass-through of international price changes to domestic markets and greater energy conservation. Lower biofuel subsidies in the advanced economies could also relieve short-term pressures on food prices. In general, priority should be given to strengthening the supply response to higher prices. For now, greater donor support for the poorest economies will be crucial to address the humanitarian challenges raised by the surge in food prices.

Unwinding Global Imbalances

The surge in commodity prices has led to a further widening in global imbalances, with wider current account surpluses in oil exporters and larger deficits in oil importers. Of course, exporters' intent to save some of the additional revenues is sensible: to date, the associated recycling of funding from surplus to deficit countries is working well. At the same time, the U.S. non-oil deficit has fallen substantially, in part reflecting the depreciation of the U.S. currency back toward a real effective rate that is broadly consistent with medium-term equilibrium. However, U.S. dollar depreciation has occurred mainly against the euro and some other flexibly managed currencies.

The multilateral strategy endorsed by the International Monetary and Financial Committee in 2005 and elaborated by the Multilateral Consultation on Global Imbalances in 2006 and 2007 remains relevant but needs to be applied flexibly. U.S. fiscal consolidation remains a key medium-term objective, but recent countercyclical fiscal stimulus and public support to stabi-

lize financial institutions have been warranted. Further effective appreciation of the renminbi would contribute to China's broader strategy to shift the sources of growth toward internal demand and to increase the effectiveness of monetary policy. A slowdown in spending growth in Middle Eastern oil exporters would help reduce overheating in their economies, as would a heightened focus on relieving supply bottlenecks. At the same time, product and labor market reforms in the euro area and Japan would raise potential growth.

Finally, rising protectionist pressures on both trade and capital flows reflect a worrisome risk to the prospective recovery. Breaking the current Doha Round deadlock would

help strengthen the open multilateral trading system, an important underpinning of strong global growth in recent years. At the same time, sovereign wealth funds (SWFs) continue to grow as investment vehicles for surplus countries. The set of principles and practices recently agreed by SWFs for their governance, investment, and risk management (the "Santiago Principles") will contribute to reducing concerns about these types of funds that could lead to counterproductive restrictions on such inflows. Moreover, guidelines for recipient countries, which are under development at the Organization for Economic Cooperation and Development, would help reassure the SWFs of fair, transparent, and open access to markets.