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Statement by IMF Managing Director, Dominique Strauss-Kahn, to the International Monetary and Financial Committee on the Global Economy and Financial Markets

The global expansion is losing speed in the face of a major financial crisis, and global growth is projected to drop from 4.9 percent in 2007 to 3.7 percent in 2008 and 3.8 percent in 2009. The slowdown will be strongest in the advanced economies, particularly in the United States, where the housing market correction continues unabated and the financial stresses are most acute. While the emerging and developing economies have so far been less affected by financial market turbulence, growth for these economies is also projected to slow, although it should remain above long-term trend in all regions. At the same time, headline inflation has increased around the world, boosted by the continuing buoyancy of food and energy prices. Risks to the global projections are tilted to the downside, especially those related to the possibility of a full-blown credit crunch, with emerging and developing economies unlikely to be insulated from a serious downturn in the advanced economies.

The fallout from strains in the U.S. subprime mortgage market sparked by a severe housing downturn has rapidly spread through an excessively leveraged financial system. Liquidity in the interbank market has been severely impaired, banks' capital adequacy has weakened, and financial intermediaries on both sides of the Atlantic have required emergency resolution. Structured credit markets have been seriously disrupted, and risk has been repriced across a broad range of instruments, as increasingly cautious banks cut back on credit lines and increased hair cuts and margin calls on other financial intermediaries. Equity prices also have retreated, and measures of volatility in equity and currency markets have remained elevated. By contrast, rates on government bonds have declined sharply, and investment in commodity markets has escalated, as investors have sought alternative asset classes.

The global economy is thus now faced with a widespread deleveraging, with both the banking system and the securities markets suffering from the financial market dislocations, and the potential for their further negative interaction with housing market corrections in the United States and elsewhere. The concern remains that further broad erosion of financial capital in a climate of uncertainty and caution could cause the present credit squeeze to mutate into a full-blown credit crunch, an event in which the supply of financing would be severely constrained across the system. While most emerging market and other developing economies have been relatively immune so far from the problems in global financial markets, global deleveraging could have a negative impact on growth prospects of these economies too, by constraining financial flows to emerging economies that are seen as vulnerable.

The pervasive impact of financial market turbulence on both banks and securities markets has prompted aggressive policy responses. The Federal Reserve and the Bank of England substantially broadened both the range of collateral accepted and the range of borrowers with access to central bank funds, and major central banks announced a coordinated initiative to ensure adequate liquidity. A number of central banks have also eased monetary policy stances in reflection of increasing downside risks to the growth outlook over this period. This notwithstanding, term premiums remain substantially higher than usual more than eight months after the initial outbreak of turbulence. Among emerging markets, some central banks have also provided liquidity to ease strains in interbank markets, but for others the principal challenge has remained to ensure that strong growth does not drive a build-up in inflation or vulnerabilities.

Recent financial developments are also affecting foreign exchange markets. The real effective exchange rate of the U.S. dollar has declined sharply since mid last year, owing to the weakening of U.S. growth prospects and interest rate cuts, as well as the reduced confidence in liquidity and returns on U.S. assets. However, the dollar still remains somewhat overvalued relative to fundamentals. Given the limited upward flexibility in the currencies of a number of countries that have large current account surpluses, the main counterpart of the decline in the U.S. dollar has been appreciation of the euro, the yen, and other floating currencies such as the Canadian dollar and some emerging market currencies. As a result, the euro is now also judged to be on the strong side, although the yen still remains somewhat undervalued. Despite some recent real appreciation, the renminbi is judged to be still substantially undervalued.

