

*Against the background of the global outlook outlined in Chapter 1, this chapter discusses how the main countries and regions that make up the world economy are coping with intense financial strains, high commodity prices, and the global downturn. It then draws policy lessons, with a view to finding an appropriate balance between responding to deteriorating short-term growth prospects, containing inflation, and fostering longer-term growth potential.<sup>1</sup>*

### **United States and Canada: Prognosis for the Downturn**

The United States has been at the center of the intensifying global financial storm discussed in Chapter 1, and the economy is now slowing fast. The latest data suggest that GDP rose 2.8 percent at an annualized rate in the second quarter as surging net exports and tax rebate checks buoyed consumption and outweighed the drag from financial turmoil, a continuing housing correction, and high commodity prices. However, taking the most recent three quarters together, the pace of growth averaged only 1¼ percent, well below potential. More important, available data for the third quarter suggest a further slowdown and forward-looking indicators—such as consumer and business confidence and accumulating evidence of the negative impact on credit of recent financial market disruptions—suggest that the economy is likely to contract in the current quarter and into early 2009.

Since the summer of 2007, declining residential investment has been a major drag on output (subtracting about ¾ percentage point off growth), inventories have been compressed, and consumption has slowed. By contrast, there have been two sources of resilience. First, net exports have continued to boom—adding 1½ percent-

age points to growth over the period—although surging oil prices kept the current account deficit at about 5 percent of GDP. Second, despite the slowing economy and tighter credit conditions, U.S. firms have remained healthy, benefiting from relatively low leverage, high profits, and strong export demand, which explain why cuts in business spending and employment were moderate until recently.

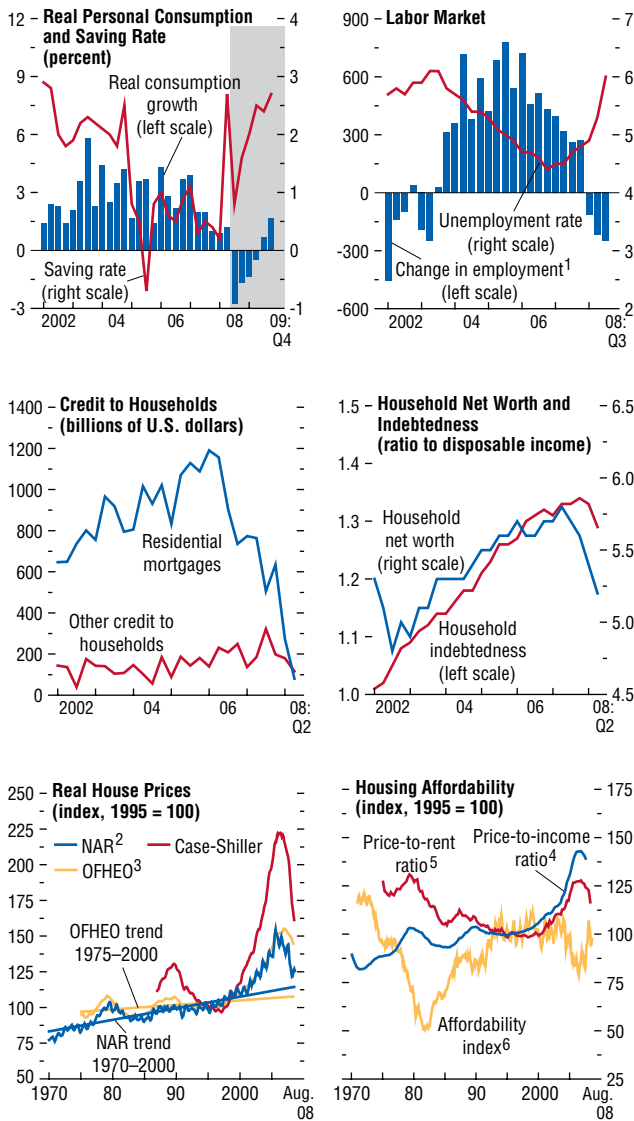
With a recession now looking increasingly likely, the key questions are, how deep will the downturn be, when will a recovery get under way, and how strong will it be? The key determinants of the short-term outlook will be the effectiveness of recent government initiatives to stabilize financial market conditions, as well as the behavior of U.S. households in the face of rising stress, the depth of the housing cycle, and the extent to which inflation concerns constrain monetary policy.

Faced by a rapidly expanding and increasingly dangerous financial crisis, the authorities have acted to deal with immediate threats to systemic stability and have passed a major initiative to purchase illiquid assets from banks—although it will take time to organize these operations. Once fully in place, these measures should help to stabilize market conditions, but even so the process of balance-sheet repair will be long and arduous. It will take considerable time before losses are fully recognized, banks are recapitalized, leverage is reduced, and market confidence is regained. Tight bank lending conditions are now having a visible impact on the growth of new loans, and credit availability is likely to remain tight throughout 2009. The impact is likely to be greatest on households, given their deteriorating balance sheets, but under current dislocated financial market conditions, firms are also likely to be affected adversely, notwithstanding stronger balance sheets and still-healthy profit margins.

<sup>1</sup>Further analysis of regional and country developments is provided in the IMF *Regional Economic Outlooks*.

**Figure 2.1. United States: Strains on Households**

U.S. households are coming under increasing strain. So far they have maintained moderate spending growth, but current drags on growth include falling employment, tightening credit, and declining net worth, as well as rising fuel and food prices. However, housing affordability has improved and there are signs that housing valuations are moving closer in line with historical trends.



Sources: Davis, Lehnert, and Martin (2007); Haver Analytics; and IMF staff estimates.  
<sup>1</sup>Quarterly change in total nonfarm payrolls, thousands.  
<sup>2</sup>National Association of Realtors; three-month moving average of 12-month percent change.  
<sup>3</sup>Office of Federal Housing Enterprise Oversight (OFHEO).  
<sup>4</sup>Ratio of OFHEO house price index to personal disposable income per capita.  
<sup>5</sup>Inverse of the rent-price ratio for the aggregate stock of owner-occupied housing.  
<sup>6</sup>Index equal to 100; median family income qualifies for an 80 percent mortgage on a median-priced existing single-family home, reindexed to 1995 = 100.

While consumption has continued to increase in recent quarters, U.S. households face rising cash-flow and balance-sheet strains. Income growth has slowed as employment has dropped since January, the average workweek has shrunk, unemployment has risen by a full percentage point, wages have stagnated, and gas prices remain high (Figure 2.1). Falling house prices and the weakening equity market have contributed to a 10 percent drop in household net worth relative to GDP. Moreover, access to credit has tightened markedly, most notably for mortgages but also for other sources of consumer finance.

A key element of the baseline forecast is that consumption will now show more obvious signs of weakness. In the projections, consumption declines in the second half of 2008, as the stimulus from the the tax rebate checks wears off, and in the early part of 2009. It would then recover gradually during the remainder of the year, held back by cash-flow strains and the need to rebuild savings.

Strains on households are in part a reflection of the massive continuing downturn in the housing market. The drop in house prices—in the range of 5 to 17 percent over the past year, depending on the index used—is unprecedented since the Great Depression. As a result, more than 10 million households owe more on their mortgages than the market value of their homes. Housing-related activity has also plummeted—housing starts have fallen 60 percent from their peak. This was a needed correction after a period of excess, and there are now some tentative signs of stabilization, for example in recent home sales data, although up to one-third of sales now involve foreclosure, an indicator of weakness rather than strength.

The baseline projections anticipate that the housing cycle will eventually find a floor in 2009 after four years of correction. The projections build in a further 10 percent decline in house prices by the end of the year, in line with market expectations (although these forward markets are very thin), which will bring prices closer in line with fundamentals. Moreover, residential

investment relative to GDP is around a 40-year low, and the drop in housing starts is bringing down inventories of unsold new homes. Support should also be provided by recent legislation to facilitate the refinancing of “underwater” mortgages with federal guarantees and to provide assurances that Fannie Mae and Freddie Mac—the government-sponsored enterprises (GSEs) that are behind about 80 percent of new mortgage lending in recent quarters—will continue to provide housing finance.

On the inflation front, still-high energy prices boosted headline personal consumption expenditure (PCE) inflation to 4.6 percent (12-month rate) in August 2008, while core PCE inflation ticked up to 2.6 percent. Given the recent retreat in international oil prices, headline figures are likely to start coming down, and the widening output gap, moderate wage increases, and a pickup in productivity should all help contain underlying inflation.

Putting together the pieces of the puzzle, activity is projected to decline in the final quarter of 2008 and the first quarter of 2009, stabilize in the second quarter, and then embark on a gradual recovery. On a year-over-year basis, growth moderates from 2.0 percent in 2007 to 1.6 percent in 2008 and 0.1 percent in 2009 (Table 2.1). The economy only returns to potential growth in 2010. Risks around this forecast are to the downside. Particular concerns are that the credit crunch could impose an ever-greater constraint on activity, that the house price correction could extend into 2010, and that inflation pressures may prove more persistent, limiting the Federal Reserve’s room for maneuver. The principal upside potential is that U.S. firms may be able to maintain their spending patterns better than expected, despite financial strains, which would provide greater-than-anticipated support for household incomes.

While the immediate task is to stabilize financial conditions, policymakers must ensure appropriately supportive macroeconomic policy settings, including efforts to contain negative macrofinancial feedback loops. The present highly accommodative monetary policy stance

could be eased still further if the downturn seems likely to deepen, even though its effectiveness may be limited if financial strains persist, and the Federal Reserve will continue to be watchful on the inflation front. Eventually, policy will need to move toward a more neutral stance as an economic recovery gathers steam and financial conditions improve. On the fiscal front, the stimulus package provided well-timed support, but the fiscal deficit is rising sharply and is now projected at 4½ percent of GDP in 2009, the highest among the G7 countries, without allowing for the potentially sizable impact of recent measures to stabilize the financial and housing sectors. The need for fiscal consolidation in the face of medium-term spending pressures and long-term challenges posed by demographics and rising medical costs point to the need for adjustment measures elsewhere once the situation has stabilized in order to offset the costs of financial system support.

In Canada, economic activity has slowed sharply since mid-2007, and growth is projected to come down from 2.7 percent in 2007 to 0.7 percent in 2008 before picking up to 1.2 percent in 2009. Although the resource-intensive sectors have benefited from high commodity prices, the lagged effect of past real appreciation of the Canadian dollar, together with the U.S. slowdown, has hit manufacturing hard. The Bank of Canada eased interest rates by 150 basis points between December 2007 and April 2008 and has held rates steady since then. Despite its recent acceleration to 3½ percent, inflation has generally remained well anchored, in part owing to the rising currency. Banks have generally weathered the financial strains well so far, reflecting conservative regulation and low exposure to structured products, but risks remain given the strong economic and financial linkages with the United States.

### Western Europe: Struggling with Multiple Shocks

Western Europe is being hit by major shocks that are weakening economic activity, notably

**Table 2.1 Advanced Economies: Real GDP, Consumer Prices, and Unemployment***(Annual percent change and percent of labor force)*

	Real GDP				Consumer Prices				Unemployment			
	2006	2007	2008	2009	2006	2007	2008	2009	2006	2007	2008	2009
<b>Advanced economies</b>	<b>3.0</b>	<b>2.6</b>	<b>1.5</b>	<b>0.5</b>	<b>2.4</b>	<b>2.2</b>	<b>3.6</b>	<b>2.0</b>	<b>5.7</b>	<b>5.4</b>	<b>5.7</b>	<b>6.5</b>
United States	2.8	2.0	1.6	0.1	3.2	2.9	4.2	1.8	4.6	4.6	5.6	6.9
Euro area <sup>1</sup>	2.8	2.6	1.3	0.2	2.2	2.1	3.5	1.9	8.7	7.4	7.6	8.3
Germany	3.0	2.5	1.8	—	1.8	2.3	2.9	1.4	9.8	8.4	7.4	8.0
France	2.2	2.2	0.8	0.2	1.9	1.6	3.4	1.6	9.2	8.3	7.7	8.3
Italy	1.8	1.5	-0.1	-0.2	2.2	2.0	3.4	1.9	6.8	6.2	6.7	6.6
Spain	3.9	3.7	1.4	-0.2	3.6	2.8	4.5	2.6	8.5	8.3	11.2	14.7
Netherlands	3.4	3.5	2.3	1.0	1.7	1.6	2.9	2.6	3.9	3.2	2.8	2.9
Belgium	2.9	2.8	1.4	0.2	2.3	1.8	4.6	2.8	8.3	7.5	7.1	8.6
Austria	3.4	3.1	2.0	0.8	1.7	2.2	3.5	2.3	4.8	4.4	4.2	4.4
Finland	4.9	4.5	2.5	1.6	1.3	1.6	3.9	2.5	7.7	6.8	6.2	6.2
Greece	4.2	4.0	3.2	2.0	3.3	3.0	4.4	3.1	8.9	8.3	7.7	8.3
Portugal	1.4	1.9	0.6	0.1	3.0	2.4	3.2	2.0	7.7	8.0	7.6	7.8
Ireland	5.7	6.0	-1.8	-0.6	2.7	2.9	3.5	2.4	4.4	4.5	5.7	7.0
Luxembourg	6.1	4.5	2.3	1.8	2.7	2.3	3.7	1.8	4.4	4.4	4.4	4.8
Slovenia	5.7	6.1	4.3	3.7	2.5	3.6	5.9	3.3	5.9	4.8	4.8	5.0
Cyprus	4.0	4.4	3.4	2.8	2.2	2.2	4.6	3.5	4.6	3.9	3.9	3.9
Malta	3.1	3.7	2.8	2.3	2.6	0.7	3.7	2.2	7.3	6.4	6.5	7.0
Japan	2.4	2.1	0.7	0.5	0.3	—	1.6	0.9	4.1	3.8	4.1	4.5
United Kingdom <sup>1</sup>	2.8	3.0	1.0	-0.1	2.3	2.3	3.8	2.9	5.4	5.4	5.4	6.0
Canada	3.1	2.7	0.7	1.2	2.0	2.1	2.5	2.1	6.3	6.0	6.2	6.3
Korea	5.1	5.0	4.1	3.5	2.2	2.5	4.8	4.0	3.5	3.3	3.1	3.0
Australia	2.7	4.2	2.5	2.2	3.5	2.3	4.6	3.6	4.8	4.4	4.3	4.8
Taiwan Province of China	4.9	5.7	3.8	2.5	0.6	1.8	4.2	2.5	3.9	3.9	3.9	4.1
Sweden	4.1	2.7	1.2	1.4	1.5	1.7	3.4	2.8	7.0	6.1	6.6	7.1
Switzerland	3.4	3.3	1.7	0.7	1.0	0.7	2.6	1.5	3.0	2.5	2.6	2.8
Hong Kong SAR	7.0	6.4	4.1	3.5	2.0	2.0	4.8	4.3	4.8	4.1	3.5	3.6
Denmark	3.9	1.7	1.0	0.5	1.9	1.7	3.4	2.8	3.9	2.8	1.8	2.6
Norway	2.5	3.7	2.5	1.2	2.3	0.8	3.2	2.7	3.4	2.5	2.5	3.0
Israel	5.2	5.4	4.3	2.8	2.1	0.5	4.8	3.3	8.4	7.3	6.0	6.2
Singapore	8.2	7.7	3.6	3.5	1.0	2.1	6.5	3.3	2.7	2.1	2.1	2.2
New Zealand <sup>2</sup>	1.9	3.2	0.7	1.5	3.4	2.4	4.2	3.8	3.8	3.6	4.0	4.3
Iceland	4.4	4.9	0.3	-3.1	6.8	5.0	12.1	11.2	1.3	1.0	2.2	3.9
<i>Memorandum</i>												
Major advanced economies	2.7	2.2	1.2	0.1	2.4	2.2	3.5	1.7	5.8	5.5	5.8	6.6
Newly industrialized Asian economies	5.6	5.6	4.0	3.2	1.6	2.2	4.8	3.5	3.7	3.4	3.3	3.3

<sup>1</sup>Based on Eurostat's harmonized index of consumer prices.<sup>2</sup>Consumer prices excluding interest rate components.

extraordinary financial stress. Real GDP growth has stalled in the euro, following a first-quarter rebound. Growth was already noticeably weaker elsewhere during the first quarter, including in the United Kingdom and most Nordic countries, and conjunctural indicators now suggest that many countries are moving close to or into recession. At the same time, high oil and food prices are still keeping inflation at elevated levels.

