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

The world economy is now entering a major slowdown as a result of the most severe shock to mature financial markets since the 1930s, adding to pressure on global economies from high prices for oil and other commodities. Advanced economies face several quarters of near-zero growth, before recovering very gradually later next year. On an 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. For advanced economies, projected growth would slow to about 0.5 percent in 2009. Emerging economies have thus far been less affected by the shocks, with many commodities exporters benefiting from improved terms of trade. But they will also feel the effects of tightening credit and reduced demand. Accordingly, their real GDP growth is expected to slow from around 8 percent in 2007 to 6.1 percent in 2009. The combination of rising slack and stabilizing commodity prices is expected to bring inflation in advanced economies back below 2 percent in 2009. In emerging and developing economies, which suffered more from the rise in food prices, inflation is projected to recede to about 6¼ percent in late 2009.

The financial crisis that originated in the collapse of U.S. subprime mortgage market in August 2007 has deepened further and is now affecting many parts of the global financial system, including emerging markets. Intensifying solvency concerns about a number of the largest U.S.-based and European financial institutions have pushed the global financial system to the brink of systemic meltdown since mid-September. The United States and European authorities have taken extraordinary measures, including massive liquidity provision, intervention to restore weak institutions, extension of guarantees. Legislation has been enacted in the United States to use public funds to buy troubled assets from U.S.-based banks. And there have been coordinated policy rate cuts from a number of advanced-economy central banks. But these measures have not yet achieved the goal of stabilizing markets and bolstering confidence. Thus, additional moves will likely be needed in the coming months.

Short-term prospects

Looking ahead, financial conditions are expected to remain very difficult, restraining global growth prospects. The baseline projections assume that policies succeed in restoring more normal market functioning. However, with losses mounting as economies slow, raising private capital will continue to be difficult. Accordingly, the deleveraging process is likely to be long and arduous, implying downward pressure on credit creation and activity.

Nonetheless, three key factors lay the ground for an emerging recovery in 2009. First, commodity prices are projected to stabilize, although at much higher levels than at any time in the past twenty years. 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. Second, the U.S. housing sector should reach bottom some time in

2009, following a deep retrenchment. Third, emerging economies should provide a source of resilience, although the longer the crisis lasts the more they are likely to be affected.

Accordingly, growth in advanced economies is projected to pick up in the second half of late 2009 and return to potential in 2010. However, uncertainty is exceptionally large and there are major downside risks. The principal concerns are that financial stress could remain 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 could deteriorate for longer than envisaged, and weakness in European housing markets could spread more broadly.

Turning to individual countries and regions, economic growth in the *United States* continued at a moderate pace in the first half of 2008, but the outlook is for output declining in the second half, with further weakness in 2009. On an annual basis, real GDP growth is expected to slow to 1.6 percent in 2008 and 0.1 percent in 2009. There is a tepid recovery projected for the second half of 2009, reflecting lower commodity prices, stabilizing residential real estate-related activity, and still relatively healthy nonfinancial corporate sector balance sheets. Underlying price pressures would remain contained as economic slack rises.

Activity in the *euro area* has decelerated sharply. Higher oil and food prices have undercut real disposable incomes, while tighter financial conditions have raised the costs of household mortgages and slowed investment. Residential real estate prices and activity are falling in several countries. As in the United States, financial conditions have tighetened significantly. Real GDP growth is now projected to come in at 1.3 and 0.2 percent, on an annual basis, for 2008 and 2009, respectively. There is a mild pick-up projected later in 2009. Assuming stable energy prices, headline inflation is projected to fall below 2 percent in 2009.

The near-term outlook for *Japan* has weakened noticeably. Financial conditions have tightened to a lesser extent than in other major economies, in part owing to Japanese banks' lower exposure to securitized products, but prospects remain uncertain. Accordingly, annual growth is expected to weaken to 0.7 and 0.5 percent in 2008 and 2009 respectively. While headline inflation has risen on the back of higher food and fuel prices, underlying inflation remains around zero. Stabilizing terms of trade and a recovery in export demand should reaccelerate real GDP growth mildly in the course of 2009, but this depends on economic conditions elsewhere.

Growth in *emerging Asia* will moderate over the near term, but is projected to remain around trend in many countries. While decelerating external demand is weighing on exports, in some cases the impact on firms is mitigated by still loose macroeconomic policies and currency depreciation. Annual growth in China is expected to fall from about 12 percent in 2007 to 9¼ percent in 2009; in India, growth is expected to slow from just over 9 percent in 2007 to around 7 percent in 2009. Similar developments are expected in NIEs and ASEAN countries. Financial markets have weakened and current accounts and currencies have come under pressure in several countries. Inflation is high across the region and pressures are expected to recede, although still remaining elevated in some countries.

