I. Global, U.S., and Canadian Outlook

Global Outlook

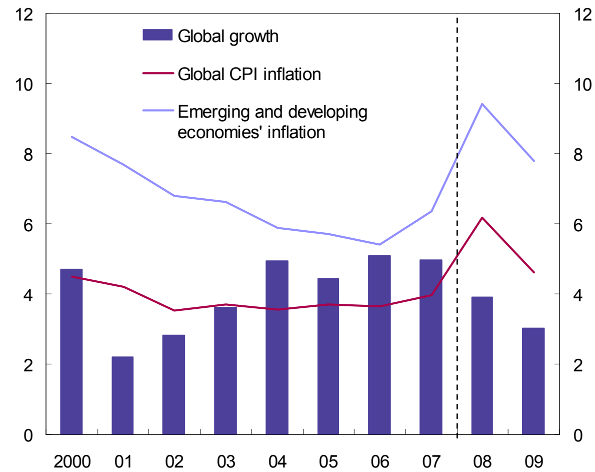
The world economy continues to be buffeted by the burgeoning downdraft of the financial crisis and volatile commodity prices. As such, the outlook points to a major downturn for the global economy, with growth falling to its slowest pace since the 2001–02 recession. Levels of uncertainty and volatility are very high, presenting policymakers with a challenging environment to navigate.

Cooling global growth has at its center the slowdown foreseen in the United States and tightening global financial conditions. Higher-than-expected commodity prices in the first half of the year sharpened existing global imbalances and added additional overall drag to world activity. Global output growth is currently projected to slow from 5.0 percent in 2007 to 3.9 percent in 2008 and 3.0 percent in 2009. As the world economy slows down, commodity prices are expected to continue to recede from still-high levels in the coming quarters.

Industrial economies have been hardest hit. Euro area growth is pegged at just 1.3 percent in 2008 and 0.2 percent in 2009, while Japan is set to grow at around ½ percent in both years. Emerging markets are also slowing, but they—in particular, China and India—are still expected to be the largest contributors to global growth.

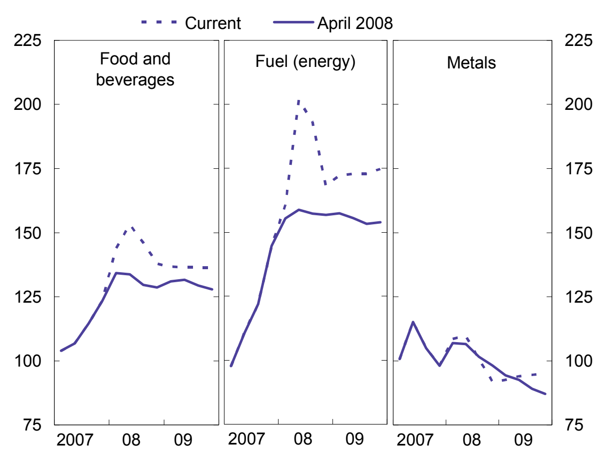
Through mid-2008 the growth slowdown had been accompanied by a rise in inflation, reflecting in part higher food and fuel prices. However, core and expected inflation remain relatively well anchored in advanced economies and widening output gaps in these economies will exert increasing downward pressure on prices. Inflation should also ease in a number of emerging market countries, although elevated price pressures will remain an issue in a number of these countries.

Global Outlook
(Annual percent change)



Source: IMF staff calculations.

Commodity Price Projections
(Index, 2006 Q4 = 100)

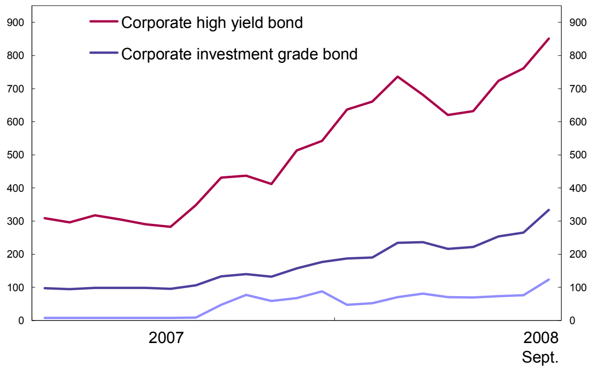


Sources: Bloomberg, L.P.; and IMF staff calculations.

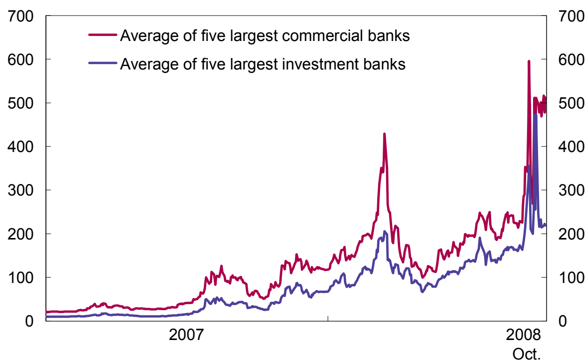
Note: This chapter was prepared by Rupa Duttagupta, Marcello Estevão, Koshy Mathai, and Andrew Swiston.