Economic growth is being slowed by a number of factors, initially mainly by rising oil prices but now increasingly by tightening financial

conditions.<sup>2</sup> Relative to 2007, oil prices are some 40 percent higher in euro terms and, together with surging food prices, have squeezed already-sluggish consumption growth. All other things equal, standard rules of thumb would imply output losses from such a shock in a broad range up to about ⅓ percent of GDP for the

<sup>2</sup>See also the forthcoming *Regional Economic Outlook: Europe*, where the implications for Europe of commodity price shocks and ongoing financial turmoil are discussed in more detail.

euro area—less for oil producers such as the United Kingdom and Norway. Although oil prices increased sevenfold over 1999–2008, the response of wages has remained generally subdued, unlike during the 1970s, reflecting structural reforms and improved policy frameworks. Together with rapidly cooling activity and rising unemployment fears, these factors should help contain wages over the coming year (Figure 2.2). Thus, while headline inflation has recently been running in the 3–4 percent range in many countries, core inflation (excluding all food and energy) has generally been below 2 percent in the euro area and the United Kingdom.<sup>3</sup> Inflation expectations have generally remained well anchored, although somewhat less so in the United Kingdom than in the euro area.

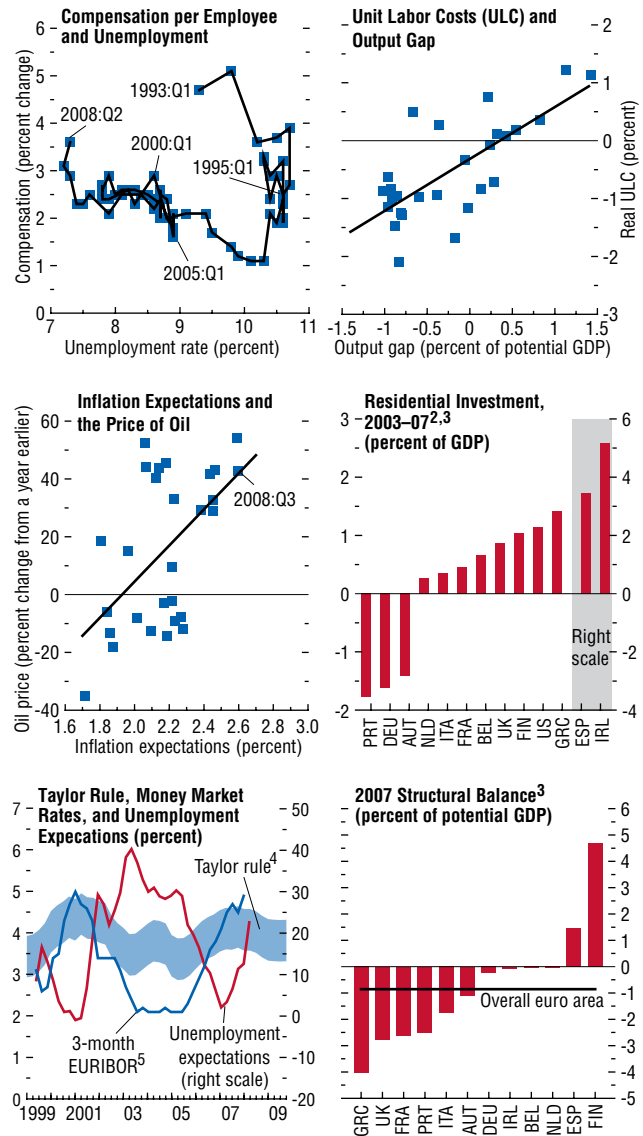
While oil and food price hikes are undercutting real disposable incomes, financial conditions are tightening quickly. European banks are struggling with a confluence of adverse shocks. They have been exposed to losses on their holdings of U.S.-mortgage-related assets and deteriorating overall credit quality since 2007. Concerns that initially focused on liquidity are also affecting solvency. Confidence in the sector has weakened and highly leveraged banks are struggling to maintain funding in the face of rising creditor concerns about balance-sheet risk. Equity-to-asset ratios will need to be boosted, which, to a large extent, will have to be achieved by cutting back on lending because bank stock prices have declined. The process of deleveraging, including market exit by some institutions, will likely be long and arduous and banks have already tightened lending standards to far above pre-turmoil levels.

Households and firms operating in real estate are struggling under growing debt burdens,

<sup>3</sup>Consumer price index (CPI) food price inflation in the euro area increased from about 2 percent in mid-2007 to 6.2 percent in August 2008, contributing 0.8 percentage point to the 3.8 percent August headline CPI inflation rate. Energy contributed 1.1 percentage points. Higher food prices mainly redistribute income within western Europe and thus have much smaller direct effects on economic growth than high oil prices (see Chapter 3).

**Figure 2.2. Western Europe: Slowing Demand and High Inflation<sup>1</sup>**

Although headline inflation is high, wages have generally remained subdued, and slowing activity and rising unemployment fears should restrain demand for pay hikes. In the euro area, monetary conditions are on the tight side by the standards of recent history, and countries have little room for discretionary fiscal stimulus, lest they breach the Maastricht limit of 3 percent of GDP deficit.



Sources: European Central Bank; European Commission; Eurostat; Haver Analytics; Thomson Datastream; and IMF staff estimates.

<sup>1</sup>Data refer to the euro area unless otherwise noted.

<sup>2</sup>Deviation from 1993–2002 average.

<sup>3</sup>AUT: Austria; BEL: Belgium; FIN: Finland; FRA: France; DEU: Germany; GRC: Greece; IRL: Ireland; ITA: Italy; NLD: Netherlands; PRT: Portugal; ESP: Spain; UK: United Kingdom; US: United States.

<sup>4</sup>The formula gives equal weight (0.5) to the deviation of breakeven inflation from the inflation target and to the output gap; the lower band is based on a natural rate equal to 3.5 percent; the upper band is based on a natural rate equal to 4.5 percent.

<sup>5</sup>Euro interbank offered rate.

particularly in countries such as Ireland, Spain, and the United Kingdom, where floating-rate mortgages indexed to short-term interest rates are common. In real terms, residential property prices are falling in these and some other countries, while slowing quickly elsewhere (see Box 1.2). While there is a risk of an outright housing-related credit crunch, some factors would mitigate pernicious feedback loops between the financial and real sectors (Chapter 4). Although residential real estate generally accounts for a larger share of activity in western Europe than the United States, the recent expansion of residential investment was generally less pronounced, except in Finland, Greece, Ireland, Spain, and the United Kingdom. Furthermore, these countries are less likely to suffer from the financial vulnerabilities exposed in the United States: household savings are generally higher and debt lower, non-prime lending is much less widespread, loan-to-value ratios are more conservative, and opportunities for equity withdrawal are much more limited. However, even in the absence of an outright credit crunch, the downturn in residential real estate will have an appreciable short-run impact in some countries (for example, Ireland, Spain, and the United Kingdom) and, with the exception of a few countries (for example, Austria, Germany, and Switzerland), produce noticeable medium-term headwinds.

Turning to nonfinancial firms, balance sheets are stronger than at the onset of the 2001–02 cyclical downturn, and this should limit the effect of financial sector strains on investment. On the other hand, the longer the financial stresses last, the more corporate profits, balance sheets, and investment will suffer.

The euro area's external current account was close to balance in 2007 (Table 2.2). Exports are expected to slow in line with world demand, however, and the current account is expected to deteriorate, mainly on account of worsened terms of trade. Also, the real effective exchange rate is on the strong side of medium-term fundamentals, despite some recent weakening. By contrast, the United Kingdom's current account is in notice-

**Table 2.2. Advanced Economies:  
Current Account Positions**  
(Percent of GDP)

	2006	2007	2008	2009
<b>Advanced economies</b>	<b>-1.3</b>	<b>-0.9</b>	<b>-1.0</b>	<b>-0.6</b>
United States	-6.0	-5.3	-4.6	-3.3
Euro area <sup>1</sup>	0.3	0.2	-0.5	-0.4
Germany	6.1	7.6	7.3	6.8
France	-0.7	-1.2	-2.8	-2.7
Italy	-2.6	-2.5	-2.8	-2.4
Spain	-8.9	-10.1	-10.1	-7.7
Netherlands	8.2	6.8	5.6	5.1
Belgium	2.7	2.1	—	-1.1
Austria	2.4	3.2	2.8	2.4
Finland	4.6	4.6	3.4	2.9
Greece	-11.1	-14.1	-14.0	-14.1
Portugal	-10.1	-9.8	-12.0	-12.7
Ireland	-3.6	-5.4	-5.0	-4.4
Luxembourg	10.5	9.9	8.6	8.2
Slovenia	-2.8	-4.9	-4.7	-4.7
Cyprus	-5.9	-9.7	-9.7	-7.8
Malta	-8.2	-5.4	-7.7	-6.4
Japan	3.9	4.8	4.0	3.7
United Kingdom	-3.4	-3.8	-3.6	-3.4
Canada	1.4	0.9	0.9	—
Korea	0.6	0.6	-1.3	-0.7
Australia	-5.3	-6.2	-4.9	-4.3
Taiwan Province of China	7.2	8.6	7.8	6.5
Sweden	8.5	8.5	6.4	5.8
Switzerland	14.7	16.6	9.3	8.7
Hong Kong SAR	12.1	13.5	11.7	10.3
Denmark	2.9	1.1	1.3	1.8
Norway	17.3	15.4	19.1	18.0
Israel	5.9	3.2	0.4	0.5
Singapore	21.8	24.3	19.2	17.0
New Zealand	-8.7	-8.2	-9.3	-8.1
Iceland	-25.4	-14.6	-18.2	-13.7
<i>Memorandum</i>				
Major advanced economies	-2.0	-1.5	-1.3	-0.9
Euro area <sup>2</sup>	—	0.3	-0.5	-0.5
Newly industrialized Asian economies	5.3	6.2	4.7	4.3

<sup>1</sup>Calculated as the sum of the balances of individual euro area countries.

<sup>2</sup>Corrected for reporting discrepancies in intra-area transactions.

able deficit, and the pound sterling has depreciated by more than 10 percent in real effective terms since the onset of the market turmoil.

In this challenging environment, central banks have tried to ease liquidity pressures, including through provision of U.S. dollar liquidity, and a number of governments (for example, Belgium, France, Germany, Luxembourg, the Netherlands, and the United Kingdom) have stepped in to provide solvency support for resolutions of a number of major

financial institutions (including Dexia and Fortis) or by raising deposit guarantee limits and extending guarantees to creditors (for example, Ireland), or by providing explicit assurances to depositors (for example, Germany and the United Kingdom). However, even if a comprehensive approach to address the growing concerns is put in place rapidly, it will take time to return perceptions of counterparty risk to more normal levels. Accordingly, banks' deleveraging will weigh noticeably on economic growth over the coming quarters.

The baseline projections thus envisage a significant slowdown in activity across western Europe followed by a very gradual recovery beginning in the second half of 2009. Euro area growth is expected to moderate from 2.6 percent in 2007 to 1.3 percent and 0.2 percent, respectively, in 2008–09, before returning to 1.4 percent in 2010. In the United Kingdom, real GDP growth would fall from 3.0 percent in 2007 to 1.0 percent in 2008; activity would contract by 0.1 percent in 2009 and then accelerate to 2.2 percent in 2010. The risks around these growth projections are to the downside. They include accelerated deleveraging in the financial sector set off by broader asset price deflation and a global credit crunch, an abrupt unwinding of global imbalances, and sharp appreciation of the euro. On the upside, risks relate to still-buoyant employment and therefore higher-than-projected consumption, but these are small. Volatile energy and food prices are a source of two-way risk.

The fiscal positions of western European countries differ widely, but many have made significant progress toward consolidation since the previous downturn. Even with some widening in 2008–09 related to both cyclical factors and policy support, the general government deficit for euro area countries would still average about 1¼ percent of GDP, 1¼ percentage points less than in 2003–04. However, fiscal deficits of some countries (France, Greece, Ireland, Italy, and Portugal) are still far from their medium-term objectives and, in some cases, are likely to exceed the Maastricht deficit limit of 3 percent of GDP in the near term. The United Kingdom's

fiscal position—a deficit of 3½ percent of GDP is projected for 2008—is considerably weaker than before the previous downturn.

The rules of the revised Stability and Growth Pact provide room for fiscal objectives to be adjusted in response to changing economic conditions. With the effectiveness of discretionary easing diminished in the context of a loss of confidence in financial markets, discretionary use of fiscal resources should be primarily focused on measures to stabilize the financial sector, as needed. More generally, given the challenges associated with an aging population, fiscal policy should be consistent with achieving medium-term objectives. Automatic stabilizers can be allowed to operate freely around the adjustment path in response to weakening activity, except when this might breach fiscal rules. Similarly, the United Kingdom should set policy consistent with meeting its medium-term fiscal rules. For 2009 and 2010, the agreed medium-term expenditure plans should remain in place, with automatic stabilizers allowed to operate fully around the adjustment path.

Over the past six months, changes in policy interest rates have been limited, and central banks have focused on providing liquidity to stressed markets. The European Central Bank increased policy rates by 25 basis points to 4¼ percent in July 2008, the first move since June 2007, whereas the Bank of England has kept rates unchanged at 5 percent since April 2008. The projections see headline inflation falling below 2 percent in the euro area and the United Kingdom by end-2009. The immediate priority for central banks is to maintain calm in financial markets by continuing to provide liquidity as needed. However, the deteriorating outlook, moderating inflation pressure, and tightening financial conditions provide scope for monetary easing in both the euro area and the United Kingdom.

The continuing financial turmoil presents important policy challenges on various fronts, including because of complex cross-border financial linkages and spillovers. The latter is a particular concern for EU countries, given their quest to build a single market in financial ser-

vices. The specific challenges are already evident as actions taken in specific countries to alleviate financial strains are having adverse effects on financial institutions in other countries. Addressing the concerns raised by spillovers will require movement toward more joint responsibility and accountability for financial stability, notably for crisis prevention, management, and resolution, in line with the commitments of the ECOFIN Council of Finance Ministers in May 2008.<sup>4</sup> Restoring confidence now requires a decisive commitment to concerted and coordinated action to alleviate financial stresses and avoid the serious risk of backtracking on European financial integration.

The emphasis on policies to limit the damage from the financial turmoil should, however, not distract from structural policy challenges. Ten years following the introduction of the euro, the main medium-term policy challenge facing euro area member countries is to make economic union as successful as monetary union (Box 2.1). In this regard, productivity growth has lagged that in other advanced economies, and large and persistent intra-euro-area current account divergences are raising concerns about adjustment mechanisms in the monetary union. Accordingly, the structural reform momentum needs to be kept up and reoriented in a coordinated manner to improve adjustment in response to intra-area disparities. The ongoing reforms are bearing fruit, contributing to the marked growth in employment and to improved productivity in liberalized sectors. However, large parts of the services sector remain unaffected, forfeiting important income, resilience, and inflation benefits. Thus, the specific reform recommendations under the Lisbon Agenda that concern the euro area as a whole appropriately emphasize accelerating services market reform and financial integration. Enhanced

<sup>4</sup>For further details see May 15, 2008, “ECOFIN Council of Finance Ministers adopt conclusions on financial supervision and provision of financial stability in the EU,” available at [www.eu2008.si/en/News\\_and\\_Documents/Press\\_Releases/May/0514MF\\_Svet\\_ECOFIN.html](http://www.eu2008.si/en/News_and_Documents/Press_Releases/May/0514MF_Svet_ECOFIN.html).

policy coordination is needed to ensure greater consistency of national reform programs with these euro area recommendations.

### Advanced Asia: Responding to External Shocks

Although growth in Japan held up well through the first quarter, rising commodity prices and weakening external demand have started to weigh on economic activity. In the second quarter of 2008, the economy contracted at a 3 percent quarter-over-quarter annualized rate, and growth over the past four quarters was below 1 percent. The recent decline was led by private consumption and fixed investment, while the contribution from net exports fell to zero (Figure 2.3).

Recent indicators point to growing weakness ahead. Slowing external demand from the United States and western Europe, rising input costs, and diminishing profit expectations are weighing on corporate sentiment and companies’ investment plans. At the same time, high food and fuel prices and weakening wage prospects have pushed consumer confidence to low levels. Although financial conditions have tightened to a lesser extent than in other major economies, in part owing to Japanese banks’ lower exposure to securitized products, the stock market has fallen sharply, driven by concerns about the weaker growth outlook. Bank credit default swap (CDS) spreads have risen on concerns about global financial strains and the weaker outlook.<sup>5</sup> Following the collapse of Lehman Brothers, concerns about Japanese banks’ exposures to the failed institution rose, contributing to a sharp widening of CDS spreads for some entities and a broad-based fall

<sup>5</sup>Although liquidity pressures have been less acute in Japan than in other G3 economies, the Bank of Japan’s significant liquidity provision also contributed to stabilizing money markets. See the *Selected Issues* paper accompanying the 2008 report on Article IV consultations with Japan (available at [www.imf.org](http://www.imf.org)) for more details on the impact of the global financial turmoil on the Japanese economy (IMF, 2008c).



in equity prices. Strains in the financial system are expected to persist, even if to a lesser extent than in the United States or western Europe.

