EXECUTIVE SUMMARY

The global economy grew strongly in the first half of 2007, although turbulence in financial markets has clouded prospects. While the 2007 forecast has been little affected, the baseline projection for 2008 global growth has been reduced by almost ½ percentage point relative to the July 2007 World Economic Outlook Update. *This would still leave global growth at a solid 4¾ percent, supported by generally sound fundamentals and strong momentum in emerging market economies. Risks to the outlook, however, are firmly on the downside, centered around the concern that financial market strains could deepen and trigger a more pronounced global slowdown. Thus, the immediate focus of policymakers is to restore more normal financial market conditions and safeguard the expansion. Additional risks to the outlook include potential inflation pressures, volatile oil markets, and the impact on emerging markets of strong foreign exchange inflows. At the same time, longer-term issues such as population aging, increasing resistance to globalization, and global warming are a source of concern.*

Global Economic Environment

The global economy continued to expand vigorously in the first half of 2007, with growth running above 5 percent (Chapter 1). China's economy gained further momentum, growing by 11½ percent, while India and Russia continued to grow very strongly. These three countries alone have accounted for one-half of global growth over the past year. Robust expansions also continued in other emerging market and developing countries, including low-income countries in Africa. Among the advanced economies, growth in the euro area and Japan slowed in the second quarter of 2007 after two quarters of strong gains. In the United States, growth averaged 2¼ percent in the first half of 2007 as the housing downturn continued to apply considerable drag.

Inflation has been contained in the advanced economies, but it has risen in many emerging market and developing countries, reflecting higher energy and food prices. In the United States, core inflation has gradually eased to below 2 percent. In the euro area, inflation has generally remained below 2 percent this year, but energy and food price increases contributed to an uptick in September; while in Japan, prices have essentially been flat. Some emerging market and developing countries have seen more inflation pressures, reflecting strong growth and the greater weight of rising food prices in their consumer price indices. The acceleration in food prices has reflected pressure from the rising use of corn and other food items for biofuel production and poor weather conditions in some countries (Appendix 1.1). Strong demand has kept oil and other commodity prices high.

Financial market conditions have become more volatile. As discussed in the October 2007 *Global Financial Stability Report* (GFSR), credit conditions have tightened as increasing concerns about the fallout from strains in the U.S. subprime mortgage market led to a spike in yields on securities collateralized with such loans as well as other higher-risk securities. Uncertainty about the distribution of losses and rising concerns about counterparty risk saw liquidity dry up in segments of the financial markets. Equity markets initially retreated, led by falling valuations of financial institutions, although prices have since recovered, and long-term government bond yields declined as investors looked for safe havens. Emerging markets have also been affected, although by relatively less than in previous episodes of global financial market turbulence, and asset prices remain high by historical standards.

Prior to the recent turbulence, central banks around the world were generally tightening monetary policy to head off nascent inflation pressures. In August, however, faced by mounting market disruptions, major central banks injected liquidity into money markets to stabilize short-term interest rates. In September, the Federal Reserve cut the federal funds rate by 50 basis points, and financial markets expect further reductions in the coming months. Expectations of policy tightening by the Bank of England, Bank of Japan, and European Central Bank have been rolled back since the onset of the financial market turmoil. Among emerging markets, some central banks also provided liquidity to ease strains in interbank markets, but for others the principal challenge remains to address inflation concerns.

The major currencies have largely continued trends observed since early 2006. The U.S. dollar has continued to weaken, although its real effective value is still estimated to be above its medium-term fundamental level. The euro has appreciated but continues to trade in a range broadly consistent with fundamentals. The Japanese yen has rebounded strongly in recent months but remains undervalued relative to medium-term fundamentals. The renminbi has continued to appreciate gradually against the U.S. dollar and on a real effective basis, but China's current account surplus has widened further and its international reserves have soared.

