This World Economic Outlook presents the IMF staff’s view of the world economy in spring 2008, with our assessment of current conditions and prospects and with an in-depth analysis of several key elements that will affect conditions and prospects in the months and years ahead. This report has been prepared by a team composed primarily of the staff of the World Economic Studies division, ably led by Charles Collyns and, since January, Subir Lall. I would also like to recognize the particular contribution of Tim Callen, who led this division for three years and who helped shape this issue of the World Economic Outlook during its design and development. In addition, I must emphasize, as always, that other IMF staff, both within the Research Department and across the organization, have played critical roles in producing this report, through direct contributions to all the chapters and through a continual process of collegial interaction and productive feedback.

The world economy has entered new and precarious territory. The U.S. economy continues to be mired in the financial problems that first emerged in subprime mortgage lending but which have now spread much more broadly. Strains that were once thought to be limited to part of the housing market are now having considerable negative effects across the entire economy, with rising defaults, falling collateral, and tighter credit working together to create a powerful and hard-to-defeat financial decelerator.

In addition to serious problems at the intersection of credit and the real economy, the United States remains plagued by profound errors in risk management among its leading financial institutions. Problems that were once thought to be limited to issues surrounding liquidity in short-term money markets—and thought capable of being dealt with as such—have cascaded across much of the financial sector, triggering repeated waves of downgrades, upward adjustment of losses for both U.S. and European banks, and now an apparently unstoppable move toward some significant degree of global deleveraging.

This cutback in lending and the associated attempt to reduce risks played a major role in a most dramatic pair of events—both of which happened as this World Economic Outlook entered its final stages of preparation. First, one of the five largest U.S. investment banks, Bear Stearns, was sold under difficult circumstances—including the presumed imminence of a far-reaching default. Second, and just as headline-grabbing, were the virtually unprecedented steps taken by the Federal Reserve to prevent Bear Stearns’s problems from spreading. These steps have had a definite stabilizing effect, at least for now.

In our view, the continuing deep correction in the U.S. housing market and the unresolved financial sector problems have led the U.S. economy to the verge of recession. In fact, we are now anticipating that the United States will indeed slip into recession—meaning that it will experience two or more quarters of negative growth—during the course of 2008, before starting a moderate recovery at some point during 2009.

The effects on the rest of the world are likely to be significant. We have already reduced our expectations for growth in Europe and much of the emerging world. Our revised global growth forecast is 3.7 percent, down from 4.9 percent in 2007, which represents a pronounced slowdown. However, I would stress that achieving growth even at this level will require that most advanced economies experience only mild slowdowns and that many emerging economies be able to keep their rapid pace of growth largely on track.

In addition to problems within the financial sector, there are two main short-run vulnerabilities for the global economy, both of which
are covered in considerable detail in this *World Economic Outlook*. The first is that housing prices may adjust downward significantly in many other advanced economies (first figure). Although Chapter 3 shows that the particular dynamics of the housing market in the United States are not matched by those in other countries, it also shows that housing may now play a more marked role in the business cycle more broadly—as the nature of mortgage financing has changed and as valuations have increased almost everywhere over the past 10 years.

The second potential vulnerability is, of course, commodity prices. Chapter 5 examines the role of commodity prices in contributing to the strong performance of many emerging and developing economies in recent years. It is striking how the surging tide of commodity prices over the past five years (second figure) has lifted almost all commodity-based boats around the world. Although there is some reason to believe that the countries exporting commodities are now better able than in the past to withstand a serious downturn, we continue to urge caution: commodity prices have fallen, on average, by 30 percent during significant global slowdowns over the past 30 years.

All eyes now turn to the world’s leading emerging economies. They have come of economic age in the past half-decade—diversifying their exports, strengthening their domestic economies, and improving their policy frameworks. It is conceivable that their strong momentum, together with some timely policy adjustments, can sustain both their domestic demand and the global economy.

At this moment, however, these emerging economies find themselves beset not by impending recession, but rather by inflation pressures. In particular, the financial dynamics of dollar depreciation and increasing financial market uncertainty have combined with continuing strong demand growth in the emerging economies and sluggish supply responses by commodity producers in such a way as to keep upward pressure on food and energy prices despite the darkening clouds over the global economy.
Therefore, at the very time when preparations for countercyclical measures would seem to be warranted, leading emerging economies find themselves trying hard to take the edge off inflation.

These immediate issues are compelling, but we must not lose sight of the longer-term challenges, including the global challenge of climate change. The IMF can contribute to the important current debate by analyzing the macroeconomic consequences of climate change, which can be far-reaching and quick-acting. Chapter 4 has a particular focus on the macroeconomic impact of mitigation strategies and argues that well-designed policy frameworks can limit carbon and related emissions without having a major negative effect on growth.

In addition to the compelling medium-term case for containing emissions, we urgently need a more coherent global approach to energy pricing. It is essential that increases in fuel prices be passed on to final consumers, thus allowing the price mechanism to play an appropriate role across the global economy in reducing demand (and limiting inflation pressure) whenever supply conditions or financial events push commodity prices up. Attempts to protect consumers from the true short-, medium-, or long-run costs of using fossil fuels are likely to prove worse than futile.

Simon Johnson
Economic Counsellor and Director, Research Department