

FOREWORD

Having just joined the IMF, I can take very little credit for this edition of the *World Economic Outlook*. I regret it: Like its predecessors, this is a remarkable document which gives the reader a clear sense of what is happening in the world economy. I thank Simon Johnson, Charles Collyns, Jörg Decressin, and their team for their work.

Chapters 1 and 2 assess the state and the evolution of the world economy, an exercise that has rarely been so difficult. The world economy is decelerating quickly—buffeted by an extraordinary financial shock and by still-high energy and commodity prices—and many advanced economies are close to or moving into recession.

Developments in financial markets have dominated the news in recent weeks. The subprime crisis that unfolded in 2007 has now morphed into a credit crisis that has caused major disruption to financial institutions in the United States and Europe. Intensifying solvency concerns about a number of the largest U.S.-based and European financial institutions have pushed the global financial system to the brink of systemic meltdown. The effects on the real economy have been limited so far. In part, this may be because tax rebates in the United States supported consumption, while strong nonfinancial corporate balance sheets and profitability have allowed firms to use their own funds rather than borrow. But neither of these factors can be expected to last for very long. Credit conditions have become significantly tighter in recent weeks, threatening the ability of nonfinancial firms and a number of emerging economies to raise capital. The U.S. and European authorities have taken extraordinary measures, including massive liquidity provision, intervention to restore weak institutions, extension of guarantees, and recent U.S. legislation to use public funds to buy troubled assets from banks. But it is not yet clear that these measures will be sufficient to stabilize

markets and bolster confidence, and the situation remains highly uncertain.

This is not the only shock buffeting the world economy. Prices of oil and basic commodities have reached historically high levels in recent months. In advanced economies, a combination of real wage flexibility, well-anchored inflation expectations, and prospects of sharply reduced activity have helped to limit rises in core inflation. But in emerging and developing economies, the impact has been much more damaging. Real wages have fallen substantially. Oil exporters have found it difficult to dampen overheating economies.

Looking to the future, it is necessary to assess how these shocks will likely work their way through the world economy. Our forecasts are based on three major assumptions. The first is that commodity and oil prices are likely to stabilize, relieving pressure on inflation and giving more room, if needed, for expansionary policies. The second is that U.S. housing prices and activity will hit bottom within the next year, leading to a recovery of residential investment. The third is that, although credit will remain tight, the elements of a systemic solution to the financial crisis are now being put in place and will prevent a further worsening of financial intermediation. It is this combination that leads us to forecast that world growth will begin to recover at the end of 2009, albeit at a very slow pace. There is, however, more than the usual amount of uncertainty, and the downside risks are far from negligible.

As usual, this *World Economic Outlook* also tackles a number of topically important issues in greater depth. Chapter 3 examines the threat that the recent boom in commodity prices could unwind the past two decades' progress against inflation. To be sure, the fall in some prices—notably for oil—since mid-July has eased some of the pressure, but it is too early to relax. Com-

modity prices are likely to remain much higher in real terms than in recent decades, and this shift in relative prices will need to be absorbed without triggering second-round effects on price and wage formation. This task is likely to be easier in the advanced economies, where widening output gaps are helping to restrain inflation pressures. Moreover, these economies are much less commodity-intensive than they were in the 1970s and have more flexible labor markets and well-established monetary policy frameworks that have largely succeeded in anchoring inflation expectations. However, emerging and developing economies are more vulnerable to inflation spillovers—because of their greater resource intensity, less-well-established policy frameworks, and more rapid rates of growth. In many of these economies, second-round effects are already increasingly visible, and although slowing global growth and softening commodity prices should help rein inflation back in, risks remain that continued inflationary excesses will degrade hard-earned inflation-fighting credentials, requiring even tougher action in the future to put the cork back in the bottle.

Chapter 4 addresses what is clearly a central concern for the global economy: What will be the impact of the current financial crisis on economic activity? It is now all too clear that we are seeing the deepest shock to the global financial system since the Great Depression, at least for the United States. Are we then doomed to a slump in output as occurred in the 1930s? As Chapter 4 shows, the historical record is mixed. Periods of financial stress have not always been followed by recessions or even by economic slowdowns. However, the analysis also shows that when the financial stress does major damage to the banking system—as in the current episode—the likelihood increases of a severe and protracted downturn in activity. This is clearly demonstrated by the experiences of many economies that have struggled with virulent financial crises over the past decades, for example, the Nordic countries and Japan. Moreover, economies with more-arm's length or market-based financial systems seem to be particularly vul-

nerable to sharp contractions in activity in the face of financial stress. This is because leverage tends to be more procyclical in these economies—the risks of a credit crunch are greater. Does this mean that the United States—with a market-based financial system par excellence—is heading for a deep recession? Not necessarily, because, as the chapter shows, other factors also matter. Two sources of support for the U.S. economy are the quick and strong reaction of the Federal Reserve to lower policy rates and the robust state of the U.S. nonfinancial corporate sector. Low indebtedness and high profits have helped U.S. businesses ride the financial storm. However, the longer the financial crisis continues, the less likely it is that nonfinancial firms will be able to support strong growth.

Chapter 5 takes a fresh look at an old debate—about the value of fiscal policy as a countercyclical tool—which has taken on new relevance as the global economy slows and as turbulence in financial markets has raised questions about the effectiveness of monetary policy. The findings are not very encouraging for proponents of fiscal activism: fiscal multipliers—the impact of discretionary fiscal stimulus on output—are generally found to be quite low, and sometimes even to operate in the wrong direction, especially in economies with high debt levels where a turn to expansionary fiscal policy may raise doubts about long-term debt sustainability. This does not necessarily mean that policymakers should abandon fiscal policy as a countercyclical tool, but it does underline that fiscal initiatives, when needed, must be well targeted to have the maximum short-run impact without undermining long-run fiscal rectitude.

It is also worthwhile to consider whether the role of fiscal policy as a macroeconomic stabilizer could be enhanced by strengthening the broader fiscal framework. Two options are worth considering. First, there is the possibility that automatic stabilizers could be boosted by making regular tax and transfer programs more cyclically responsive. For example, the generosity of unemployment insurance systems could be automatically increased when the economy is in

a downturn and jobs are harder to find. Second, steps could be taken to strengthen the overall governance structure for fiscal policy—thereby reducing the risk of “debt bias” by ensuring that fiscal easing during a downturn is balanced by tightening during expansions. Improved governance could bolster the credibility and thus the effectiveness of fiscal stimulus. Recognizing the pros and cons of these approaches, I do feel they are worthy of consideration.

Finally, Chapter 6 tries to solve an important puzzle: Why have the current account balances of emerging economies been so divergent in recent years, with some economies in emerging Asia registering large surpluses and others, particularly in emerging Europe, sustaining very large and long-lasting deficits? There is no single

answer, but the chapter suggests that important contributors have been emerging Europe’s rapid financial liberalization and capital account opening, particularly in those economies integrating rapidly into the European Union, and the focus in emerging Asia on building large stocks of international reserves as self-insurance in the wake of the Asian crisis of 1997–98. This leaves open the question of whether the recent patterns will be sustained. Certainly the turbulent global environment is putting a strain on economies with large current account deficits and commensurately large external financing requirements.

Olivier Blanchard

Economic Counsellor and Director, Research Department