Outlook and Risks

In the face of turbulent conditions in financial markets, the baseline projections for global growth have been marked down moderately since the July *World Economic Outlook Update*, although growth is still expected to continue at a solid pace. The global economy is projected to grow by 5.2 percent in 2007 and 4.8 percent in 2008—the latter forecast is 0.4 percentage point lower than previously expected. The largest downward revisions to growth are in the United States, which is now expected to grow at 1.9 percent in 2008; in countries where spillovers from the United States are likely to be largest; and in countries where the impact of continuing financial market turmoil is likely to be more acute (see Chapter 2).

The balance of risks to the baseline growth outlook is clearly on the downside. While the underlying fundamentals supporting growth are sound and the strong momentum in increasingly important emerging market economies is intact, downside risks emanating from the financial markets and domestic demand in the United States and western Europe have increased. While the recent repricing of risk and increased discipline in credit markets could strengthen the foundations for future expansion, it raises the near-term risks to growth. The extent of the impact on growth will depend on how quickly more normal market liquidity returns and on the extent of the retrenchment in credit markets. The IMF staff's baseline forecast is based on the assumption that market liquidity is gradually restored in the coming months and that the interbank market reverts to more normal conditions, although wider credit spreads are expected to persist. Nonetheless, there remains a distinct possibility that turbulent financial market conditions could continue for some time. An extended period of tight credit conditions could have a significant dampening impact on growth, particularly through the effect on housing markets in the United States and some European countries. Countries in emerging Europe and the Commonwealth of Independent States region with large current account deficits and substantial external financing inflows would also be adversely affected if capital inflows were to weaken.

Several other risks could also have an impact on the global outlook. While downside risks to the outlook from inflation concerns have generally been somewhat reduced by recent developments, oil prices have risen to new highs and a further spike in prices cannot be ruled out—reflecting limited spare production capacity. Risks related to persistent global imbalances still remain a concern.

Policy Issues

Policymakers around the world continue to face the immediate challenge of maintaining strong noninflationary growth, a challenge heightened by recent turbulent global financial conditions. In the advanced economies, after a period of tightening that has brought monetary stances close to or above neutral, central banks have addressed the recent drying up of market liquidity and associated financial sector risks while continuing to base monetary policy decisions on judgments about the economic fundamentals. In the United States, signs that growth was likely to continue below trend would justify further interest rate reductions, provided that inflation risks remain contained. In the euro area, monetary policy can stay on hold over the near term, reflecting the downside risks to growth and inflation from financial market turmoil. However, as these risks dissipate, further tightening eventually may be required. In the event of a more protracted slowdown, an easing of monetary policy would need to be considered. In Japan, while interest rates will eventually need to return to more normal levels, such increases should await clear signs that prospective inflation is moving decisively higher and that concerns over recent market volatility have waned.

In due course, lessons will need to be drawn from the current episode of turbulent global financial market conditions. One set of issues concerns the various approaches that central banks have used to provide liquidity to relieve financial strains and the linkage of this liquidity support with financial safety nets. A series of regulatory issues will need to be addressed, as discussed in the October 2007 GFSR. Greater attention will need to be given to ensuring adequate transparency and disclosure by systemically important institutions. It will also be relevant to examine the regulatory approach to treating liquidity risk, the relevant perimeter around financial institutions for risk consolidation, the approach to rating complex financial products, and whether the existing incentive structure ensures adequate risk assessment throughout the supply chain of structured products.

Substantial progress has been made toward fiscal consolidation during the present expansion in advanced economies, but more needs to be done to ensure fiscal sustainability in the face of population aging. Much of the recent improvement in fiscal positions has reflected rapid revenue growth driven by strong growth in profits and high-end incomes, and it is not clear to what extent these revenue gains will be sustained. Further, current budgetary plans envisage limited additional progress in reducing debt ratios from current levels over the next few years. Governments should adopt more ambitious medium-term consolidation plans, together with reforms to tackle the rising pressures on health and social security spending, although in most countries there is scope to let the automatic fiscal stabilizers operate in the event of a downturn.