Short-Term Prospects

The spreading crisis in financial markets has significantly dampened the global outlook. Under the current baseline projection, global growth is projected to slow from 4.9 percent in 2007 to 3.7 percent in 2008 with only a modest recovery in 2009, as conditions in financial markets are expected to stabilize only gradually, risk spreads remain substantially wider than the exceptionally low levels that prevailed prior to mid 2007, bank lending standards continue to tighten, and commodity prices, including most notably oil, remain at high levels. Negative interaction between credit and housing markets in the United States will take a toll on demand and, as a result, the U.S. economy is projected to contract mildly in 2008, despite the substantial monetary and fiscal support that is now in train, before gradually regaining momentum in 2009. Other advanced economies would slow below trend. Growth in emerging and developing economies are also expected to moderate, reflecting efforts to prevent overheating in some countries, as well as trade and financial spillovers and some easing in commodity prices, although growth would remain above trend in all regions. Headline inflation is expected to remain elevated in the first half of 2008, but to moderate gradually thereafter, reflecting the receding impact of recent increases in commodity prices and the emergence of slack in some economies. The risks around this lower baseline remain tilted to the downside, particularly from possible further negative financial developments and adverse interaction with national housing markets. The risk of global growth falling below 3 percent, consistent with a global recession, is now assessed at 25 percent.

Turning to individual countries and regions, the *United States* is now projected to grow at 0.5 percent in 2008 (1 percent slower than projected at the time of the January *WEO* update) and 0.6 percent in 2009. On a fourth quarter over fourth quarter basis, activity would decline moderately during 2008 before starting to recover in 2009. Residential investment would continue to drop, consumption would be held back by tighter credit, declining household wealth, and deteriorating employment conditions, and business investment would also be weak. Relative to the lower growth baseline, the potential for further downside surprises to domestic demand has receded somewhat, but remains sizeable especially for 2009 when the projected recovery could be stifled by a confluence of continuing financial strains, a deep housing market correction, and the deteriorating household balance sheets. In particular, a sharper drop in house prices than currently projected could have serious repercussions, both through a direct impact on household net wealth and the impact on mortgage-related losses to bank capital from rising default rates.

The *euro area* continued to grow at a well above potential 2.6 percent in 2007, fuelled by robust domestic demand. Looking ahead, however, growth is forecast to decelerate to 1.4 percent in 2008 and 1.2 percent in 2009, 0.2 and 0.7 percent slower than in the January 2008 baseline respectively, as consumer and business sentiment deteriorate in response to financial sector stresses, and the impact of the U.S. slowdown and sharp appreciation of the euro feeds through. Relative to the baseline, risks to the growth outlook are seen as broadly balanced, with financial and external risks to the downside and domestic demand risks to the upside. Despite prospects for moderating growth, inflation pressures remain a source of concern, with headline inflation in the euro area rising to 3.5 percent in February 2008, owing to the surge in energy and food prices. While core inflation remained stable in 2007, concerns about second-round price effects have increased, especially with unemployment at its lowest level since the early 1990s.

Japan's economy remained resilient to the global slowdown through the end of the year, and GDP rose at 2.1 percent in 2007—above potential—sustained by robust net exports and business investment. However, growth is expected to slow to 1.4 percent in 2008 and 1.5 percent in 2009, owing to weaker export growth and consumption. Against the considerable uncertainty surrounding global growth, the risks to the lower baseline forecast still appear tilted to the downside. The key risk is a sharper-than-anticipated slowdown in the global economy, which would also adversely affect the demand for Japanese exports from emerging economies, and would lower business and consumer confidence.

Growth in *emerging Asia* remained strong in the second half of 2007, although with some emerging signs of softness. Growth was led by China, where output expanded by 11½ percent in the second half of 2007, driven by strong investment growth and net exports, and India, where output rose 8½ percent as investment continued at a brisk pace, while consumption cooled in response to tighter monetary policy. Growth in emerging Asia is expected to decelerate but remain robust at about 7.6 percent in 2008 and 7.9 percent in 2009, compared with 9.1 percent in 2007, as the negative impact from weaker net exports and, to a lesser extent, lower capital inflows due to the tightening of global financial conditions are only partially mitigated by the strength of domestic demand. Risks to the outlook remain broadly balanced. A sharper-than-anticipated slowdown in the advanced economies could be expected to have a pronounced adverse impact on the region's growth prospects, cooling investment as well as export growth. On the upside, domestic demand could be more resilient than projected to tightening measures and a weaker external environment.