Headline inflation has risen well above the 2007 level, to above 2 percent, on the back of higher food and fuel prices, but core inflation, excluding food and fuel, remains around zero.<sup>6</sup> Firms have started to pass through cost increases to consumers, but they are also granting smaller wage increases as activity is slowing and unit labor costs continue to fall on a year-over-year basis. Measures of inflation expectations suggest that short-term expectations have edged up, while long-term expectations remain contained.

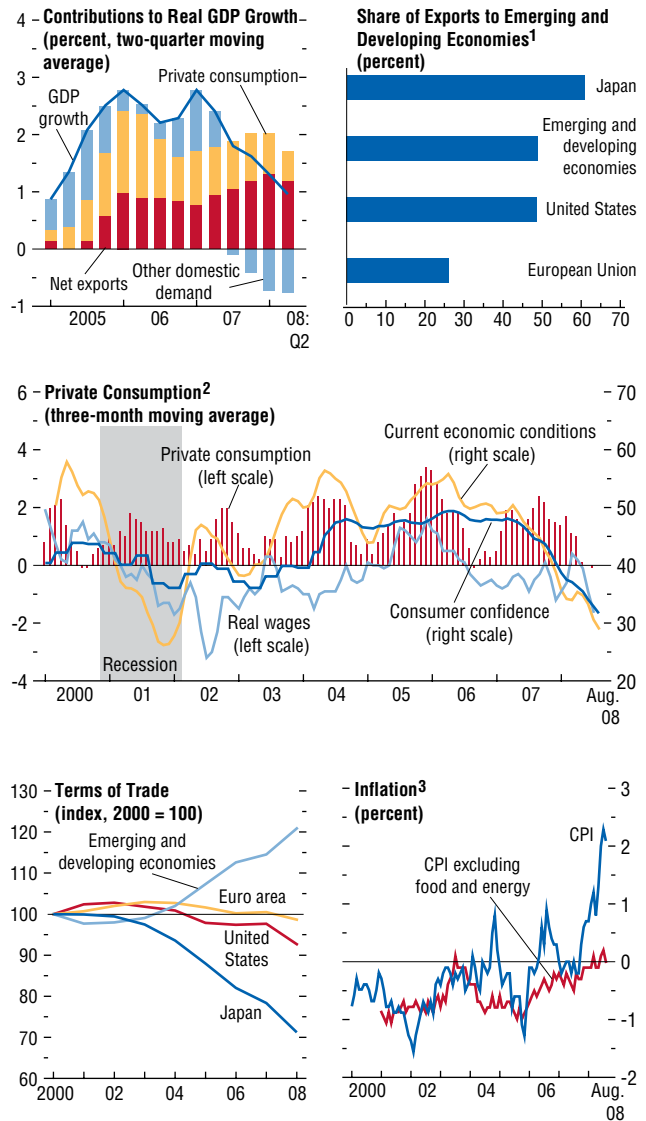
Although the trade surplus deteriorated because of a higher bill for commodity imports, rising investment income helped keep the current account balance near historical highs. Through March 2008, the yen appreciated against other major currencies, particularly the U.S. dollar, reflecting an unwinding of carry trades in volatile foreign exchange markets (see Figure 2.3). Then the currency started to weaken again, as expectations of monetary tightening dissipated amid slowing growth, before resuming an appreciating trend in September owing to declining commodity prices and increased risk aversion on the part of investors. Given the medium-term prospects for continued large external surpluses, the yen is still assessed to be undervalued relative to medium-term fundamentals.

As shown in Figure 2.3, Japan has experienced a much larger decline in its terms of trade in past years than other major advanced economies. Several factors have so far mitigated the impact on activity. First, robust exports to emerging and developing economies, many of which are exporters of commodities, have partly offset the effect of the deterioration in Japan's terms of trade. Second, although Japan is dependent on imported oil for almost all its

<sup>6</sup>Core inflation on the authorities' definition (excluding only fresh food) has been running at about 2 percent, reflecting recent increases in fuel and other commodity prices.

**Figure 2.3. Japan: How Well Would the Economy Weather a Terms-of-Trade Shock?**

The Japanese economy has been particularly exposed to deterioration in the terms of trade. Robust exports to emerging and developing economies should provide support for growth, but the outlook for consumption is weakening.



Sources: Haver Analytics; IMF, *Direction of Trade Statistics*; and IMF staff calculations.  
<sup>1</sup>Percent of total exports, 2006–08 averages.  
<sup>2</sup>Year-over-year percent changes of real private consumption and real earnings; current economic conditions, Econ Watch Survey diffusion index; and consumer confidence, all households diffusion index.  
<sup>3</sup>CPI = consumer price index.

### Box 2.1. EMU: 10 Years On

Ten years ago, EU heads of state gave the go-ahead for the third stage of European Economic and Monetary Union (EMU), approving the introduction of the euro in 11 EU member countries on January 1, 1999. Since then, four more EU members have adopted the euro, and the Slovak Republic is set to follow at the beginning of 2009. Monetary union is a distinct success, and the euro area is a zone of stability in the international economy. Thanks to the high credibility of the European Central Bank, inflation has declined over the past decade, and inflation expectations are now less variable in the euro area than in other advanced economies (Beechey, Johannsen, and Levin, 2008).<sup>1</sup> The key remaining challenge on the monetary front is the integration into the euro area of all EU members that are committed to adopting the euro (which does not include Denmark or the United Kingdom).<sup>2</sup> Economic union, however, remains a challenge even among the current euro area members, and there are concerns about the area's growth performance and large intra-area current account divergences.

**The record on growth.** The widespread perception among observers that EMU has delivered economic stability but not growth is not well founded. The EMU record with respect to employment has been strong, which helps explain why in per capita terms euro area real GDP growth has not lagged behind U.S. growth during EMU (first table). The euro area's employment performance is in part related to EMU, which likely has contributed to greater monetary policy credibility, as well as labor market reforms, including well ahead of the introduction of the single currency in 1999. Employment rates remain lower than in the United States, and per capita income is still about 30 percent below U.S. levels. However, full convergence is not likely:

<sup>1</sup>The main authors of this box are Jörg Decressin and Emil Stavrev, based on the findings in Decressin and Stavrev (forthcoming).

<sup>2</sup>Adoption of the euro depends on certain economic convergence criteria. For further details, go to [http://ec.europa.eu/economy\\_finance/the\\_euro/joining\\_euro9413\\_en.htm](http://ec.europa.eu/economy_finance/the_euro/joining_euro9413_en.htm).

### Euro Area and United States: Key Macroeconomic Variables

(Seven-year trailing average, in percent)

		1992	1999	2007
Per capita real GDP growth	Euro area	2.5	1.7	1.3
	United States	1.7	2.6	1.3
Real GDP growth	Euro area	2.9	2.0	1.8
	United States	2.8	3.7	2.4
Employment growth	Euro area	0.5	0.7	0.9
	United States	1.8	1.8	1.4
Employment-population ratio, end of period	Euro area	40.8	41.7	44.4
	United States	45.3	47.4	47.8
General government fiscal balance	Euro area	-5.0	-3.7	-2.1
	United States	-4.5	-1.7	-3.1
Current account	Euro area	-0.7	0.3	0.3
	United States	-1.7	-2.0	-5.1
Inflation	Euro area	3.4	2.1	2.2
	United States	3.9	2.5	2.7
Per capita GDP <sup>1</sup>	Euro area	75.1	70.8	70.9
Memorandum item	TFP <sup>2</sup>	1980-95	1995-2004	
	Euro area	0.8	0.2	
	United States	0.7	1.6	

Sources: Eurostat; IMF *International Financial Statistics*; and IMF staff calculations.

<sup>1</sup>Percent of U.S. per capita GDP, at purchasing power parity.

<sup>2</sup>TFP = total factor productivity.

Europeans have used the growth in productivity since World War II to increase leisure more than in the United States (Blanchard, 2004), and insofar as this greater leisure is sustainable, this development is not undesirable.

The euro area's poor productivity performance under EMU has attracted much attention (for example, Pisani-Ferry and others, 2008), but, as in the case of economic growth, the reality may well be more complex than the raw numbers suggest. Labor productivity growth, for example, has averaged about 1 percent a year in the past 15 years, down considerably compared with previous years. Total factor productivity (TFP) growth has almost ground to a halt during the current decade. However, the low productivity growth may well be related to the boom in employment, as argued by Dew-Becker and Gordon (2008). In fact, there is

strong evidence for a negative relationship between TFP growth and labor input in a cross section of EU KLEMS data (van Ark, O'Mahony, and Ypma, 2007) for 12 advanced economies and six sectors for each country (see first figure). There could be many reasons for such a trade-off. One obvious reason is capital-labor substitution in response to reforms that raised labor supply and, possibly, demand (via cuts in payroll taxes). Accordingly, as the labor market completes its adjustment to reforms and demographic changes, TFP growth may well revert to the higher levels recorded in the 1980s.

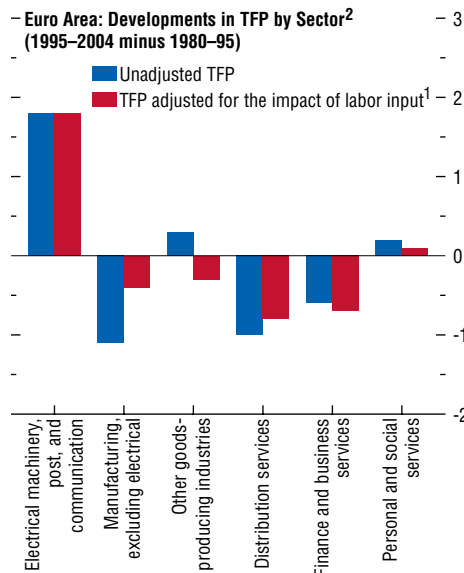
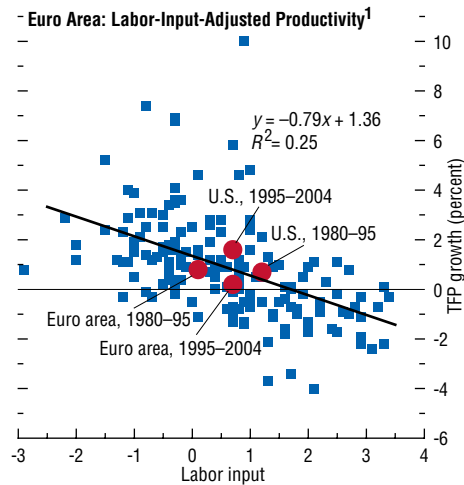
There is still concern, however, that even with adjustment for differences in labor input, TFP growth on average has been lower in the euro area than in the United States, particularly in the service sectors. This points to a need to open up the more sheltered service sectors to competition, that is, to make services tradable.

The dispersion of real GDP growth rates has also raised concern; however, business cycles among EMU members have in fact become more synchronized as the importance of common shocks has increased over time. These shocks now explain some 60 percent of output developments, as opposed to 30 percent before the introduction of the euro (Stavrev, 2007). Furthermore, country-specific developments in output reflect, to a considerable extent, per capita income convergence to higher levels. Overall, the dispersion of growth rates in the euro area is now similar to that among U.S. states, although it is more persistent. The slow speed of adjustment means that prolonged periods of strong growth may be followed by prolonged periods of sluggish activity, as experienced recently, for example, by Portugal (Blanchard, 2007).

**The record on the current account.** The external position of the euro area as a whole has remained in balance since EMU inception and thus has not raised concern. This external balance has been preserved despite the significant appreciation of the real effective exchange rate of the euro over the past several years (see Chapter 1). In addition, the euro has firmly established itself as the world's number two international currency, accounting for more than one-quarter of international reserves and more than one-half of trade invoicing.

**Productivity Performance**

(Percentage points unless otherwise noted)



Sources: EU Klems database; and IMF staff calculations.  
<sup>1</sup>Based on a cross-country, cross-sector pooled regression of total factor productivity (TFP) on labor input.  
<sup>2</sup>For average TFP growth rates. Negative numbers indicate a deterioration of TFP performance.

The European Commission and others have raised concerns about large intra-area current

**Box 2.1 (concluded)****Current Account Dispersions and Implications for Net Foreign Asset (NFA) Position**

	Current Account Balance <sup>1</sup>	Estimated Equilibrium Current Account	NFA Position	NFA Position When the Current Account Balance Reaches Estimated Equilibrium <sup>2</sup>
	(2007, in percent of GDP)			
Austria	2.7	1.1	-22	-10
Belgium	3.2	2.5	34	40
Finland	4.6	-0.3	-28	10
France	-1.3	0.6	5	-9
Germany	5.6	2.5	28	52
Greece	-13.9	-4.4	-100	-174
Ireland	-4.5	1.1	-1	-45
Italy	-2.2	-0.1	-6	-22
Netherlands	6.6	2.2	0	35
Portugal	-9.4	-5.8	-80	-107
Spain	-10.1	-5.7	-74	-109

Sources: IMF *International Financial Statistics*; and IMF staff estimates.

<sup>1</sup>Data are based on the April 2008 *World Economic Outlook* estimates. Please see Table A11 in the Statistical Appendix for the latest figures.

<sup>2</sup>The estimated speed of convergence implies that 70 percent of the deviation of the current account from the steady state is closed in about 10 years.

account and competitiveness imbalances (see, for example, European Commission, 2008). Current account divergence among euro area members appears large, ranging from deficits close to or exceeding 10 percent of GDP (for example, in Greece, Portugal, and Spain) to surpluses greater than 5 percent of GDP (for example, in Germany and the Netherlands—second table). In fact, this divergence—measured by the standard deviation across countries in each year—has risen substantially over the past two decades (second figure). But is it unusually large for today's world? As Chapter 6 shows, greater divergence of current account behavior is a widespread phenomenon. A simple approach to determining whether the divergence is unusually large is to divide the standard deviation of current accounts for euro area countries by the same measure for the current accounts of a group of 13 other advanced economies.<sup>3</sup> The results show that this ratio has not

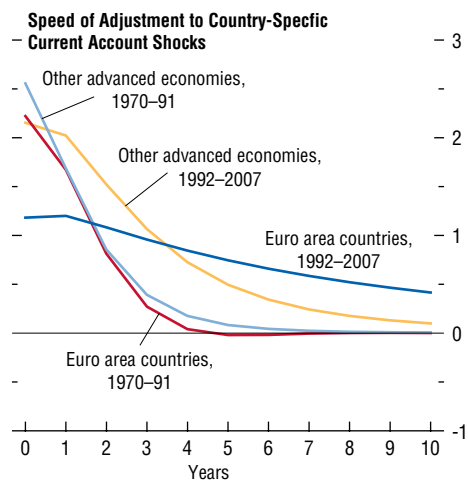
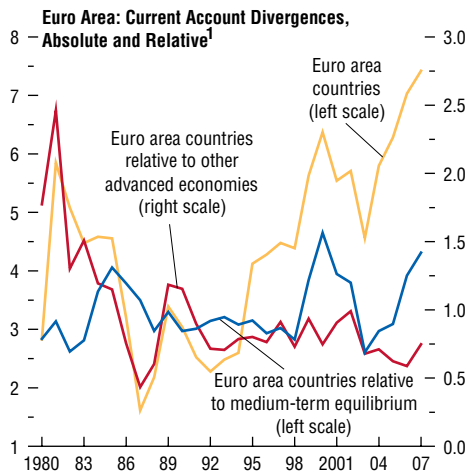
<sup>3</sup>Specifically, the two samples include 11 EMU members (Austria, Belgium, Finland, France, Germany, Greece, Ireland, Italy, Netherlands, Portugal, and Spain) and 13 other advanced economies (Australia, Canada, Denmark, Iceland, Israel, Japan, Korea, New Zealand, Norway, Sweden, Switzerland, United Kingdom, and United States). Data are from the April 2008 *World Economic Outlook*.

grown systematically. This is because the divergence among the other 13 advanced economies has also been on the rise.

A related question is whether current account imbalances are a reflection of equilibrium or disequilibrium forces and how these have evolved over time. To answer this question, a model of equilibrium current account balances, based closely on the IMF CGER methodology (Lee and others, 2008), is used to compute the developments in deviations from equilibrium over time. Specifically, the equilibrium current account for each euro area country is obtained as a function of real GDP growth, relative per capita income, population growth, the net foreign-assets-to-GDP ratio, the fiscal balance in percent of GDP, the old-age dependency ratio, and the oil balance in percent of GDP. The next step is to compute for each year the sum across countries of the absolute values of the deviation from equilibrium current accounts. This shows that divergence from equilibrium has not increased over time.

