

Financial turbulence clouds growth prospects

Following strong growth through the third quarter of 2007, the global economic expansion has begun to moderate in response to continuing financial turbulence. Global growth is projected to decelerate from 4.9 percent in 2007 to 4.1 percent in 2008, a markdown of 0.3 percentage point relative to the October 2007 World Economic Outlook. Risks to the outlook remain tilted to the downside.*

Recent data suggest that global growth slowed markedly in the final quarter of 2007 in the face of significant headwinds from the financial sector, following a stronger than expected third quarter. As discussed in the accompanying *GFSR Financial Market Update*, the financial market strains originating in the U.S. subprime sector—and associated losses on bank balance sheets—have intensified, while the recent steep sell-off in global equity markets was symptomatic of rising uncertainty. Economic growth in the United States slowed notably in the fourth quarter, with recent indicators showing weakening of manufacturing and housing sector activity, employment, and consumption. Growth has also slowed in western Europe, and confidence indicators have generally deteriorated. In Japan, growth has been dampened by a tightening in building standards, while consumer and business sentiment has weakened. Despite some slowing of export growth, emerging market and developing economies have thus far continued to expand strongly, led by China and India. These economies have benefited from the strong momentum of domestic demand, more disciplined macroeconomic policy frameworks, and for commodity exporters, from high food and energy prices as well.

*The global and regional growth aggregates in this Update use country weights calculated from the new PPP data published by the International Comparison Program in December 2007. This has resulted in a downward revision of the estimates of global growth during 2005–08 of around ½ percentage point a year relative to the estimates in the October 2007 World Economic Outlook. See <http://www.imf.org/external/pubs/ft/survey/so/2008/RES018A.htm> for more details.

Headline inflation has increased since mid-2007 in both advanced and emerging market economies. Core inflation has also drifted upward. In the United States, the Federal Reserve has been cutting interest rates in response to increasing downside risks to activity, while policy has been on hold in the euro area and Japan. Meanwhile, central banks have continued to tighten monetary policy in many emerging market economies, where food and energy represent a higher share of consumption baskets and overheating is more of a concern.

Against this background, global growth is projected at 4.1 percent in 2008, down from 4.9 percent in 2007 (Table 1). The projections for the advanced economies have been reduced significantly. Projected growth in the United States in 2008 has been lowered to 1.5 percent on a year-on-year basis, down from 2.2 percent in 2007. The annual growth figure for the U.S. economy in 2008 reflects the carryover from 2007. Projections on a fourth-quarter-on-fourth-quarter basis thus give a better sense of the slowing growth momentum. On this basis, growth is projected at 0.8 percent in 2008, compared to 2.6 percent over the same period in 2007. For the euro area, growth has been lowered to 1.3 percent, again on a fourth-quarter-to-fourth-quarter basis, compared to 2.3 percent during 2007.

This is the second in a series of *World Economic Outlook Updates*, which will be posted between the full Spring and Fall WEO reports. For all inquiries related to the content of this *Update*, please e-mail weo@imf.org.

Table 1. World Economic Outlook Update Projections*(Annual percent change unless otherwise noted)*

	2005	2006	Estimates		Projections		Difference from October 2007 Projections ¹		Estimates	Projections
			2007	2008	2007	2008	2006 Q4 to 2007 Q4	2007 Q4 to 2008 Q4		
World Output	4.4	5.0	4.9	4.1	0.2	-0.3	...	...
Advanced economies	2.5	3.0	2.6	1.8	0.1	-0.4	2.6	1.5		
<i>of which</i>										
United States	3.1	2.9	2.2	1.5	0.3	-0.4	2.6	0.8		
Euro area (15)	1.5	2.8	2.6	1.6	0.1	-0.5	2.3	1.3		
Japan	1.9	2.4	1.9	1.5	-0.1	-0.2	1.2	1.6		
Other advanced economies	3.2	3.7	3.8	2.8	0.1	-0.2	3.9	2.9		
Emerging market and developing economies	7.0	7.7	7.8	6.9	0.2	-0.2	...	...
Africa	5.9	5.8	6.0	7.0	—	-0.2	...	...
Central and eastern Europe	5.6	6.4	5.5	4.6	-0.3	-0.6	...	...
Commonwealth of Independent States	6.6	8.1	8.2	7.0	0.5	—	...	...
Developing Asia	9.0	9.6	9.6	8.6	—	-0.1	...	...
<i>of which</i>										
China	10.4	11.1	11.4	10.0	-0.1	—	11.2	9.4		
Middle East	5.6	5.8	6.0	5.9	0.1	-0.1	...	...
Western Hemisphere	4.6	5.4	5.4	4.3	0.5	—	...	...

Note: Real effective exchange rates are assumed to remain constant at the levels prevailing during December 4, 2007–January 2, 2008.

¹Country weights used to construct aggregate growth rates for groups of countries were revised from those reported in the October 2007 World Economic Outlook to incorporate updated PPP exchange rates released by the World Bank.

Growth in emerging market and developing economies is also expected to ease, moderating from 7.8 percent (on an annual basis) in 2007 to 6.9 percent in 2008. In China, growth is projected to decelerate from 11.4 percent to 10 percent, which should help alleviate overheating concerns.

The overall balance of risks to the global growth outlook is still tilted to the downside. The main risk to the outlook for global growth is that the ongoing turmoil in financial markets would further reduce domestic demand in the advanced economies and create more significant spillovers into emerging

market and developing economies. Growth in emerging market economies that are heavily dependent on capital inflows could be particularly affected, while the strong momentum of domestic demand in some emerging market economies provides upside potential. In addition, a number of other risks also remain elevated. Monetary policy faces the difficult challenge of balancing the risks of higher inflation and slower economic activity, although a possible softening of oil prices could moderate inflation pressures. There are also concerns about continuing large global imbalances, in the context of heightened financial volatility.