A number of emerging markets still face overheating pressures and rising food prices, and further monetary tightening may be required. Moreover, notwithstanding recent financial market developments, strong foreign exchange inflows are likely to continue to complicate the task of policymakers. As discussed in Chapter 3, there is no simple formula for dealing with these foreign exchange inflows. Countries need to take a pragmatic approach, finding an appropriate blend of measures suited to their particular circumstances and longer-term goals. Fiscal policy is likely to play a key role. While fiscal positions have improved, this reflects strong revenue growth generated by high commodity prices that may not be sustained. At the same time, government spending in many countries has accelerated, which has added to the difficulties of managing strong foreign exchange inflows. The avoidance of public spending booms, particularly in emerging Europe but also in Latin America, would help both in managing inflows and in continuing to reduce public debt levels. In fuel-exporting countries, however, there is scope to further increase spending, subject to absorptive capacities and the cyclical position of the economy. A tightening of prudential standards in financial systems and steps to liberalize controls on capital outflows can all play useful roles. In some cases, greater exchange rate flexibility would provide more room for better monetary control. Specifically for China, further upward flexibility of the renminbi, along with measures to reform the exchange rate regime and boost consumption, would also contribute to a necessary rebalancing of demand and to an orderly unwinding of global imbalances.

Across all countries, a common theme is the need to take advantage of the opportunities created by globalization and technological advances, while doing more to ensure that the benefits of these ongoing changes are well distributed across the broad population. A key part of this agenda is to make sure that markets work well, with priorities being to boost productivity in the financial and service sectors in Europe and Japan; resist protectionist pressures in the United States and Europe; and improve infrastructure, develop financial systems, and strengthen the business environment in emerging market and developing countries.

Globalization is often blamed for the rising inequality observed in most countries and regions. Chapter 4 of this report finds that technological advances have contributed the most to the recent rise in inequality, but increased financial globalization—and foreign direct investment in particular—has also played a role. Contrary to popular belief, increased trade globalization is actually associated with a decline in inequality. It is important that policies help ensure that the gains from globalization and technological change are more broadly shared across the population. Reforms to strengthen education and training would help to ensure that workers have the appropriate skills for the emerging "knowledge-based" global economy. Policies that increase the availability of finance to the poor would also help, as would further trade liberalization that boosts agricultural exports from developing countries.

Chapter 5 of this report examines the current global expansion from a historical perspective. It finds that not only has growth been stronger than in other recent cycles, but also the benefits are being more widely shared across the world and economic volatility has been lower. Indeed, better monetary and fiscal policies, improved institutions, and increased financial development mean that it is likely that business cycles will be of longer duration and lesser magnitude than in the past. Nevertheless, the prospects for future stability should not be overstated, and recent increased financial market volatility has underlined concerns that favorable conditions may not continue. The abrupt end to the period of strong and sustained growth in the 1960s and early 1970s provides a useful cautionary lesson of what can happen if policies do not adjust to tackle emerging risks in a timely manner.

In some key areas, joint actions across countries will be crucial. The recent slow progress with the Doha Trade Round is deeply disappointing, and major countries should demonstrate leadership to re-energize the process of multilateral trade liberalization. Concerns about climate change and energy security also clearly require a multilateral approach. As discussed in Appendix 1.2, global warming may be the world's largest collective action problem where the negative consequences of individual activities are felt largely by others. It will be important that countries come together to develop a market-based framework that balances the long-term costs of carbon emissions against the immediate economic costs of mitigation. Energy policy should focus less on trying to secure national sources of energy and more on ensuring the smooth operation of oil and other energy markets, encouraging diversification of energy sources (for example, by reducing barriers to trade in biofuels), and paying greater attention to price-based incentives to curb the growth of energy consumption.

Welcome progress has been made toward developing a joint approach toward tackling global imbalances, and this now needs to be followed through. The IMF's Multilateral Consultation on Global Imbalances with key countries represents the first use of an innovative approach to addressing systemic global challenges. The Consultation provided a forum to strengthen mutual understanding of the issues, to reaffirm support for the International Monetary and Financial Committee (IMFC) Strategy of sustaining global growth while reducing imbalances, and for each country to indicate specific policies consistent with the Strategy. The result of the Consultation was a set of policy plans that, according to IMF staff analysis, will make a significant contribution toward the goals of the IMFC Strategy. With the agreement of the participants in the Consultation, the implementation of the policy plans will be the subject of regular IMF surveillance.