Although the size of divergence might not be of major concern, slow adjustment to equilibrium current account balances might be. Sustained deficits add to countries' external debt and, unlike in a currency union, such as the United States, people cannot expect help from a federal author-

**Current Account Divergence**



Source: IMF staff calculations.  
<sup>1</sup>Based on current account balances in percent of GDP.  
 Divergences are measured by the standard deviation across European Economic and Monetary Union members and across the other advanced economies, respectively.

imbalances in the EMU over time can be gauged with a pooled univariate regression of the current account balances on their own lags, allowing for country-specific steady-state current account balances (fixed effects). The results suggest that since 1992 it takes roughly 10 years to close about 70 percent of a gap between actual and steady-state current accounts within the euro area (see second figure). This speed of adjustment is significantly lower than during the pre-1992 period, when exchange rates were more flexible, but has not slowed significantly further during EMU. Moreover, it is significantly lower than in the group of 13 other advanced economies. However, the typical country-specific current account shock in the euro area is only about half as large as in the other countries during 1992–2007, which is a mitigating factor. In addition, it is only about half as large as in 1970–91 within the euro area, which again underscores the growing integration of EMU members.

These results can gauge the implications of today’s current account divergence for the net foreign asset positions of euro area countries (see second table). Clearly, some countries will be footing considerably higher external debt servicing bills that will limit consumption and slow growth. Because there is a risk that during periods of austerity the performance of EMU might be questioned, it is imperative for policymakers to ensure that goods and factor markets are flexible enough to deliver rapid adjustment: boosting productivity is one way to foster internal adjustment as are measures to foster more wage flexibility (Blanchard, 2007). At the same time, social safety nets need to provide sufficiently generous but temporary help to those who suffer from the dislocations that accompany adjustment. Moreover, internal adjustment processes (via their effects on the union) concern all countries, and so addressing this challenge is a matter of common interest. The European Union’s Lisbon Agenda offers the right vehicle for the design and implementation of the required structural reforms in a manner that leverages reform spillovers and complementarities.

ity or easily move to better-off areas to improve their repayment capacity. Moreover, in a currency union of countries, adverse economic developments in parts of the union are more likely to affect the strength of the union as a whole. The persistence of the current account

domestic needs, the efficiency with which oil is used in the economy is much higher than in the United States. Last, with underlying price pressures subdued, monetary conditions are likely to remain accommodative.

The outlook envisages that growth in 2008–09 will be well below 1 percent, significantly below potential. Although weakness in the United States and western Europe will weigh appreciably on activity, growth in emerging economies is expected to remain more resilient and should continue to support exports. Private consumption is expected to remain moderate because of weakening prospects for wage increases and high food and fuel prices, while the weakening demand and profit outlook will slow private investment.

The outlook is subject to considerable uncertainty surrounding the external environment, with the overall risks tilted to the downside. External risks relate mainly to a larger-than-expected slowdown in emerging and developing economies and a renewed bout of global financial instability. On the domestic front, high commodity prices could weigh further on firms' profits and households' incomes.

Given the outlook for further weakening of domestic demand and subdued inflation pressures, the Bank of Japan (BoJ) is appropriately retaining an accommodative monetary policy stance and keeping interest rates at the current low levels until uncertainties over the outlook are resolved. Japan has been battling deflation for nearly a decade, and although an end to this problem appears in sight, it is not yet ensured. While core inflation on the authorities' definition is close to the 2 percent upper bound of the "understanding" of price stability by the BoJ policy board members, wage growth is slowing, and inflation expectations have been contained. There are few indications of excessive risk taking in asset markets (the second perspective of the BoJ's monetary policy framework) or of bubbles in the financial or real estate markets.<sup>7</sup>

<sup>7</sup>The BoJ's monetary policy framework encompasses two perspectives: the short-term outlook for economic

A sharper-than-expected slowdown of the economy may justify a further reduction of the policy interest rate, although with the current rate already at 50 basis points, room for easing is limited. In this context, the BoJ's move to greater transparency, by expanding the discussion of the policy board members' views on the outlook and the risks to it and by placing a greater emphasis on the 1 percent median of the "understanding of price stability" in its communications, should help guide expectations.

Looking beyond the near term, the Japanese economy continues to face a rapidly aging population and rising public debt. The pace of fiscal consolidation has understandably slowed in the environment of diminishing global growth, with the general government primary deficit excluding social security expected to widen in 2008 and 2009 and discussions on raising the consumption tax rate postponed. In late August, the Japanese government put forward an economic stimulus package aimed at supporting faltering growth. However, the scope for fiscal stimulus is limited, and building fiscal space for projected increases in expenditures owing to demographic pressures remains a top priority for the medium term.<sup>8</sup> The authorities' current plans, which target a primary balance by fiscal year 2011, need to be strengthened further to prevent net public debt from trending up.

Australia and New Zealand are slowing down noticeably, after prolonged economic expansions driven by commodity and housing booms. The expansions have stretched productive capacity, pushing inflation to historical highs. The authorities have responded by tightening monetary policies, and domestic demand pressures have eased. Real GDP growth in Australia is projected to fall below potential, to about 2½ percent in 2008–09 from 4¼ percent in 2007.

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activity and prices and a longer-term outlook for risks to the outlook, including from asset price bubbles.

<sup>8</sup>The government's proposal includes spending of around \$17 billion (0.4 percent of GDP) and government guarantees for business loans. The government has also committed to an income tax cut by the end of fiscal year 2008.

The recent moderation in domestic demand and the tightening of credit conditions have prompted the Reserve Bank of Australia (RBA) to cautiously ease monetary policy. The Reserve Bank of New Zealand has also moved to ease monetary policy. In both countries, sound fiscal positions provide scope for allowing automatic stabilizers to operate in full and for judicious use of discretionary stimulus if the outlook deteriorates further.

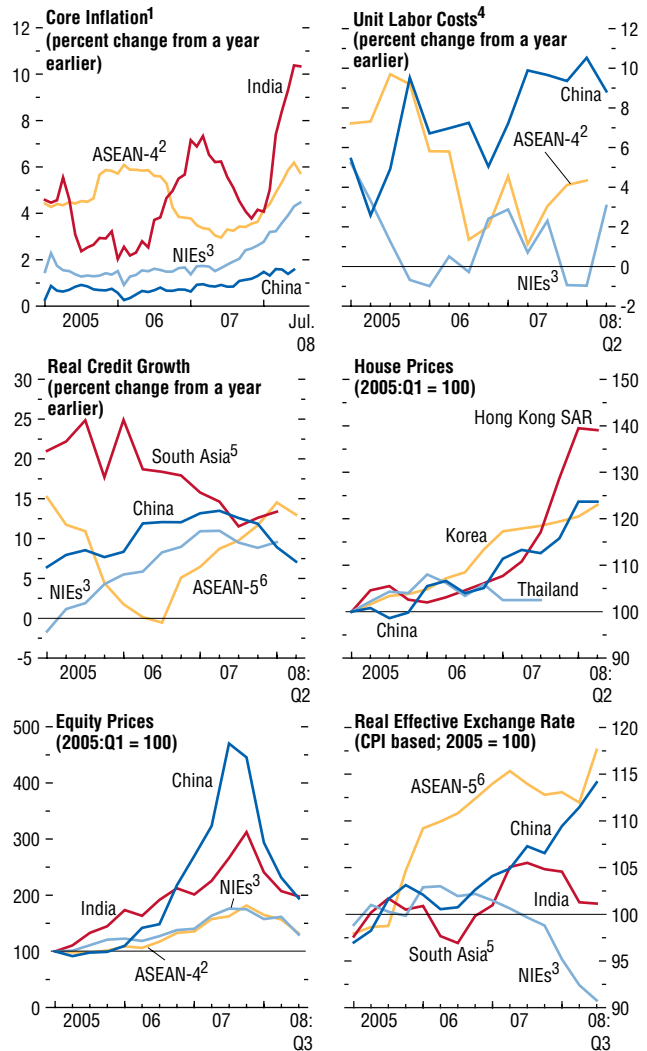
### Emerging Asia: Balancing Risks to Growth and Price Stability

The economic cycle in emerging Asia started to turn in early 2008, and more weakness is expected ahead in response to slowing demand from advanced economies and growing strains in regional financial markets. Growth in China eased to 10½ percent (year over year) in the first half of 2008, from 12 percent in 2007, partly because of slowing exports. Activity continued to be supported by steady investment growth and accelerating consumption. In India, growth in the second quarter came down to about 8 percent, on the back of weakening investment, while private consumption and export growth have held up well. In the newly industrialized Asian economies (NIEs) and the Association of Southeast Asian Nations (ASEAN) economies, activity has also been decelerating. Domestic demand has softened, as rising food and fuel prices have started to weigh on consumption, while declining profit margins and weakening demand have prompted firms to scale back their investment plans. Vietnam is undergoing a sharp correction as the demand boom caused by large capital inflows unwinds.

Financial markets have weakened in recent months, driven by increasing concerns about the global outlook and declining investor risk appetite, particularly in the context of the September market turbulence. Equity markets that experienced the largest run-up in prices in recent years—during 2005–07, prices more than quadrupled in China and tripled in India—have declined the most (Figure 2.4). In some coun-

### Figure 2.4. Emerging Asia: Remaining Inflation Concerns

Underlying inflation pressures rose across emerging Asia in recent quarters. Wage increases, despite productivity improvements, have contributed to a buildup in inflation in some cases. In part owing to a rapid expansion of bank loans, house prices have continued to trend upward. In contrast, an extended run-up in equity prices ended with a sharp correction in early 2008, triggered by global financial turmoil. Exchange rates have failed to provide much respite for inflation, because currencies have either appreciated too little or weakened.



Sources: Haver Analytics; IMF, *International Financial Statistics*; and IMF staff calculations.

<sup>1</sup>The definition of core inflation varies across countries, though it generally excludes food and energy prices from overall consumer price index (CPI).

<sup>2</sup>Indonesia, Malaysia, Philippines, and Thailand.

<sup>3</sup>Newly industrialized Asian economies (NIEs) comprise Hong Kong SAR, Korea, Singapore, and Taiwan Province of China.

<sup>4</sup>Calculated as overall compensation divided by GDP, except for China, where wages are used instead of compensation, and Indonesia and Malaysia, where calculations cover only the manufacturing sector. Data for China need to be treated with caution because of their partial coverage, biased toward large state-owned manufacturing enterprises.

<sup>5</sup>Bangladesh, India, Maldives, Nepal, Pakistan, and Sri Lanka.

<sup>6</sup>ASEAN-4 and Vietnam.

tries, borrowing spreads have risen markedly for banks relying on wholesale funding.

Current account balances have generally come under pressure from rising import bills for commodities and slowing export growth, while capital account and exchange rate developments have varied. Capital inflows to China have remained strong, as evidenced by a continuing surge of foreign reserves in excess of the trade surplus; capital flows to some other countries have become more volatile, particularly to those running sizable external deficits. Their currencies have come under pressure, prompting central banks to intervene in support (India, Pakistan, and Vietnam). The Korean won has also weakened, partly owing to a turnaround in the current account balance to a small deficit, on the back of worsening terms of trade. Differing nominal exchange rate developments, in turn, have driven divergent trends in real effective exchange rates, with the Chinese renminbi and the ASEAN currencies continuing to appreciate, and the South Asian and NIEs' currencies weakening (see Figure 2.4).

Growth in the region is projected to moderate to 7¾ percent in 2008 and 7 percent in 2009 from 9¼ percent in 2007 (Table 2.3). Weakening external demand is likely to weigh on exports, but, in some cases, the impact may be mitigated by still-loose macroeconomic policies and currency depreciation. Investment will also moderate, mainly because of deteriorating export prospects. Consumption will ease because of still-high fuel and food prices, although subsidies, which are common in the region, may cushion the impact on purchasing power. The risks to the outlook are firmly to the downside. The main concern is that a buildup of stress in the global financial system and a sharper-than-anticipated global slowdown could further weigh on activity. On the upside, domestic demand may prove more resilient, with falling commodity prices providing a boost to real incomes.

Headline CPI inflation has soared in a number of countries on the back of increases in food prices and administered fuel prices in the first half of the year. Indicators of underlying infla-

tion pressure have risen to a lesser extent, but some countries still face risks of further second-round effects. In China, headline CPI inflation has steadily declined since its 8½ percent peak in April, as food supply conditions have normalized. Core inflation has been rising gradually, but remains contained. In India, CPI inflation jumped to 9 percent in August. Underlying inflation pressures have increased, as high resource utilization and robust credit growth have created fertile ground for second-round effects (see Figure 2.4). Insufficient policy tightening has also contributed.

Although increases in food and fuel prices may continue to subside in the coming months and growth will moderate, inflation is expected to remain at elevated rates over the near term. Headline inflation is projected to rise to about 7¼ percent (year over year) in 2008 for the region as a whole from 5 percent in 2007, before declining to near 6 percent in 2009. Underlying inflation pressures are also likely to remain high in the environment of tight resource utilization and still-loose macroeconomic policies.

Responses to rising inflation have varied across the region. Some economies tightened monetary policy—by hiking interest rates (India, Indonesia, Korea, Philippines, Thailand, Taiwan Province of China, and Vietnam), tightening reserve requirements (Cambodia, India, Vietnam), and creating more scope for appreciation in the exchange rate band (Singapore). More recently, the People's Bank of China lowered the benchmark lending rates and reduced the reserve requirement ratio, on concerns about slowing growth. India and Korea intervened in the foreign exchange market to support their currencies. Countries that have continued to accumulate foreign reserves have partially sterilized them through the issuance of bonds and increases in reserve requirements to contain the buildup of liquidity. Offsetting the effects of monetary tightening, the fiscal policy stance has been eased in many countries, however, reflecting significant increases in fuel subsidies. Although several countries have raised administered fuel prices (for example, Bangladesh,



**Table 2.3. Selected Asian Economies: Real GDP, Consumer Prices, and Current Account Balance***(Annual percent change unless noted otherwise)*

	Real GDP				Consumer Prices <sup>1</sup>				Current Account Balance <sup>2</sup>			
	2006	2007	2008	2009	2006	2007	2008	2009	2006	2007	2008	2009
<b>Emerging Asia<sup>3</sup></b>	<b>9.2</b>	<b>9.3</b>	<b>7.7</b>	<b>7.1</b>	<b>3.8</b>	<b>4.9</b>	<b>7.3</b>	<b>5.8</b>	<b>5.8</b>	<b>6.8</b>	<b>5.2</b>	<b>5.0</b>
China	11.6	11.9	9.7	9.3	1.5	4.8	6.4	4.3	9.4	11.3	9.5	9.2
<b>South Asia<sup>4</sup></b>	<b>9.2</b>	<b>8.7</b>	<b>7.6</b>	<b>6.4</b>	<b>6.5</b>	<b>6.9</b>	<b>8.8</b>	<b>8.8</b>	<b>-1.4</b>	<b>-1.7</b>	<b>-3.3</b>	<b>-3.3</b>
India	9.8	9.3	7.9	6.9	6.2	6.4	7.9	6.7	-1.1	-1.4	-2.8	-3.1
Pakistan	6.9	6.4	5.8	3.5	7.9	7.8	12.0	23.0	-3.9	-4.8	-8.7	-6.4
Bangladesh	6.5	6.3	7.0	5.6	7.1	9.1	10.1	10.0	1.2	1.1	1.0	0.9
<b>ASEAN-5</b>	<b>5.7</b>	<b>6.3</b>	<b>5.5</b>	<b>4.9</b>	<b>8.1</b>	<b>4.4</b>	<b>9.6</b>	<b>7.2</b>	<b>4.8</b>	<b>5.1</b>	<b>2.7</b>	<b>2.1</b>
Indonesia	5.5	6.3	6.1	5.5	13.1	6.2	9.8	8.8	3.0	2.5	0.1	-0.1
Thailand	5.1	4.8	4.7	4.5	4.6	2.2	5.7	3.2	1.1	6.4	3.1	2.0
Philippines	5.4	7.2	4.4	3.8	6.2	2.8	10.1	7.0	4.5	4.4	2.4	2.2
Malaysia	5.8	6.3	5.7	4.8	3.6	2.0	6.0	4.7	16.1	15.6	14.8	13.2
Vietnam	8.2	8.5	6.3	5.5	7.5	8.3	24.0	15.0	-0.3	-9.9	-11.7	-10.4
<b>Newly industrialized Asian economies</b>	<b>5.6</b>	<b>5.6</b>	<b>4.0</b>	<b>3.2</b>	<b>1.6</b>	<b>2.2</b>	<b>4.8</b>	<b>3.5</b>	<b>5.3</b>	<b>6.2</b>	<b>4.7</b>	<b>4.3</b>
Korea	5.1	5.0	4.1	3.5	2.2	2.5	4.8	4.0	0.6	0.6	-1.3	-0.7
Taiwan Province of China	4.9	5.7	3.8	2.5	0.6	1.8	4.2	2.5	7.2	8.6	7.8	6.5
Hong Kong SAR	7.0	6.4	4.1	3.5	2.0	2.0	4.8	4.3	12.1	13.5	11.7	10.3
Singapore	8.2	7.7	3.6	3.5	1.0	2.1	6.5	3.3	21.8	24.3	19.1	17.0

<sup>1</sup>Movements in consumer prices are shown as annual averages. December/December changes can be found in Table A7 in the Statistical Appendix.