Growth in *Latin America* reached a robust 5.6 percent in 2007, slightly stronger than in 2006, capping the region's best four-year performance since the 1970s. Looking ahead, growth in the region is projected to be dampened but not overwhelmed by the slowdown in the United States and other advanced economies and by tighter financial conditions. GDP growth is expected to moderate to 4.4 percent in 2008 and to slow further to 3.6 percent in 2009. The greater resilience of the region can be explained by the progress on the domestic front—lower external debt, higher international reserves, and stronger government and corporate balance sheets in many countries in the region—but also the specific character of the current global business cycle, as sustained strong growth in other emerging economies is expected to keep commodity prices at high levels despite the slowdown in the advanced economies.

Growth in *emerging Europe* moderated by almost a full percentage point to 5.8 percent in 2007. In most countries, growth continued to be driven by buoyant domestic demand, which again substantially outpaced production in 2007, inducing a further widening of the region's overall current account deficit. Demand continued to be supported by strong credit growth fueled by capital inflows and—in many countries—vigorous wage growth, as labor market conditions tightened further. The outlook for 2008 is for a further slowing of GDP growth to 4.4 percent. Growth in most economies in the region would ease closer to potential, reflecting a slowing both of domestic demand and of export growth in the face of lower demand from western Europe. A critical risk for the region's outlook, however, is the degree to which external bank flows could be disrupted by tightening conditions in mature financial markets, inducing a disorderly unwinding of large external imbalances in some countries, with spillovers to the rest of the region.

Growth in the *Commonwealth of Independent States* was sustained at 8.5 percent in 2007, as high commodity prices, expansionary macroeconomic policies, strong capital inflows during most of the year, rapid credit growth, and rising asset prices fueled very strong domestic demand growth. While high oil and commodity prices should continue to provide support, a weaker global economy and slower credit growth would slow the pace of the expansion. Consequently, real GDP growth is expected to ease to 7 percent this year and 6.5 percent in 2009. Risks to the outlook are tilted to the downside, as a sharper-than-expected slowdown in the global economy would likely lead to a decline in oil and commodity prices, a key driver of regional growth, and could adversely affect external financing conditions.

The pace of economic activity in *sub-Saharan Africa* (SSA) accelerated to 6.8 percent in 2007, led by very strong growth in oil-exporting countries and supported by robust expansions in the region's other economies. As regional economies are becoming more diversified, and benefit from improved policies and structural reforms that are under way in many countries, they should be more resilient to a slowdown in the advanced economies than in the past. Growth in SSA during 2008–09 is thus projected to slow only modestly from the pace recorded in 2007, both in oil exporters and nonfuel exporting countries. Still, the balance of risks is tilted to the downside, with the key downside risk being a sharper-than-expected slowdown in the advanced economies that reduces the demand for the region's principal commodity exports.

In the *Middle East*, growth remained strong over 2007, reaching 5.8 percent for the year. Outside of the main oil-exporting countries growth has been even stronger, spurred by trade and financial spillovers from oil-exporting countries as well as domestic reforms. The short-term outlook for the region generally remains positive, with growth projected to rise to over 6 percent in both 2008 and 2009. Risks to the outlook at this stage appear broadly balanced. Continued high oil prices and/or the large cut in U.S. interest rates could stimulate a stronger-than-expected expansion of domestic demand, although this would likely come at the cost of higher inflation and would create risks of a possible asset price bubble. A broad-based global slowdown that resulted in a substantial drop in oil prices and regional geopolitical uncertainties are the main near-term downside risks to the outlook.

Policy Issues

Policymakers around the world face a 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 the financial market crisis and responding to downside risks to growth—but policy choices should also take into account recent high inflation indicators and longer-term concerns. In the United States, rising downside risks to output justify the Federal Reserve's rapid interest rate cuts and a continuing bias toward monetary easing until the economy moves to a firmer footing. Although the recent jump in headline inflation caused by higher energy and food prices, and the uptick in core inflation are of concern, softening labor markets and a rising output gap have alleviated inflation risks. In the euro area, while 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 ECB can afford some easing of the policy stance. In Japan, there is merit in keeping interest rates on hold for now, but there would be some scope, albeit limited, to reduce interest rates from already low levels if there is a substantial deterioration in growth prospects.