Selected Financial Indicators for the United States

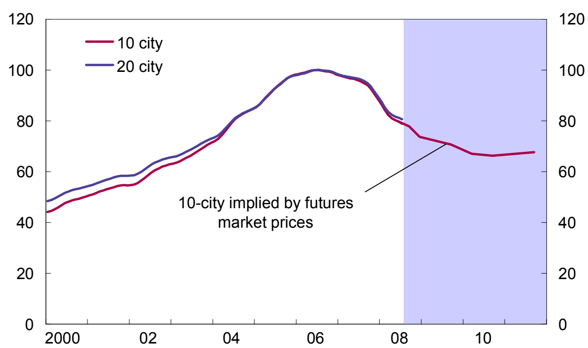
Selected Financial Indicators for the United States
(Interest rate spreads, basis points)



Cost of Insuring Debt of Financial Institutions Against Default
(Basis points)



***Case-Shiller House* Price Indices**
(June 2006=100)



Sources: Bloomberg, L.P., Haver Analytics; Merrill Lynch; and IMF staff calculations.

U.S. Outlook: Major Downturn with Protracted Recovery

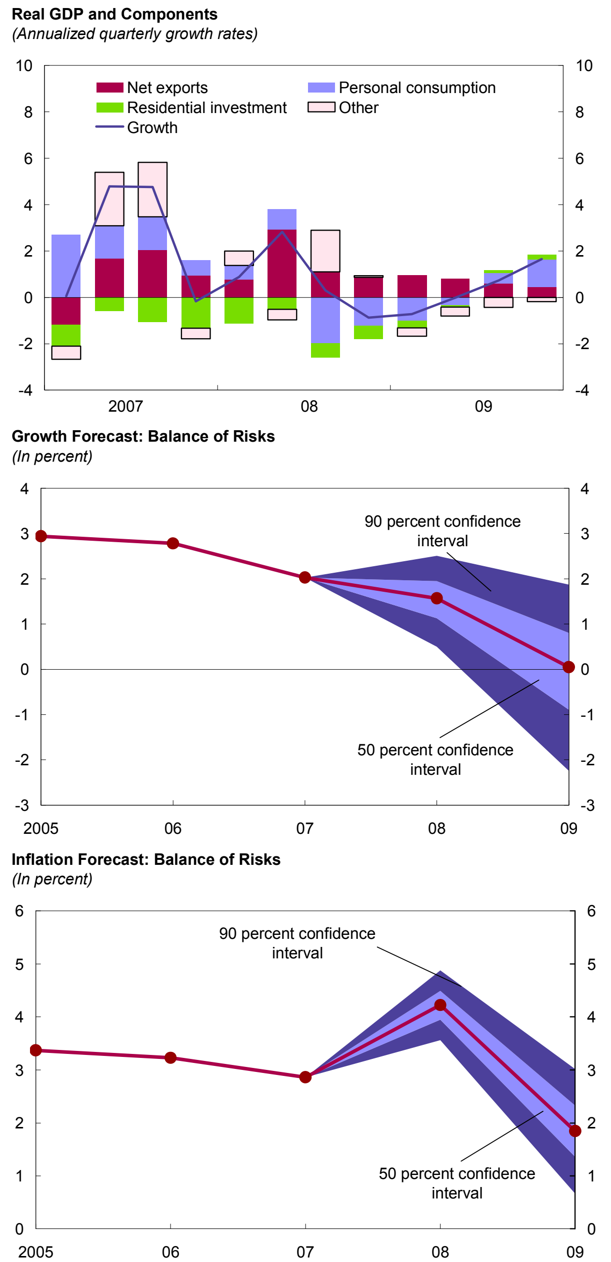
The U.S. economy has weakened substantially over the past year. Net exports have provided remarkable support to headline GDP growth so far, but domestic demand has weakened, shrinking in the fourth quarter of 2007 and remaining essentially flat since then. The impact of the housing downturn, earlier limited to the construction sector, has now fed through to household spending and financial markets. Payrolls have shrunk steadily since January, driving the unemployment rate above 6 percent and curbing household purchasing power. And while inflation has started to ease, in line with fuel and food prices, it still stood at nearly 5½ percent year-on-year in August, putting further pressure on households.

Most dramatic, however, have been the recent developments in financial markets. Money markets have seized up; long-enduring Wall Street institutions have gone bankrupt, or been acquired; and the investment banking model has disappeared. Fannie Mae and Freddie Mac have been taken under federal conservatorship. The government has been forced to step in with massive interventions to keep credit flowing, including with innovative Federal Reserve (Fed) facilities and a broad program to buy bad assets and recapitalize the banking system. In mid-October the United States joined other advanced economies to adopt far-reaching measures—including guarantees for interbank lending, broader coverage of deposit insurance, and injections of capital—aimed at restoring confidence in the global financial system. The U.S. Treasury will channel up to US$250 billion of the US$700 billion approved under the Emergency Economic Stabilization Act (EESA) to inject capital into major U.S banks as well as other financial institutions. Most European countries, including France, Germany, Italy, and the United Kingdom, committed to a coordinated effort to bolster domestic banking systems with rescue packages for financial institutions totaling about US$2.5 trillion. The Japanese authorities have also maintained supportive monetary conditions and taken measures to inject liquidity into the interbank market. To boost international U.S. dollar liquidity, central banks also agreed to offer unlimited dollar funds to banks in short- and medium-term maturities, expanding existing international swap arrangements.