<sup>2</sup>Percent of GDP.

<sup>3</sup>Consists of developing Asia, the newly industrialized Asian economies, and Mongolia.

<sup>4</sup>Includes Maldives, Nepal, and Sri Lanka.

China, India, Malaysia, and Vietnam), the increase was small (except in Vietnam) compared with the increase in world fuel prices, and in some cases resources raised have been used to increase other expenditures, for example, food subsidies. Several major rice exporters in the region (Cambodia, China, India, and Vietnam) introduced export bans, quotas, or taxes to raise domestic food supplies and lower domestic prices, adding to pressure on world prices.

Against this background, a major policy dilemma for the region is how to respond to the weakening growth outlook and global financial turbulence, without losing sight of inflation risks. Although there is considerable divergence in country circumstances, downside risks to growth in emerging Asia have risen in recent months, while inflation risks have moderated as food and oil prices came down from the peaks observed earlier in the year. Policy priorities have shifted accordingly, although there remain notable differences in country circumstances.

- In most countries domestic demand is weakening rapidly and some policy tightening has already taken place. Although authorities need to remain alert to inflation risks, policy easing could be justified if downside risks to growth are significant. In countries with strong fiscal positions, automatic stabilizers can be allowed to operate in full. However, the use of discretionary fiscal policy needs to be approached with caution, as past experience suggests that such actions are difficult to time well and have not been very effective (see Chapter 5). But it could be justified in the face of deteriorating growth prospects in countries with strong underlying fiscal positions.
- By contrast, in a few countries where growth is expected to remain relatively strong, where risks for further second-round inflation effects are higher, and where monetary policy credibility has not yet been firmly established—macroeconomic policies still need to lean toward tightening (for example,

in Indonesia and Vietnam). Monetary policy tightening should be the first line of defense against rising inflation but may need to be complemented in some cases by greater exchange rate flexibility or fiscal action. Fiscal restraint could help reduce inflation pressures, especially in countries where rising food and fuel subsidies, as well as public wage increases, have weakened fiscal positions and contributed to price pressures.

### Latin America and the Caribbean: Navigating a More Perilous Environment

As in other parts of the world, Latin American economies are facing an awkward combination of slowing activity, more difficult external conditions, and still-high inflation. After four years of strong output growth, the pace eased in most economies of the region during the first half of 2008, largely because of moderating exports. Domestic demand has remained quite robust so far this year, sustained by terms-of-trade gains for commodity exporters, but is expected to be dampened as the global economy slows and by the shift toward monetary policy tightening to contain inflation. Countries in the region have also been facing more difficult external conditions in recent months. Latin America has been increasingly affected by turbulent conditions in mature financial markets, with equity prices falling sharply, spreads widening markedly, access to dollar funding tightening appreciably, and exchange rates coming under pressure, especially in commodity-exporting countries facing lower export prices.

Overall, GDP growth is projected to come down from 5½ percent in 2007 to 4½ percent in 2008 and 3¼ percent in 2009 (Table 2.4). The somewhat sharper deceleration in 2009 than envisaged in the July 2008 *World Economic Outlook Update* reflects the weaker global outlook, softer commodity prices, and more difficult external financial conditions. Growth in Brazil would come down below trend, and activity would remain sluggish in Mexico as exports and remittances are dampened by the

U.S. slowdown. Growth in Central America and the Caribbean is also expected to ease, reflecting the impact of slow U.S. growth on remittances, trade, and tourism, as well as high fuel costs.

Headline inflation for the region as a whole rose to 8 percent in August, the highest rate in five years, although it is expected to moderate in the latter part of 2008 and 2009, helped by softening international commodity prices, tighter monetary policies, and slowing demand growth. Still, inflation will remain at double-digit levels in a number of countries in the region, including Bolivia, Paraguay, the República Bolivariana de Venezuela, and several Central American countries, and analysts believe that actual inflation in Argentina is considerably higher than the official rate of 9.0 percent in August (Figure 2.5).<sup>9</sup> Although nominal wage growth has remained under control in most countries, high inflation expectations are feeding into wage negotiations in countries such as Argentina and the República Bolivariana de Venezuela, where capacity constraints are tight. In countries with inflation-targeting central banks—Brazil, Chile, Colombia, Mexico, and Peru—inflation has also risen, in some cases above target ranges, but increases have generally been more contained than elsewhere in the region, and there are signs of stabilizing or even declining inflation expectations for some countries.

In response, central banks have raised policy interest rates, most actively in the inflation-targeting countries, where exchange rate appreciation has also helped contain inflation pressures. In Brazil, monetary policy tightening has been supported by an increase in the primary fiscal surplus target for 2008 by ½ percentage point of GDP. However, fiscal policy has not in general been restrictive across the region, in part because of the budgetary impact of delayed pass-through

<sup>9</sup>Data for CPI inflation for several provincial capitals for August 2008 are generally well above this rate, although it should be noted that provincial data do not reflect price changes on the same basket of goods.

**Table 2.4. Selected Western Hemisphere Economies: Real GDP, Consumer Prices, and Current Account Balance***(Annual percent change unless noted otherwise)*

	Real GDP				Consumer Prices <sup>1</sup>				Current Account Balance <sup>2</sup>			
	2006	2007	2008	2009	2006	2007	2008	2009	2006	2007	2008	2009
<b>Western Hemisphere</b>	<b>5.5</b>	<b>5.6</b>	<b>4.6</b>	<b>3.2</b>	<b>5.3</b>	<b>5.4</b>	<b>7.9</b>	<b>7.3</b>	<b>1.5</b>	<b>0.4</b>	<b>-0.8</b>	<b>-1.6</b>
<b>South America and Mexico<sup>3</sup></b>	<b>5.4</b>	<b>5.6</b>	<b>4.6</b>	<b>3.1</b>	<b>5.2</b>	<b>5.3</b>	<b>7.6</b>	<b>7.1</b>	<b>1.8</b>	<b>0.8</b>	<b>-0.5</b>	<b>-1.3</b>
Argentina	8.5	8.7	6.5	3.6	10.9	8.8	9.1	9.1	2.6	1.7	0.8	-0.6
Brazil	3.8	5.4	5.2	3.5	4.2	3.6	5.7	5.1	1.3	0.1	-1.8	-2.0
Chile	4.3	5.1	4.5	3.8	3.4	4.4	8.9	6.5	4.7	4.4	-1.1	-0.9
Colombia	6.8	7.7	4.0	3.5	4.3	5.5	7.3	5.5	-1.8	-2.9	-2.2	-1.9
Ecuador	3.9	2.5	3.0	3.0	3.3	2.3	8.5	5.1	3.9	2.3	5.6	1.5
Mexico	4.9	3.2	2.1	1.8	3.6	4.0	4.9	4.2	-0.2	-0.6	-1.4	-2.2
Peru	7.7	8.9	9.2	7.0	2.0	1.8	5.6	4.4	3.0	1.4	-2.0	-1.8
Uruguay	7.0	7.4	6.5	5.5	6.4	8.1	6.8	6.2	-2.4	-0.8	-2.6	-1.9
Venezuela, Rep. Boliv. de	10.3	8.4	6.0	2.0	13.7	18.7	27.2	33.5	14.7	8.8	8.5	3.4
<b>Central America<sup>4</sup></b>	<b>6.2</b>	<b>6.6</b>	<b>4.6</b>	<b>4.2</b>	<b>6.5</b>	<b>6.7</b>	<b>10.9</b>	<b>8.5</b>	<b>-4.8</b>	<b>-6.9</b>	<b>-9.1</b>	<b>-8.7</b>
<b>The Caribbean<sup>4</sup></b>	<b>7.8</b>	<b>5.6</b>	<b>3.7</b>	<b>2.9</b>	<b>7.8</b>	<b>6.7</b>	<b>12.1</b>	<b>10.1</b>	<b>-0.7</b>	<b>-1.7</b>	<b>-5.3</b>	<b>-4.4</b>

<sup>1</sup>Movements in consumer prices are shown as annual averages. December/December changes can be found in Table A7 in the Statistical Appendix.

<sup>2</sup>Percent of GDP.

<sup>3</sup>Includes Bolivia and Paraguay.

<sup>4</sup>The country composition of these regional groups is set out in Table F in the Statistical Appendix.

of international oil price increases and increased explicit subsidies. Although inflation should now gradually recede, monetary tightening is still warranted in some countries where real interest rates have become significantly negative and there is a sense that policy credibility is being eroded. Central banks with inflation-targeting regimes have earned some limited scope to tolerate temporary deviations of headline inflation from objectives, but, depending on evolving risks to activity, some may still need to raise rates further. At the same time, tighter control over the growth of government spending would help restrain domestic demand growth and reduce exposure to adverse shifts in market sentiment.

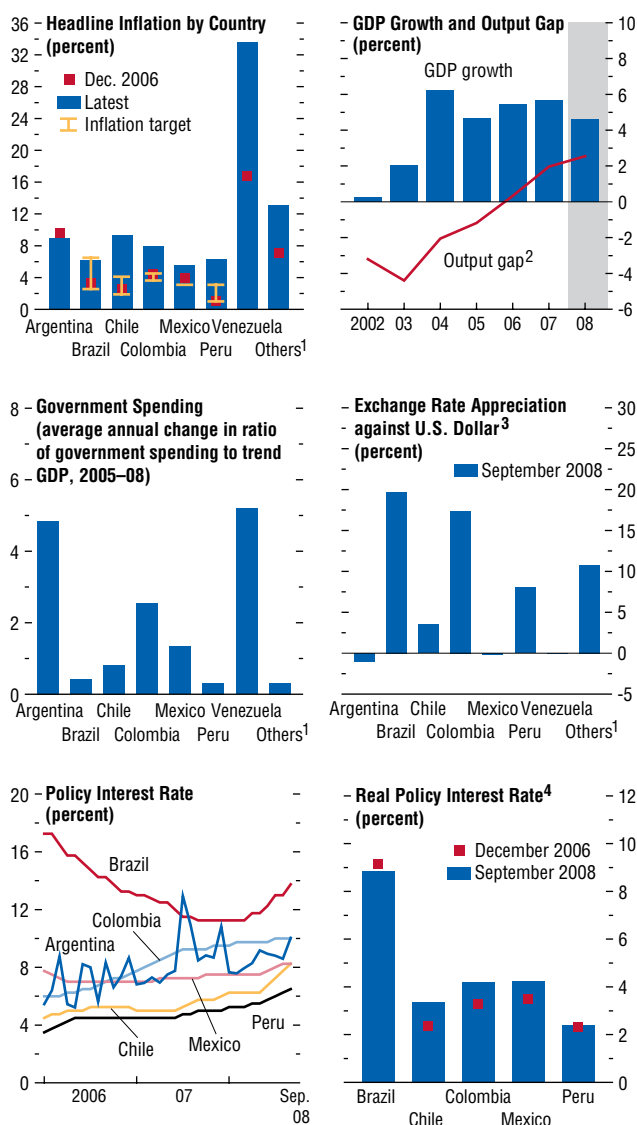
External positions are generally robust, although the turbulence in the global economy may erode the cushions that have been built up over the past few years. The region's current account balance is expected to move to deficit in 2008 and 2009, after being in surplus since 2003, but the deficit will remain quite low. Moreover, reserve levels are high, and flexible exchange rates provide room to maneuver in a number of countries. Overall, public sector

balance sheet vulnerabilities have been reduced and credit ratings raised—Brazil and Peru both achieved “investment grade” ratings in recent months. However, conditions for U.S. dollar funding have tightened in several countries over the past month, which—together with a sustained drop in commodity prices—could stretch macroeconomic policy frameworks.

Risks to this outlook are to the downside, largely related to external developments. A deeper downturn in global growth could trigger a sharp drop in commodity prices, while external financing conditions facing Latin America could continue to tighten. Such a scenario would slow growth in the region even more, and although inflation would moderate considerably, external positions could come under serious stress. In this event, policymakers would need to stand ready to adapt policies as needed to preserve macroeconomic stability and the prospects for long-term growth. Those few countries with very strong fiscal positions may have some scope for a countercyclical fiscal response. Flexible exchange rate management would provide resilience in the face of potentially volatile foreign exchange flows.

**Figure 2.5. Latin America: Inflation Returns**

Inflation has risen across the region, driven by rising food prices and tightening capacity constraints. Inflation-targeting central banks have generally been more active in raising interest rates, supported by more flexible exchange rate management.



Sources: Haver Analytics; Inter-American Development Bank; and IMF staff estimates.  
<sup>1</sup>Bolivia, Costa Rica, Guatemala, Honduras, Paraguay, and Uruguay.  
<sup>2</sup>Estimates of the output gap, expressed as ratio to potential GDP, are based on IMF staff calculations.  
<sup>3</sup>Since December 2006.  
<sup>4</sup>Relative to one-year inflation expectations.

## Emerging Europe: Prospects for a Soft Landing

Following a prolonged economic expansion, activity in emerging Europe has started to moderate and a significant slowdown appears in the offing. Weaker external demand, especially owing to the cooling of demand in western Europe, and tighter external financing conditions are weighing on investment and exports, while private consumption has slowed in the face of soaring food and energy prices. Nonetheless, ongoing expansion of productive capacity and rapid lending to the private sector by mostly foreign banks (particularly in Bulgaria and Romania) have continued to support domestic demand, although prospects for continued strong capital inflows have weakened noticeably. The Baltics, notably Estonia and Latvia, 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 (Figure 2.6). With real incomes eroded by high debt service and inflation and with foreign banks pulling back loan expansion on increasing concerns about a buildup of imbalances, private consumption and, to a lesser extent, investment have plummeted and current account deficits have started to decline.

Amid still-buoyant domestic demand and still-tight labor markets, inflation has been further boosted by increases in food and energy prices. By June 2008, headline inflation in most countries was double what it was a year earlier, reaching double digits in the Baltics (especially Latvia), Bulgaria, and Turkey. Underlying inflation has also climbed because of rising wages (for example, in Poland and the Slovak Republic) and strong demand pressures (particularly in Bulgaria, Romania, and Turkey). There is also evidence of second-round effects from surging food and energy prices, and inflation expectations have edged up in many countries. With inflation targets exceeded by wide margins, monetary policy has been tightened in central and eastern Europe (CEE), Romania, and

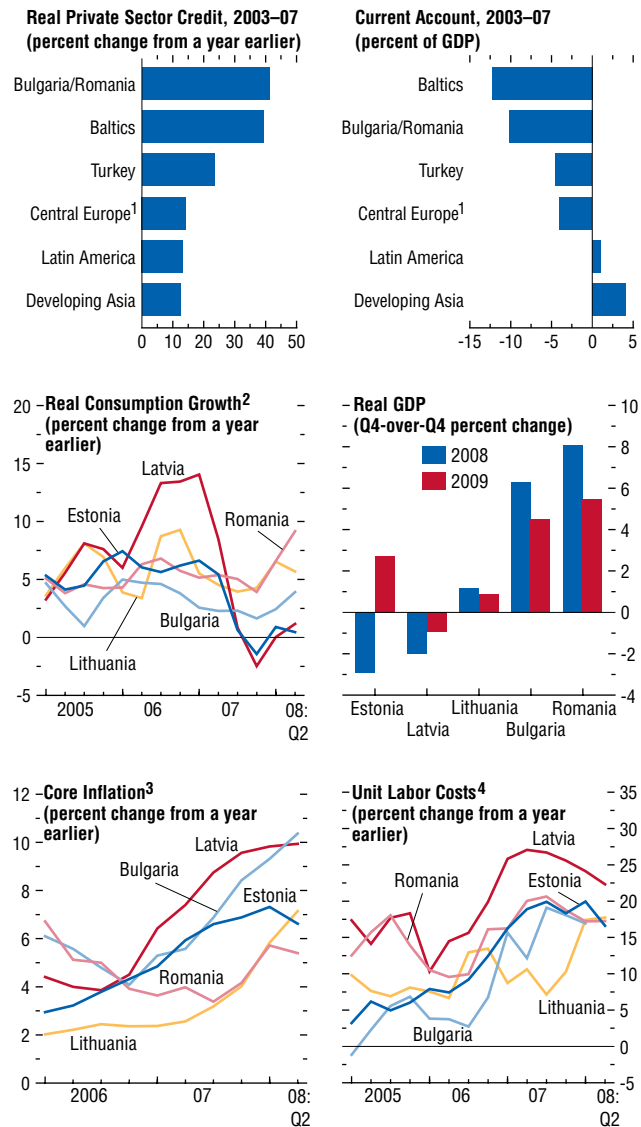
Turkey in the context of floating exchange rate regimes. In the CEE economies, strengthening currencies and good harvests have helped combat inflation pressures. However, countries with fixed exchange rates (the Baltics and Bulgaria) have had less room to tighten the monetary stance; in Romania and Turkey, currency depreciation contributed to inflation despite interest rate increases. Nonetheless, in Estonia, Hungary, and Latvia, inflation pressures have started to ebb in the course of economic corrections (see Figure 2.6).