Fiscal policy can play a useful countercyclical role in a downturn in economic activity. In countries where automatic stabilizers are more extensive, such as in the euro area, they should be allowed to play out fully around a fiscal deficit path that is consistent with steady advancement toward medium-term objectives. In the United States, however, where automatic stabilizers are quite low, the recent legislation to provide additional fiscal support for an economy under stress is fully justified, and fiscal space may need to be found to provide support and help stabilize housing and financial markets. However, it will be important not to jeopardize long-term fiscal consolidation goals, which are important to help reduce global imbalances as well as meet challenges from an aging population and rising healthcare costs. In Japan, where net public debt is projected to remain at very high levels, automatic stabilizers could be allowed to operate in the context of an economic downturn, but further consolidation efforts would buy "policy insurance" against shocks and help meet the challenges associated with an aging society.

Policymakers in advanced economies 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. Priorities include rebuilding counterparty confidence, reinforcing the financial soundness of institutions, and easing liquidity strains. Initiatives to support the housing sector could also play a useful role to reduce the negative feedback between house prices, delinquency rates, and financial losses. Forceful action is essential to avoid the protracted problems that could impose a lingering drag, such as was experienced in Japan in the 1990s after the collapse of its equity and housing bubbles. In the longer term, policies should be developed to bolster the resilience of the financial system. In this regard, steps are needed to enhance the oversight of mortgage originators; reform the credit ratings system, especially as it is applied to structured credit instruments; enhance the supervision and regulation of banks and nonbanks, including with regard to liquidity risk management and disclosure of off-balance sheet entities. Priority will also need to be attached by central banks and supervisors to strengthening crisis management and resolution mechanisms, including bank resolution frameworks, deposit insurance, and central bank liquidity facilities.

Emerging and developing economies face the challenge of controlling inflation while being alert to downside risks from the slowdown in the advanced economies and the increased stress on financial markets. In some countries, further tightening of monetary policy stances may be needed to keep inflation under control, recognizing that even though higher headline inflation may be driven initially by rising food and energy prices, it could quickly lead to broader price and wage pressures in a rapidly growing economy. China and other countries in this situation that have diversified economies would benefit from moving toward more flexible exchange rate regimes that would provide greater scope for monetary policy. Fiscal and financial policies can also play useful roles in preventing overheating and related problems. Restraint on government spending can help moderate domestic demand, lessen the need for monetary tightening, and ease pressures from short-term capital inflows attracted by high interest rates. Similarly, vigilant financial supervision can help by moderating the demand impulse from rapid credit growth and by reducing the risk of a buildup in balance-sheet vulnerabilities that could be costly in a downturn.

At the same time, policymakers in these countries should be ready to respond to a more negative external environment, which could well emerge in the months ahead and could involve both weaker trade performance and a reduction of 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. The appropriate mix will need to be judged country by country. 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 a downturn in activity and an alleviation of inflation pressures. Automatic fiscal stabilizers could be allowed to operate, although there would be less room for discretionary fiscal stimulus, given still-high public debt levels. However, some countries that have large current account deficits or other vulnerabilities, such as some economies in Emerging Europe, may need to respond by tightening policies promptly in order to maintain confidence and avoid the type of external crises experienced in earlier decades.

Finally, reducing risks associated with global current account imbalances remains an important task. Therefore, 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. This road map remains relevant, but should be used flexibly to take account of the changing global context. Thus, some reversal of recent progress toward fiscal consolidation in the United States can provide insurance against a worldwide slowdown, but it will be important that the fiscal support be strictly temporary, and not be allowed to jeopardize medium-term consolidation goals. In China, further tightening of monetary policy alongside upward flexibility of the remnimbi would contribute to rebalance the Chinese economy and contain inflationary pressures while easing downward pressure on other major currencies in response to the depreciating dollar. For the oil-exporting countries, priority should be given to tackling supply bottlenecks, which have contributed to rising inflationary pressures as domestic spending has built up. And in the euro area and Japan, more rapid progress with structural reforms of product and labor markets could provide an additional boost to confidence and help sustain growth.