After four years of strong growth, the pace of growth in *Latin America* eased in most of the region in the first half of 2008, largely due to moderating export growth. Domestic demand has remained quite robust so far this year, sustained by terms of trade gains for commodity exporters, but is expected to ease as the global economy slows and as countries in the region shift toward monetary policy tightening to contain elevated inflationary pressures. Countries have also been facing more difficult financing conditions in recent months, and an intensification of this process represents a clear downside risk. Overall, annual real GDP growth is projected to come down from about 5½ percent in 2007 to just over 3 percent in 2009. Growth in Brazil would come down below trend and would remain sluggish in Mexico, as exports and remittances are dampened by the U.S. slowdown.

Following a prolonged economic expansion, activity in *central and eastern Europe* has started to moderate and a significant slowdown is in prospect. Annual growth is expected to fall from about 5½ percent in 2007 to 3½ percent in 2009. Weaker external demand and tighter external financing conditions have weighed on investment and exports, while private consumption has slowed in the face of soaring food and energy prices. Some countries are already undergoing sharp corrections, as large domestic and external imbalances that had accumulated during drawn-out consumption-and-investment booms are starting to unwind. As growth moderates, inflationary pressures would level off. The latest events have raised uncertainty about prospects for capital inflows, as foreign banks operating in emerging Europe are being increasingly affected by the turmoil, and a range of countries are vulnerable to a reversal of capital inflows.

Annual real GDP growth has been strong in most countries of the *Commonwealth of Independent States* (CIS), at over 8 percent in 2007, underpinned by buoyant domestic demand that has been boosted by terms of trade gains in most countries in the region and expansionary macroeconomic policies. However, the region has been increasingly affected by the global financial turmoil, with net commodity importers in particular seeing a marked weakening in their external positions. Annual real GDP growth is projected to slow to 5¾ percent in 2009, as recent oil price declines and lower capital inflows are set to weaken the momentum of activity. High world prices for food and fuel have contributed significantly to inflation pressures across the region. Headline inflation accelerated sharply during the first half of 2008, and core inflation is rising. Despite falls in activity, inflation is projected to remain high at over 15 percent in 2008, receding somewhat in 2009.

Growth in *sub-Saharan Africa* (SSA) is expected to show resilience to the global slowdown, as many countries are benefiting from terms-of-trade gains resulting from the surge in commodity prices. However, risks for a slowing of capital inflows are rising. Overall, growth is projected to decline moderately from 7 percent in 2007 to around 6¼ percent in 2009. For oil importers, the terms of trade are expected to deteriorate, on average modestly, with higher oil and food prices only partly offset by higher export prices of metal, coffee, cocoa, and cotton. This is likely to put the external positions of several of these countries under pressure. Recent sharp increases in food and fuel prices pose significant challenges for price stability across SSA. Inflation is expected to rise from about 7 percent in 2007 to about 12 percent in 2008, before easing to 9½ percent in 2009. Against the backdrop of rising inflation, the impact of higher food prices and slowing global activity on poverty is a major concern.

Activity continues to expand at a robust pace in much of the *Middle East*, while inflation pressures either remain high or keep rising. Annual real GDP growth in Middle Eastern countries is projected at just under 6½ in 2008 before declining to about 6 percent in 2009, with oil exporters and non-oil economies growing at a similar pace. The regions have not felt major effects from the financial turmoil thus far. Economic growth is being sustained mainly by non-oil sectors. Oil and natural gas production capacity and, to a lesser extent, output are projected to grow moderately in 2008–09. Inflation has reached double-digit rates despite limited pass-through of high fuel and, to a lesser extent, food prices to domestic markets. Oil exporters are recording large and growing current account surpluses, generally projected to reach 10–50 percent of GDP in 2008–09, while deficits in the other countries have widened in response to rising import costs, reaching double-digit levels in a few countries, with associated financial vulnerabilities.

Policy Issues

The immediate challenge for policymakers is to stabilize financial conditions, while nursing economies through slow growth and keeping inflation under control.

Financial authorities are actively pursuing policies intended to restore orderly conditions in financial markets. Achieving this daunting task will require comprehensive responses that address the systemic problems—encouraging loan-loss recognition, 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 avoid creating adverse cross-border incentives. The U.S. initiative to purchase real-estate-related assets and U.K. measures to make capital available to the largest retail banks and building societies should help over time to reduce the pressure on the financial system from distressed assets, and thus support a return of liquidity and confidence. Public funds will likely be needed in the U.S. and western Europe to help banks rebuild their capital bases. 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. Schemes for bank support may also be needed in other parts of the world.

Addressing the stresses in financial markets in a lasting way requires action on a number of other fronts. A central objective is to ensure more effective and resilient risk management by individual institutions, including more robust regulatory capital requirements, stronger liquidity management practices, and improved disclosure of on- and off-balance sheet risk. Consideration should also be given to introducing a macroeconomic element in the financial prudential framework to weigh against the inherent procyclicality of credit creation, as well as to the possibility of extending monetary policy frameworks to provide for "leaning against the wind" of asset price movements, although this raises various complexities. Furthermore, the financial turmoil has revealed that national financial stability frameworks have failed to keep up with financial market innovation and globalization, and this needs to be remedied. Key to substantial progress on this and other fronts is greater

cross-border coordination and collaboration among national prudential authorities, given the ever-larger international integration of institutions and markets. This is particularly important for the purpose of preventing, managing, and resolving financial stress.