Growth is expected to continue to decelerate markedly, including on account of diminishing capital inflows and tighter financial constraints. In the CEE economies, growth is projected to ease from about 6 percent in 2007 to near 4½ percent in 2008 and 3½ percent in 2009 (Table 2.5). Weakening demand from western Europe will slow exports and investment, and high inflation will take a toll on real incomes and consumption. Growth in southern and southeastern Europe (SEE) and Turkey will also weaken, as a worsening external outlook and still-high commodity prices weigh on consumption and investment. Corrections in the Baltics are expected to continue, with growth projected to drop from an average of near 9 percent in 2007 to 1¼ percent in 2008 and to -¼ percent in 2009. The economies are projected to start to recover gradually during the second half of 2009. Inflation pressures are expected to ease in 2009 as increases in commodity prices and domestic cost and demand pressures subside.

The risks to the outlook are tilted to the downside. They relate to deterioration in external financing conditions, larger than expected weakening of external demand, and renewed increases in commodity prices. Countries with large current account deficits financed in part by non-foreign-direct-investment capital inflows are particularly vulnerable to a sharp reversal of capital inflows. In some countries in emerging Europe, large nonresident holdings of local currency bonds, extensive domestic borrowing in foreign currencies, and dependence of some financial institutions on wholesale fund-

## Figure 2.6. Emerging Europe: Are Credit Booms Cooling Off?

Credit to the private sector has expanded at a much faster rate in the Baltics, Bulgaria, and Romania than in other countries in the region. Credit booms have been accompanied by a buildup of significant external imbalances. Estonia and Latvia are now undergoing a sharp correction, while consumption and GDP continue to grow briskly in Bulgaria and Romania and, to a lesser extent, in Lithuania. Core inflation and growth of unit labor costs have started to stabilize in Estonia and Latvia, while in Bulgaria, Lithuania, and Romania inflation pressures remain strong.



Sources: Haver Analytics; IMF, *International Financial Statistics*; and IMF staff estimates.

<sup>1</sup>Includes Czech Republic, Hungary, Poland, and Slovak Republic.

<sup>2</sup>Two-quarter moving average.

<sup>3</sup>Overall consumer price index (CPI) excluding energy, food, alcohol, and tobacco.

<sup>4</sup>Calculated as overall compensation divided by GDP, except for Romania, where wages are used instead of compensation.

**Table 2.5. Selected Emerging European Economies: Real GDP, Consumer Prices, and Current Account Balance***(Annual percent change unless noted otherwise)*

	Real GDP				Consumer Prices <sup>1</sup>				Current Account Balance <sup>2</sup>			
	2006	2007	2008	2009	2006	2007	2008	2009	2006	2007	2008	2009
<b>Emerging Europe</b>	<b>6.7</b>	<b>5.7</b>	<b>4.5</b>	<b>3.4</b>	<b>5.4</b>	<b>5.7</b>	<b>7.8</b>	<b>5.8</b>	<b>-6.0</b>	<b>-6.6</b>	<b>-7.1</b>	<b>-7.2</b>
Turkey	6.9	4.6	3.5	3.0	9.6	8.8	10.5	8.4	-6.0	-5.7	-6.5	-6.7
Excluding Turkey	6.6	6.3	5.0	3.5	3.2	4.1	6.4	4.5	-6.0	-7.1	-7.4	-7.4
<b>Baltics</b>	<b>9.8</b>	<b>8.8</b>	<b>1.2</b>	<b>-0.3</b>	<b>4.8</b>	<b>7.3</b>	<b>12.5</b>	<b>7.3</b>	<b>-15.8</b>	<b>-18.1</b>	<b>-14.0</b>	<b>-8.6</b>
Estonia	10.4	6.3	-1.5	0.5	4.4	6.6	10.2	5.1	-16.7	-18.1	-10.8	-8.7
Latvia	12.2	10.3	-0.9	-2.2	6.5	10.1	15.9	10.6	-22.7	-22.9	-15.1	-8.3
Lithuania	7.9	8.9	3.9	0.7	3.8	5.8	11.3	6.2	-10.7	-14.6	-14.9	-8.7
<b>Central Europe</b>	<b>6.2</b>	<b>6.1</b>	<b>4.6</b>	<b>3.6</b>	<b>2.1</b>	<b>3.4</b>	<b>4.9</b>	<b>3.5</b>	<b>-3.6</b>	<b>-3.7</b>	<b>-4.4</b>	<b>-5.0</b>
Czech Republic	6.8	6.6	4.0	3.4	2.5	2.8	6.7	3.4	-2.6	-1.8	-2.2	-2.5
Hungary	3.9	1.3	1.9	2.3	3.9	7.9	6.3	4.1	-6.1	-5.0	-5.5	-6.1
Poland	6.2	6.6	5.2	3.8	1.0	2.5	4.0	3.3	-2.7	-3.8	-4.7	-5.7
Slovak Republic	8.5	10.4	7.4	5.6	4.3	1.9	3.9	3.6	-7.1	-5.4	-5.1	-4.7
<b>Southern and south-eastern Europe</b>	<b>7.0</b>	<b>6.0</b>	<b>7.3</b>	<b>4.5</b>	<b>6.2</b>	<b>5.1</b>	<b>8.8</b>	<b>6.4</b>	<b>-10.7</b>	<b>-14.1</b>	<b>-14.8</b>	<b>-14.0</b>
Bulgaria	6.3	6.2	6.3	4.2	7.4	7.6	12.2	7.0	-15.6	-21.4	-24.4	-21.5
Croatia	4.8	5.6	3.8	3.7	3.2	2.9	7.0	4.9	-7.9	-8.6	-10.1	-10.2
Romania	7.9	6.0	8.6	4.8	6.6	4.8	8.2	6.6	-10.4	-14.0	-13.8	-13.3

<sup>1</sup>Movements in consumer prices are shown as annual averages. December/December changes can be found in Table A7 in the Statistical Appendix.

<sup>2</sup>Percent of GDP.

ing from abroad accentuate vulnerabilities to further changes in market sentiment. Beyond these risks, there is considerable uncertainty about the pace of adjustment in the Baltics. An even-sharper-than-projected slowdown cannot be ruled out, should external or domestic confidence plummet. The downturn may also be more prolonged than expected, if the labor markets, which must adjust to restore competitiveness, proves to be less flexible than expected.

Financial risks have risen appreciably with the onset of the turbulence in advanced financial markets. Although banks operating in emerging Europe have little if any direct exposure to the U.S. subprime market, they (and their foreign parents) have been affected by the widening turmoil in western Europe. A decline in global risk appetite has raised liquidity risks by increasing banks' external funding costs and shortening maturities. Credit risks have also risen: the credit boom was accompanied by lengthening maturities, rising loan-to-value ratios, and more exposure to riskier products (for example, yen-denominated loans in Hungary and Swiss-

franc-denominated loans in Poland, including at variable rates). A recent deceleration in real estate prices, at least in some countries, makes banks more vulnerable to credit risk. Foreign currency lending is widespread, in both fixed-exchange-rate countries (for example, most lending is done in euros in the Baltics) and in floating-exchange-rate countries (for example, in Hungary and Romania, foreign currency loans accounted for about 60 percent of total household loans in 2007). Lower equity prices and rising bond spreads have raised funding costs.

The policy challenge is how to engineer a soft landing, while continuing to lay the groundwork for sustainable convergence to western European living standards.

- In the CEE economies, the risks to inflation and growth appear balanced, justifying keeping monetary policy on hold for the moment, although the balance of risks hinges on unpredictable capital flows and exchange rate developments. Fiscal positions have recently been strengthened by buoyant revenues and

spending restraint, but there is little room for automatic stabilizers to operate in full. Continued fiscal consolidation would help widen these margins and unburden monetary policy. Public finances need to be put on a sustainable long-term path to meet the challenges posed by population aging and to support continued convergence with the euro area, particularly in the Slovak Republic, which is scheduled to adopt the euro in January 2009. Addressing remaining rigidities in the labor market would facilitate long-term fiscal adjustment while easing labor market constraints and wage pressures.

- In the Baltics, macroeconomic adjustment needs to run its course. Although domestic demand pressures are subsiding, especially in Estonia and Latvia, external imbalances still loom large, inflation is at double-digit levels, and confidence is weakening. It is important to resist the temptation to significantly ease fiscal policy in the downturn, considering that these economies' high degree of openness would limit its impact on demand. It will be important to claw back unsustainable expenditure increases from the recent past and target structural balance over the medium term. There is also a need for heightened supervisory vigilance and contingency plans for financial institutions to deal with potentially significant loan losses from the economic downturn. This will require close collaboration between domestic and foreign prudential authorities, given the large share of foreign-owned banks.
- In the SEE economies, action is needed to rein in rising external and internal imbalances, mindful of the more volatile external financing conditions. Like the Baltics several years ago, these countries are still enjoying "good times," and fiscal and income policies need to avoid adding procyclical impulses to the already overheating private sector. Specifically, growth in public expenditures needs to be contained by keeping public wage increases in line with productivity growth and reducing the size of government,

in conjunction with reforms to raise the efficiency of the public sector. With credit to the private sector growing at double-digit rates, maintaining high prudential standards—and rigorously applying them—is critical in order to prevent weakening credit standards. Again, close cross-border collaboration will be important, for the same reasons as in the Baltics.

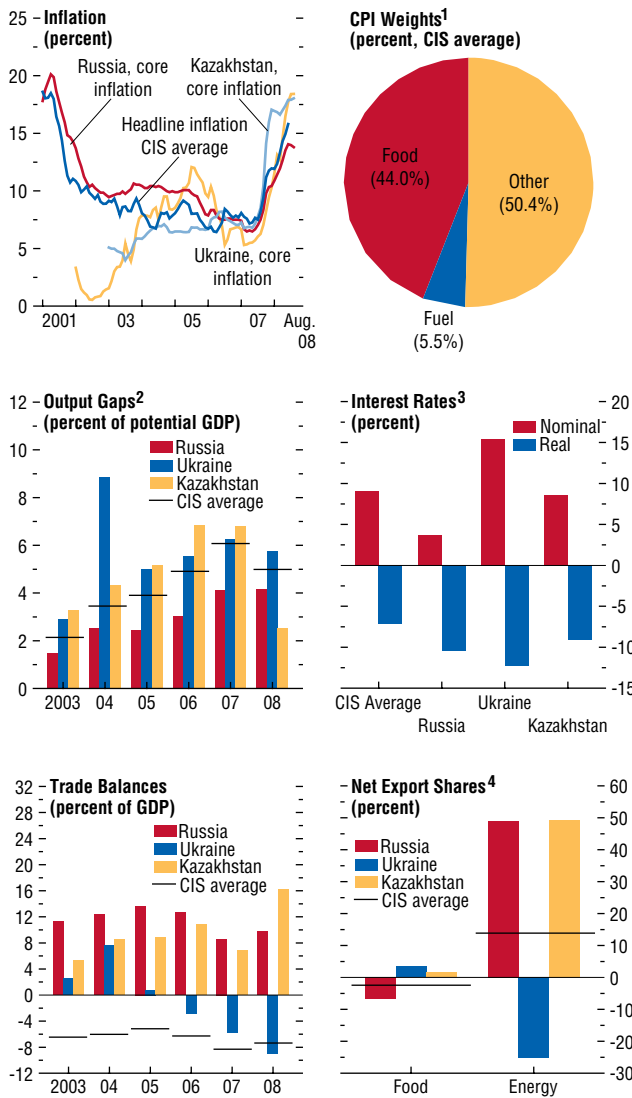
### Commonwealth of Independent States: Managing the Commodity Price Boom

Real GDP growth has been strong in most countries of the Commonwealth of Independent States (CIS), 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, growth prospects are deteriorating as the region has been affected by the global financial turmoil, notably Kazakhstan and, more recently, Russia, which have been confronted by loss of confidence and a sharp turn in capital flows. Weakening demand from partner countries would add to the effects on growth of unsettled financial markets.

High world prices for food and fuel have contributed significantly to inflation pressures across the region. Partly as a result of the high weight of food in household consumption, headline inflation accelerated sharply during the first half of 2008, reaching nearly 15 percent by the summer (Figure 2.7). Moreover, core inflation has picked up around the region, reflecting the combination of strains from rising commodity prices and domestic demand pressures. Thus, there are concerns about overheating, with output consistently above potential and labor markets remaining tight. The policy stance generally continues to be expansionary across the region; interest rates have turned negative in real terms, while government spending continues to expand rapidly. High international commodity prices have continued to boost trade balances in net commodity exporters, while net commodity importers have

**Figure 2.7. Commonwealth of Independent States (CIS): Managing the Commodity Price Boom**

Soaring food and fuel prices are causing divergence in external positions and contributing to rising inflation across the region, while expansionary policies continue to stimulate demand.



Sources: IMF, *International Financial Statistics*; and IMF staff calculations.

<sup>1</sup>CPI = consumer price index.

<sup>2</sup>Output gaps are estimated using a Hodrick-Prescott filtered potential GDP. See Box 1.3 for more detail on the methodology and the estimation issues involved.

<sup>3</sup>Deposit rates. Real rates are computed using headline inflation.

<sup>4</sup>Shares in total exports minus shares in total imports.

seen a marked weakening in their external positions. Azerbaijan, Kazakhstan, Russia, Turkmenistan, and Uzbekistan have benefited most from terms-of-trade gains, whereas terms of trade in Armenia, Moldova, and Tajikistan have worsened. In net food importers, food balances have deteriorated significantly, with deficits reaching precarious levels in some countries. Linked to the rising cost of food imports, the Kyrgyz Republic received an augmented disbursement from the IMF in May to help meet a larger than expected balance of payments shortfall.

In response to slowing external demand and emerging financial market pressure, real GDP growth is projected to slow from 7¼ percent this year to about 5¾ percent in 2009 (Table 2.6). Notwithstanding recent oil price declines, output is expected to grow at a solid pace in net energy exporters, where terms-of-trade gains should continue to boost demand, whereas net energy importers will likely see their growth momentum weaken noticeably. In Russia, the growth forecast for 2008 reflects a stronger-than-expected performance early in the year, rising terms-of-trade gains, and a larger-than-expected fiscal stimulus package. But growth is set to weaken appreciably, reflecting slowing world demand and tightening financial conditions. In Kazakhstan, growth is expected to remain relatively subdued as the excesses of the earlier credit boom unwind, although the still-buoyant oil sector should continue to partially offset the effects of the credit crunch. In Ukraine, the growth forecast for 2008 reflects strong performance during the first half of the year, terms-of-trade gains, and indications of a bumper harvest. Going forward, growth is projected to decelerate markedly, reflecting weaker export market growth, slowing real wage increases, moderating terms-of-trade gains, and higher financing costs.

Risks to the outlook have moved to the downside. Financial market uncertainties are a source of concern, notably for countries with rapidly expanding current account deficits, such as Ukraine, and for other countries that are already heavily reliant on capital inflows.



**Table 2.6. Commonwealth of Independent States (CIS): Real GDP, Consumer Prices, and Current Account Balance***(Annual percent change unless noted otherwise)*

	Real GDP				Consumer Prices <sup>1</sup>				Current Account Balance <sup>2</sup>			
	2006	2007	2008	2009	2006	2007	2008	2009	2006	2007	2008	2009
<b>Commonwealth of Independent States</b>	<b>8.2</b>	<b>8.6</b>	<b>7.2</b>	<b>5.7</b>	<b>9.5</b>	<b>9.7</b>	<b>15.6</b>	<b>12.6</b>	<b>7.5</b>	<b>4.4</b>	<b>5.5</b>	<b>3.0</b>
Russia	7.4	8.1	7.0	5.5	9.7	9.0	14.0	12.0	9.5	5.9	6.5	3.4
Ukraine	7.3	7.6	6.4	2.5	9.1	12.8	25.3	18.8	-1.5	-3.7	-7.2	-9.2
Kazakhstan	10.7	8.9	4.5	5.3	8.6	10.8	17.6	9.8	-2.4	-6.9	4.3	3.3
Belarus	10.0	8.2	9.2	8.0	7.0	8.4	15.3	9.6	-3.9	-6.8	-5.9	-8.0
Turkmenistan	11.4	11.6	10.8	10.3	8.2	6.3	13.0	12.0	15.7	15.4	26.5	33.0
<b>Low-income CIS countries</b>	<b>14.7</b>	<b>14.5</b>	<b>10.5</b>	<b>10.5</b>	<b>10.1</b>	<b>12.7</b>	<b>16.3</b>	<b>13.7</b>	<b>7.7</b>	<b>11.2</b>	<b>15.7</b>	<b>16.2</b>
Armenia	13.3	13.8	10.0	8.0	2.9	4.4	9.4	5.0	-1.8	-6.4	-9.7	-10.8
Azerbaijan	30.5	23.4	16.0	16.4	8.4	16.6	22.4	20.0	17.7	28.9	38.3	38.6
Georgia	9.4	12.4	3.5	4.0	9.2	9.2	10.0	7.6	-15.9	-20.0	-20.8	-18.7
Kyrgyz Republic	3.1	8.2	7.5	6.7	5.6	10.2	24.5	12.2	-3.1	-0.2	-4.2	-5.4
Moldova	4.8	4.0	6.5	6.5	12.7	12.4	13.7	9.7	-11.8	-17.0	-19.9	-19.1
Tajikistan	7.0	7.8	6.0	7.0	10.0	13.2	21.6	15.5	-2.8	-11.2	-8.5	-8.1
Uzbekistan	7.3	9.5	8.0	7.5	14.2	12.3	11.1	10.6	17.2	19.1	16.8	12.8
<i>Memorandum</i>												
Net energy exporters <sup>3</sup>	8.2	8.7	7.2	6.0	9.7	9.4	14.5	12.1	9.1	5.9	7.5	4.8
Net energy importers <sup>4</sup>	8.0	8.1	7.0	4.2	8.5	11.4	21.5	15.4	-3.0	-5.6	-7.9	-9.6

<sup>1</sup>Movements in consumer prices are shown as annual averages. December/December changes can be found in Table A7 in the Statistical Appendix.

<sup>2</sup>Percent of GDP.

<sup>3</sup>Includes Azerbaijan, Kazakhstan, Russia, Turkmenistan, and Uzbekistan.

<sup>4</sup>Includes Armenia, Belarus, Georgia, Kyrgyz Republic, Moldova, Tajikistan, and Ukraine.

Although further monetary and fiscal tightening is expected in the second half of 2008, the near-term effects on activity and inflation will likely be limited. Accordingly, inflation risks are still on the upside for net commodity importers and exporters alike.

Inflation is now expected to be higher than projected in the April 2008 *World Economic Outlook*, 15½ percent this year and 12½ percent next year, reflecting intensifying price pressures amid persistently high commodity prices and little spare capacity. Against this backdrop, monetary policy effectiveness generally remains constrained by inflexible exchange rate regimes, although in Ukraine the exchange rate was recently revalued within a widened trading band. To compensate, governments in CIS countries have resorted to a variety of fiscal and trade measures in order to contain inflation pressures and alleviate the social impact of rising food prices. These measures include reducing or eliminating import taxes and tariffs on key

food items, cutting back domestic consumption taxes or stepping up subsidies for food and fuel, introducing direct price caps on key food items, and imposing export taxes and quotas. Some countries have introduced short-term supply-oriented measures, mainly subsidies and other supports to agriculture. However, the fiscal costs of these measures have reached disconcerting proportions in a number of economies, raising concerns about fiscal sustainability.

For as long as inflation pressure is not projected to diminish markedly from presently elevated levels, stronger policy action is needed in many countries across the region in order to ensure that long-term inflation expectations remain firmly anchored. A comprehensive policy response would require a combination of monetary tightening and greater exchange rate flexibility, combined with a prudent fiscal stance. In particular, universal subsidies, which reinforce domestic demand pressures and burden public resources, could usefully be

replaced with temporary and targeted measures to alleviate the social effects of soaring food and energy prices on vulnerable segments of the population. In this regard, export restrictions and other policy interventions that prevent the needed supply adjustment are likely to prove counterproductive.

Over the longer term, the region continues to face the challenge of reducing its sensitivity to commodity price shocks through diversification of the economy away from primary commodities. Further efforts to improve the business climate; increase competition, including in the food and energy sectors; strengthen domestic financial systems; and continue to build market institutions more broadly would foster stronger performance and reduce vulnerabilities associated with terms-of-trade shifts.

### Sub-Saharan Africa: A Test of Policy Frameworks

Economic growth in sub-Saharan Africa (SSA) is expected to moderate in the face of the financial turmoil and high energy and food prices, even though many SSA countries are benefiting from terms-of-trade gains resulting from the surge in other commodity prices. Overall, growth is projected to decline from near 7 percent in 2007 to just over 6 percent in 2008–09. However, there are important cross-country variations (Figure 2.8 and Table 2.7). Despite a weakening external environment, economic expansion in oil-exporting countries is expected to soften only moderately in 2008–09, with growth declining to about 7½ percent from near 8 percent in 2007, owing to a near 75 percent improvement in the terms of trade in 2008. For oil importers, the terms of trade would remain broadly stable in 2008, with higher oil prices offset by higher export prices for metals, coffee, cocoa, and cotton.<sup>10</sup> However,

<sup>10</sup>Oil importers stand to benefit from higher prices for metals (Botswana, Ghana, Guinea, Kenya, Mozambique, Senegal, South Africa, Togo, Uganda, and Zambia), coffee, cocoa, and cotton (Burundi, Côte d'Ivoire, Ethiopia,

the countries hit hardest (Benin, The Gambia, Kenya, Madagascar, Rwanda, and Sierra Leone) are projected to experience a 15–20 percent deterioration in the terms of trade. In South Africa, SSA's largest economy, electricity shortages early in 2008 and the need for a 500-basis-point rise in policy interest rates since mid-2006 to contain inflation are expected to slow growth from 5 percent in 2007 to about 3½ percent in 2008–09. The risks to the regional growth outlook are tilted to the downside and relate mainly to slower-than-expected growth in global demand and slowing capital inflows.

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 near 12 percent in 2008, before easing to 9½ percent in 2009, although the average masks significant variation across countries. Food price rises tend to have a large impact on inflation in SSA, reflecting a high share of food in consumer baskets (see Chapter 3). Domestic demand pressures, which have emerged in some SSA countries during the past several years of robust growth, may also be amplifying the initial impact of food and fuel price shocks through second-round effects on inflation.

Against the backdrop of rising inflation, the impact of higher food prices on poverty is a major concern as it risks undermining past progress in this area and putting social cohesion at risk. SSA countries' strong dependence on imports of food and fuel as well as a high incidence of poverty make them most vulnerable to increases in prices of these commodities. Populations in these countries have few options to hedge against rising food prices, and the urban poor tend to suffer most. The IMF staff estimates that rising prices for imported food would have the largest impact on poverty in The Gambia, Ghana, Mauritania, and Swaziland owing to their high dependence on

Kenya, Rwanda, Uganda, and Zambia, among others). For more details on the effects of the recent commodity price shock, see Chapter 3 and IMF (2008a).

imports and low incomes (IMF, 2008a). Some countries have responded to rising inflation pressures by tightening monetary policy, but many have reduced import tariffs and the value-added tax on food or have imposed export taxes and other restrictions.

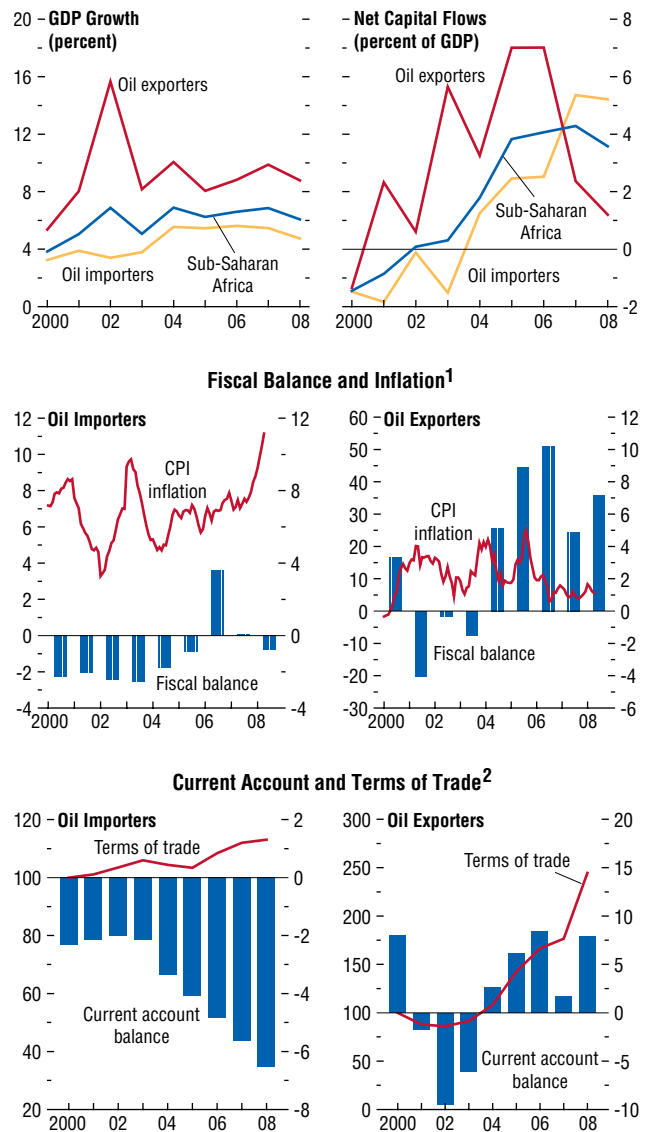
The external positions of oil-importing countries are also coming under pressure because of surging prices of imported food and fuel. Current account deficits in oil-importing countries are projected to deteriorate on average from about 5 percent of GDP in 2007 to about 5¾ percent of GDP in 2008 and 6¼ percent in 2009. In South Africa, a widening current account deficit, which stood at 7¼ percent of GDP in the second quarter of 2008, is of particular concern. The deficit is financed largely through volatile portfolio flows, although low external debt and a flexible exchange rate should provide some resilience if capital flows were to reverse. By contrast, current account balances in oil-exporting countries are in surplus and are projected to strengthen further, from 8 percent in 2007 to 13½ percent in 2008 and about 8 percent in 2009.

The main challenge for the region is how to respond to the large commodity price shock and the threat of slowing capital inflows. Oil-importing countries, where the negative terms-of-trade shock has weakened fiscal and external positions, need to adjust their monetary, fiscal, and income policies. Delaying the adjustment would put at risk not only macroeconomic stability but also recent achievements in improving policy and institutional frameworks, which have been largely responsible for SSA's impressive growth performance in recent years.

- Countries with managed or fixed exchange rates need to tighten monetary policies through interest rate increases or administrative measures to prevent inflation expectations from becoming ingrained and to strengthen the balance of payments and fiscal positions. A reduction in public sector borrowing and greater exchange rate flexibility would support monetary tightening and ease pressure on the balance of payments.

**Figure 2.8. Sub-Saharan Africa: The Mixed Blessing of High Commodity Prices**

At the aggregate level, growth in Africa is expected to show some resilience to the global slowdown, as many countries benefit from improvement in the terms of trade owing to a surge in fuel and nonfuel commodity prices, and net capital inflows to the region remain broadly steady. Nonetheless, there are dramatic differences in the economic performance of oil importers and exporters, with the former experiencing a significant deterioration in their current account and fiscal positions, as well as a sharp rise in inflation.



Sources: Haver Analytics; IMF, *Direction of Trade Statistics*; and IMF staff calculations.  
<sup>1</sup>Consumer price index (CPI) inflation measured as percent change from a year earlier, left scale; fiscal balances measured as percent of GDP, right scale.  
<sup>2</sup>Current account balances measured as percent of GDP, right scale; terms of trade measured as index, 2000 = 100, left scale.

**Table 2.7. Selected African Economies: Real GDP, Consumer Prices, and Current Account Balance**  
(Annual percent change unless noted otherwise)

	Real GDP				Consumer Prices <sup>1</sup>				Current Account Balance <sup>2</sup>			
	2006	2007	2008	2009	2006	2007	2008	2009	2006	2007	2008	2009
<b>Africa</b>	<b>6.1</b>	<b>6.3</b>	<b>5.9</b>	<b>6.0</b>	<b>6.3</b>	<b>6.2</b>	<b>10.2</b>	<b>8.3</b>	<b>2.9</b>	<b>0.4</b>	<b>3.0</b>	<b>0.2</b>
<b>Maghreb</b>	<b>4.3</b>	<b>4.3</b>	<b>5.5</b>	<b>4.9</b>	<b>3.1</b>	<b>3.0</b>	<b>4.3</b>	<b>4.0</b>	<b>13.9</b>	<b>12.1</b>	<b>15.5</b>	<b>10.3</b>
Algeria	2.0	4.6	4.9	4.5	2.5	3.6	4.3	4.0	24.8	22.8	28.1	19.8
Morocco	7.8	2.7	6.5	5.5	3.3	2.0	3.9	3.5	2.2	-0.1	0.4	-0.3
Tunisia	5.5	6.3	5.5	5.0	4.5	3.1	5.1	4.5	-2.0	-2.6	-3.4	-3.5
<b>Sub-Saharan</b>	<b>6.6</b>	<b>6.9</b>	<b>6.1</b>	<b>6.3</b>	<b>7.3</b>	<b>7.1</b>	<b>11.9</b>	<b>9.5</b>	<b>-0.3</b>	<b>-3.0</b>	<b>-0.7</b>	<b>-2.4</b>
<b>Horn of Africa<sup>3</sup></b>	<b>11.3</b>	<b>10.6</b>	<b>8.4</b>	<b>7.2</b>	<b>9.1</b>	<b>11.0</b>	<b>19.5</b>	<b>20.9</b>	<b>-13.4</b>	<b>-10.4</b>	<b>-6.3</b>	<b>-6.5</b>
Ethiopia	11.6	11.4	8.4	6.5	12.3	15.8	25.3	40.8	-9.1	-4.5	-5.0	-5.2
Sudan	11.3	10.2	8.5	7.7	7.2	8.0	16.0	10.0	-15.2	-12.6	-6.3	-6.7
<b>Great Lakes<sup>3</sup></b>	<b>7.1</b>	<b>7.0</b>	<b>6.5</b>	<b>7.6</b>	<b>10.4</b>	<b>9.2</b>	<b>15.7</b>	<b>7.9</b>	<b>-4.3</b>	<b>-4.5</b>	<b>-6.2</b>	<b>-7.8</b>
Congo, Dem. Rep. of	5.6	6.3	10.0	10.3	13.2	16.7	17.5	15.1	-2.4	-1.8	-1.9	-12.6
Kenya	6.4	7.0	3.3	6.4	14.5	9.8	25.0	6.5	-2.3	-3.1	-6.1	-4.5
Tanzania	6.7	7.1	7.5	8.0	7.3	7.0	9.2	6.5	-7.7	-9.0	-9.8	-10.0
Uganda	10.8	7.9	9.8	8.1	6.6	6.8	7.3	7.8	-3.5	-2.8	-3.4	-5.8
<b>Southern Africa<sup>3</sup></b>	<b>11.0</b>	<b>12.9</b>	<b>10.6</b>	<b>9.4</b>	<b>11.5</b>	<b>10.0</b>	<b>11.3</b>	<b>9.4</b>	<b>12.8</b>	<b>6.7</b>	<b>9.6</b>	<b>8.3</b>
Angola	18.6	21.1	16.0	12.8	13.3	12.2	12.1	9.3	23.3	11.3	18.0	15.9
Zimbabwe <sup>4</sup>	-5.4	-6.1	...	...	1,016.7	10,452.6	...	...	-7.0	-3.5	...	...
<b>West and Central Africa<sup>3</sup></b>	<b>4.9</b>	<b>5.1</b>	<b>5.4</b>	<b>6.8</b>	<b>6.8</b>	<b>4.6</b>	<b>9.3</b>	<b>8.3</b>	<b>4.5</b>	<b>-0.8</b>	<b>3.1</b>	<b>-0.4</b>
Ghana	6.4	6.3	6.5	5.8	10.2	10.7	16.8	13.3	-9.0	-10.9	-13.1	-13.2
Nigeria	6.2	5.9	6.2	8.1	8.3	5.5	11.0	11.1	9.5	2.1	6.2	0.6
<b>CFA franc zone<sup>3</sup></b>	<b>2.8</b>	<b>4.2</b>	<b>4.3</b>	<b>5.6</b>	<b>3.2</b>	<b>1.4</b>	<b>5.6</b>	<b>4.1</b>	<b>0.1</b>	<b>-2.4</b>	<b>2.5</b>	<b>0.7</b>
Cameroon	3.2	3.5	3.8	4.6	5.1	0.9	4.1	2.1	0.6	-1.9	1.3	-1.1
Côte d'Ivoire	0.7	1.6	2.9	4.7	2.5	1.9	5.6	5.7	2.8	-0.7	3.8	-0.6
<b>South Africa</b>	<b>5.4</b>	<b>5.1</b>	<b>3.8</b>	<b>3.3</b>	<b>4.7</b>	<b>7.1</b>	<b>11.8</b>	<b>8.0</b>	<b>-6.5</b>	<b>-7.3</b>	<b>-8.0</b>	<b>-8.1</b>
<i>Memorandum</i>												
Oil importers	5.9	5.3	5.0	5.0	6.3	6.6	10.9	8.5	-3.8	-4.9	-5.7	-6.3
Oil exporters <sup>5</sup>	6.5	7.9	7.4	7.6	6.4	5.5	9.2	8.0	13.1	7.9	13.5	8.1

<sup>1</sup>Movements in consumer prices are shown as annual averages. December/December changes can be found in Table A7 in the Statistical Appendix.