Regarding *macroeconomic policies*, the precise requirements differ according to countries' cyclical positions, external current accounts, structural factors, and risks to activity. In advanced economies, the deflationary impact of the major financial shock, growing unemployment fears, and solidly-anchored inflation expectations have created room for easing monetary policy, especially in those economies that still have relatively high short-term interest rates, such as the euro area and the United Kingdom. U.S. monetary policy thus far has provided appropriate support to the economy but further easing might be needed if the outlook deteriorates further. In Japan, with the economy weakening and underlying price pressures well contained, monetary policy should remain accommodative.

Regarding fiscal policy in advanced economies, automatic stabilizers play a useful role in buffering shocks and should be allowed to operate freely providing that adjustment paths are consistent with long-term sustainability, further discretionary support should be focused on supporting financial and, where appropriate, housing sectors. In the United States, the fiscal stimulus package provided a timely boost to activity while in the euro area, automatic stabilizers can be allowed to play freely around adjustment paths to medium-term objectives, except when this might lead to breaches of EU fiscal rules. For Japan, the priority remains medium-term consolidation owing to a rapidly aging population and rising public debt; any fiscal stimulus should be limited in size.

Macroeconomic policy priorities vary considerably across emerging and developing economies, as policy makers must balance growth and inflation risks. In an increasing number of these countries, the balance of risks is now shifting towards concerns with 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 in countries 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. However, in some other countries inflation pressures are still rising in the context of sharp increases in food prices, continued strong growth, and tightening supply constraints. Policymakers in these countries may still need to tighten policy settings further.

Countries with inflexible exchange rate regimes face significant challenges. Many are now importing a highly accommodative monetary policy stance from the United States. Under current circumstances, these countries would benefit from more flexible exchange rates and some should consider moving in this direction. There are, however, many longer-run considerations that feed into choices of exchange rate regimes. Fiscal deficits need to be lowered in emerging economies that are experiencing high inflation and operate with currency pegs. The tightening, however, would have to be selective, leaving room for targeted support for the poor that are struggling to meet rising food costs as well as for infrastructure projects that alleviate bottlenecks to activity. Regarding other emerging economies, a number have greater scope than in the past to use countercyclical fiscal policy should their economic outlook deteriorate. However, past experience suggests that this is

unlikely to be effective unless confidence in fiscal sustainability has been firmly established, and measures are timely and well targeted.

Beyond addressing the financial turmoil, multilateral efforts take on particular importance to alleviate the tightness in commodities markets, lower global imbalances, and support low-income economies burdened by high food prices.

The recent declines in commodity prices should not detract from efforts to relieve strains in commodity markets. Joint multilateral efforts will be required to encourage better balance between supply and demand in the longer term, while avoiding measures that could exacerbate market tightness in the short term. This needs to include greater pass-through of international price changes to domestic markets and greater energy conservation in the advanced economies. Priority should also be given to policies to strengthen supply responses to higher prices. Action in advanced economies to reduce subsidies and trade restrictions to promote use of domestic biofuels would allow a shift to more efficient and environmentally preferable alternatives.

The surge in commodity prices has led to a further widening in global imbalances. Some progress has been made toward the unwinding of the large U.S. current account deficit. However, the euro remains on the strong side of medium-run fundamentals and the currencies of a number of current account surplus countries on the weak side. The multilateral strategy endorsed by the IMFC in 2005 and elaborated by the Multilateral Consultation in 2006-07 remains relevant, but needs to be applied flexibly. U.S. fiscal consolidation remains a key medium-term objective, but counter-cyclical fiscal support has been needed to alleviate the current slowdown. Progress needs to continue toward appreciation of the renminbi as part of China’s broader strategy to shift the sources of growth toward internal demand and to increase the effectiveness of monetary policy. Middle Eastern oil exporters will need to adjust plans to build-up spending out of oil revenues in order to reduce over-heating in their economies, including both less ambitious spending increases and a tighter focus on relieving supply bottlenecks. The euro area and Japan should press ahead with reforms to raise potential growth in their economies.

Finally, it will be important to break the current deadlock on the Doha round so as to help strengthen the open multilateral trading system, including by liberalizing access for agricultural products to advanced economy markets. This would also play an important part to establishing a stronger long-term framework for agricultural development in response to the surge in food prices. In the meantime, greater donor support for the poorest economies will be crucial to address humanitarian challenges. On the capital account side, the growing role of sovereign wealth funds as an investment vehicle is an important development. The set of principles and practices recently agreed by sovereign wealth funds for their governance, investment, and risk will contribute to reducing concerns about these types of funds that could lead to counter-productive restrictions on such inflows.