<sup>2</sup>Percent of GDP.

<sup>3</sup>The country composition of these regional groups is set out in Table F in the Statistical Appendix.

<sup>4</sup>No projections for 2008 and beyond are shown. The inflation figure for 2007 represents an estimate.

<sup>5</sup>Includes Chad and Mauritania in this table.

- At the same time, targeted fiscal measures, including subsidies, are needed to help protect the poor. These measures would need to be complemented by steps to safeguard the long-term budget position, including a gradual yet full pass-through of international oil prices to consumer prices as better-targeted measures are put in place for the poor. Price controls on food items are likely to be ineffective, leading to shortages and budgetary costs rather than reduced inflation.
- Additional donor assistance is needed to cushion the impact of adjustment on vulnerable countries that have high poverty levels, limited access to foreign financing,

low reserve cushions, and high external or public debt levels. Such funding would allow these countries to meet higher import bills and provide targeted budget assistance to the poorest segments of the population while the necessary adjustments are phased in. Over the longer term, donor assistance could seek to promote the development of domestic agriculture and sustainable social safety nets. Oil-exporting countries face the challenge of managing the windfall gains from high commodity prices more successfully than during similar past episodes, which failed to produce permanent improvements in living standards. Rising current account surpluses and inflation

pressures call for close coordination between monetary and fiscal policies. Saving a portion of oil revenues would help mitigate emerging inflation pressures while laying a solid financial basis for addressing vital infrastructure, health, and social needs. Monetary tightening could help stabilize inflation and guard against the development of a generalized inflation process. Allowing nominal exchange rates to appreciate would also help keep inflation under control.

### Middle East: Overheating Still a Concern

Activity continues to grow at a robust pace in much of the Middle East, while inflation pressures either remain high or keep rising, particularly in a number of oil exporters. Real GDP growth in Middle Eastern countries is projected to weaken only modestly during 2008–09, from 6½ percent to just below 6 percent, with oil exporters and non-oil economies growing at a similar pace (Table 2.8). The effects of falling demand in advanced partner economies and increasing supply-side constraints in oil sectors are projected to be partly offset by robust domestic demand and activity in non-oil sectors. Rising oil and food prices are posing important budgetary challenges for many non-oil economies. By contrast, the global financial turmoil has had relatively little effect on the region thus far, beyond pressing stock markets to surrender earlier gains.

Economic growth is being sustained mainly by non-oil sectors, as capacity constraints are slowing oil output growth (Figure 2.9). Growth in oil exporters is being driven by private construction, retail trade, transportation, and financial services. Aside from the indirect effect of high oil revenues, the strength reflects an improved business environment that is fostering private investment and a buildup in public projects to alleviate infrastructure and housing bottlenecks that have accumulated with rapid population growth. Notwithstanding record oil prices, recent activity in the oil sector has been noticeably less buoyant than in the non-oil sector. Despite heavy investment, production and

distribution capacity are rising slowly, owing to soaring investment costs, technological and geological constraints, and the depletion of existing fields. Still, oil and natural gas production capacity and, to a lesser extent, output are projected to expand moderately in 2008–09, with significant new capacity in Qatar and Saudi Arabia. Real GDP growth in the non-oil economies is benefiting from past efforts to improve their business environments. Sizable FDI inflows are boosting activity in Egypt and Jordan, while Lebanon is continuing to recover from the conflict in 2006.

Signs of overheating are multiplying. Inflation has reached double-digit rates even in some countries with traditionally low rates, such as Saudi Arabia, and exceeds 20 percent in Egypt and the Islamic Republic of Iran. The surge in inflation has occurred despite limited pass-through of high fuel and, to a lesser extent, food prices to domestic markets.<sup>11</sup> Not surprisingly, although inflation is still driven mainly by foreign-determined prices (including the depreciation of the U.S. dollar against third currencies), pressures are increasingly spilling over into domestically determined prices of nontraded goods. This is particularly true in oil-exporting countries, where expanding and wealthier populations and an influx of foreign workers are putting pressure on services prices, notably for housing, and where governments are granting large wage hikes. However, other countries are beginning to see broader pressures too. Accordingly, despite the technical assumptions of no further real effective exchange rate depreciation and broadly unchanged prices for fuel and food, inflation is expected to retreat only moderately in 2009.

At the same time, robust domestic demand is driving an acceleration of imports across the region. Current account developments differ widely between oil exporters and non-oil economies. Oil exporters are recording large and

<sup>11</sup>These items typically have a combined weight of between one-quarter and one-third in consumption baskets, with the bulk accounted for by food.

**Table 2.8. Selected Middle Eastern Economies: Real GDP, Consumer Prices, and Current Account Balance***(Annual percent change unless noted otherwise)*

	Real GDP				Consumer Prices <sup>1</sup>				Current Account Balance <sup>2</sup>			
	2006	2007	2008	2009	2006	2007	2008	2009	2006	2007	2008	2009
<b>Middle East</b>	<b>5.7</b>	<b>5.9</b>	<b>6.4</b>	<b>5.9</b>	<b>7.0</b>	<b>10.6</b>	<b>15.8</b>	<b>14.4</b>	<b>21.1</b>	<b>18.4</b>	<b>22.9</b>	<b>17.1</b>
<b>Oil exporters<sup>3</sup></b>	<b>5.6</b>	<b>5.7</b>	<b>6.2</b>	<b>5.9</b>	<b>7.6</b>	<b>10.7</b>	<b>16.8</b>	<b>14.3</b>	<b>24.2</b>	<b>21.2</b>	<b>26.0</b>	<b>19.9</b>
Iran, I.R. of	5.8	6.4	5.5	5.0	11.9	18.4	26.0	22.0	9.2	10.1	11.2	6.7
Saudi Arabia	3.0	3.5	5.9	4.3	2.3	4.1	11.5	10.0	27.9	25.1	32.5	23.8
United Arab Emirates	9.4	7.4	7.0	6.0	9.3	11.1	12.9	10.8	22.6	20.5	22.6	18.8
Kuwait	6.3	4.6	5.9	5.8	3.1	5.5	9.0	7.5	52.2	43.1	44.6	39.3
<b>Mashreq</b>	<b>5.9</b>	<b>6.3</b>	<b>6.6</b>	<b>5.8</b>	<b>5.4</b>	<b>9.2</b>	<b>11.3</b>	<b>13.5</b>	<b>-1.7</b>	<b>-2.2</b>	<b>-3.1</b>	<b>-3.6</b>
Egypt	6.8	7.1	7.2	6.0	4.2	11.0	11.7	16.1	0.8	1.5	0.6	-0.9
Syrian Arab Republic	4.4	3.9	4.2	5.2	10.4	4.7	8.0	7.0	-2.9	-1.4	-2.7	-2.9
Jordan	6.3	6.0	5.5	5.3	6.3	5.4	15.8	7.6	-11.3	-17.5	-18.5	-16.3
Lebanon	—	4.0	6.0	5.0	5.6	4.1	11.0	6.2	-5.6	-12.7	-14.0	-13.7
<i>Memorandum</i>												
Israel	5.2	5.4	4.3	2.8	2.1	0.5	4.8	3.3	5.9	3.2	0.4	0.5

<sup>1</sup>Movements in consumer prices are shown as annual averages. December/December changes can be found in Table A7 in the Statistical Appendix.

<sup>2</sup>Percent of GDP.

<sup>3</sup>Includes Bahrain, Islamic Republic of Iran, Kuwait, Libya, Oman, Qatar, Saudi Arabia, Syrian Arab Republic, United Arab Emirates, and Republic of Yemen.

growing surpluses, generally projected to reach 10–45 percent of GDP in 2008–09. In the other countries, deficits have widened in response to rising import costs—to double-digit levels in Jordan and Lebanon, but to still-low levels in Egypt.

The risks to the growth outlook remain broadly balanced. External risks are mostly to the downside and relate to weaker demand in advanced economies and potentially lower oil prices. Capital inflows to deficit countries could take a hit if global financial conditions were to worsen suddenly, and access to funding by major nonfinancial corporations could also become more difficult. Upside risks relate to still-robust domestic demand and foreign investors' continued strong interest from within (notably the Gulf Cooperation Council—GCC—countries) and outside the region. However, if upside risks materialize and exacerbate inflation pressure, this would further complicate macroeconomic policies.

In this setting, warding off mounting inflation pressures requires addressing growing imbalances. Countries that are not pegging exchange rates to foreign currencies (for example, Egypt and the Islamic Republic of Iran) can further

tighten monetary policy while enhancing its effectiveness through greater exchange rate flexibility. In countries with pegged exchange rates, monetary policy is imported from abroad, mainly from the United States. In many oil exporters, currencies are undervalued, although by varying degrees, and higher inflation is contributing to an appreciation of real effective exchange rates. The main driver of the undervaluation is the peg to the U.S. dollar, which has been depreciating while terms of trade have been improving. Once domestic prices have completely adjusted to the higher levels that are consistent with an appreciated real effective exchange rate, inflation pressures should subside, provided the peg and fiscal policy effectively anchor expectations.

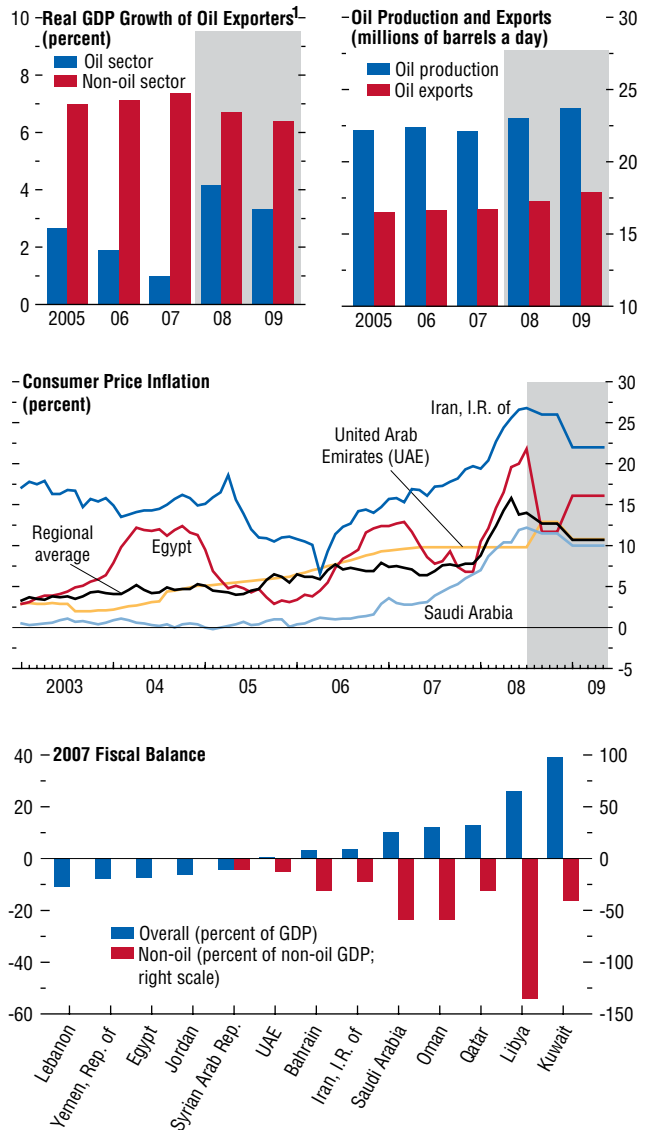
The move to a new equilibrium could also be achieved through a revaluation of currencies, but this would be complex, particularly in the GCC countries, which plan to move to monetary union in 2010. First, revaluations would introduce uncertainty as to how policy would respond to external shocks in the future, undermining the value of the peg as a nominal anchor. Second, many pegging countries still need to

develop both their capacity to conduct an independent monetary policy and the underlying financial market infrastructure. Third, volatility in oil markets could lead to volatile exchange rates under a floating regime, which might hamper some countries' efforts to diversify their export bases. Some of these issues would be addressed by a switch from a peg to the U.S. dollar to a peg to a basket of currencies that better reflects the composition of trade and services exchange with the rest of the world. However, had such a peg been in place recently, it would not have made a major difference with respect to excess demand pressures, as is evidenced by Kuwait's experience. In the long run, however, if inflation persists, a switch to a basket peg is an option worth exploring. Overall, the extent of the role of the exchange rate in managing demand pressure has to depend on country-specific circumstances, including the potential for adjustments in fiscal policy and GCC countries' commitment to peg their currencies to the U.S. dollar in the period leading up to monetary union.

Fiscal policy will be central in restraining demand pressures in Middle Eastern economies. Many non-oil economies have significantly reduced debt levels over the past decade. Nonetheless, domestic debt levels remain high by international standards, and thus both conjunctural and medium-term requirements point toward fiscal tightening. In oil exporters, the rise in oil prices has provided fiscal room for a buildup in government spending but has added to pressures on domestic resources. As a result of rapidly rising expenditures on wages and subsidies, for example, the oil price at which countries' budgets balance over the medium term has been on the rise. The specific fiscal policy requirements vary, but generally would need to emphasize cutbacks in current spending while continuing to support critical infrastructure projects that alleviate internal supply-side bottlenecks. Furthermore, fiscal policy can also help address the social challenges posed by high energy and food prices. The development of more-targeted transfer programs would

**Figure 2.9. Middle East: Managing Inflation Pressures**

Real GDP growth is forecast to remain buoyant, mainly on account of activity in non-oil sectors. Inflation pressure is rising, and tighter fiscal policies are needed to keep inflation expectations well anchored, particularly in non-oil economies, which are also experiencing widening current account deficits.



Sources: IMF, *International Financial Statistics*; and IMF staff calculations.  
<sup>1</sup>Oil exporters include Bahrain, Islamic Republic of Iran, Kuwait, Libya, Oman, Qatar, Saudi Arabia, Syrian Arab Republic, United Arab Emirates, and Republic of Yemen.

help tackle poverty and, in oil exporters, share the gains from higher oil prices. As progress is made, high outlays on general oil and food subsidies—reaching about 10 percent of GDP in Egypt and Saudi Arabia, for example—need to be rolled back.

Over the medium term, stronger macroeconomic policy frameworks and continued structural reforms are important for strengthening the resilience of Middle Eastern economies to shocks and to providing for a young and rapidly expanding population. Fiscal policies could usefully be imparted with a longer-term orientation—for example, with the help of medium-term budgetary frameworks—because of the need to lower debt in non-oil economies and in preparation for lower oil revenues in some oil exporters. The capacity to conduct independent monetary policy and to support financial markets needs to be enhanced. As domestic financial systems become more complex, rising regulatory and supervisory challenges will need to be addressed. Moreover, many countries stand to benefit from further improvements in their business environments, including by increasing investment in education and strengthening the social safety net.

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