Against this backdrop, the prospects for the U.S. economy are weak. With inventories of unsold homes at near-record highs and unemployment still rising, house prices are expected to continue dropping, eroding both household wealth and the value of mortgage-backed securities on banks' balance sheets, which would feed back into economic activity. Compounding these difficulties, the fiscal stimulus payments that helped boost growth in the second quarter have ended. And while net exports will continue supporting growth, that contribution will decline given the slowdown abroad and the recent appreciation of the dollar. Recent measures, including actions taken under EESA, should help unclog and restore the flow of credit. Nonetheless, the widening of spreads and tightening of lending standards seen over the past year will continue to have lagged impacts, weighing on growth in coming quarters.

In light of these pressures—and notwithstanding accommodative monetary, financial, and fiscal policy—the IMF staff expects the U.S. economy to enter a downturn in the second half of 2008 and first half of 2009. As is typical of housing-driven recessions, only a gradual recovery is expected thereafter, with growth returning to potential only in 2010. Unlike the last recession, it is expected that much of the slowdown will be reflected in consumption as well as investment. Growth is forecast at just 0.8 percent in 2008 on a Q4/Q4 basis, falling to 0.4 percent in 2009, which puts

United States: Forecasts for Growth and Inflation



Sources: Haver Analytics; and IMF staff calculations.

annual average growth at 1.6 and 0.1 percent, respectively, over the next two years. Increasing slack in the economy is expected to ease pressures on core inflation, while the assumed plateauing of oil prices would bring headline inflation down further, to below 2 percent by the second half of 2009.

Considerable uncertainty surrounds these forecasts, given the unprecedented nature of the shocks and the challenges in quantifying the associated macrofinancial linkages (see Box 1.1). Despite the efforts by the government and the Fed to resolve the financial crisis, markets have remained volatile, and downside risks to the baseline growth scenario are significant. Risks to the inflation baseline forecast, by contrast, are broadly balanced.

Policies are likely to continue to seek to manage these risks. Recent communications by the Fed indicate that it sees the balance of risks shifting, in light of the worsening financial turmoil and incoming data. On October 8, it cut the target for the federal funds rate by 50 basis points, as part of the coordinated step by many advanced economy central banks. Recent statements suggest that further cuts may be on the horizon. As for fiscal policy, there are calls in some quarters for a second round of tax rebates, but further fiscal actions would likely be more effective if targeted to housing and/or financial sectors directly. Indeed, this has been the orientation of the U.S. authorities with the EESA, recent bailouts, and other interventions, all of which imply substantial use of taxes to support financial markets. Finally, once the immediate crisis is past, fundamental issues of financial regulation will clearly need to be taken up.

Canadian Outlook: Feeling Effects of U.S. Slowdown

Economic activity in Canada has suffered a setback, as slower growth in the United States and the effects of past real currency appreciation have sharply slowed net exports. Domestic demand growth—initially boosted by commodity-price gains—continued but softened to more modest levels, and the housing market has been cooling from the highs reached in 2006–07. The recent decline in commodity prices has weakened the Canadian dollar, bringing it back to the level of spring 2007. At the same time, the labor market is yet to fully show the economic strains, with payrolls continuing to rise in recent months; and the unemployment rate stable at 6.1 percent—close to a 33-year low of 5.8 percent that was achieved in late 2007.

Since mid-September, Canadian credit conditions have deteriorated significantly while equity prices have plunged by over 25 percent, reflecting both the global financial turmoil and the fall in commodity prices. The authorities implemented a temporary ban on short selling of financial stocks that expired on October 8. However, banks have so far weathered the ongoing financial strains well, partly reflecting conservative regulation, greater reliance on retail deposits rather than wholesale funding, and relatively low exposure to structured products. Despite these factors, vulnerabilities remain given Canada's financial and economic ties with the United States.

Within Canada, a regional divide in economic prospects has emerged. The resource-rich western provinces have benefited from commodity gains while the manufacturing-intensive Ontario and Quebec have borne the brunt of the slowdown. If maintained, these disparate shocks could force further large reallocations of resources within the country, which may be a challenge given apparent product market rigidities in the central provinces, although labor markets seem to be reasonably flexible.

Four-quarter growth is projected to decelerate to 0.3 percent in 2008—largely reflecting the negative outturn in the first half of the year—and recover to 1.7 percent in 2009, as the drag from net exports wears off. Average growth is estimated at 0.7 percent in 2008 and 1.2 percent in 2009. However, downside risks remain, in particular due to possibly tighter credit conditions for a protracted period, a slower-than-projected recovery in the

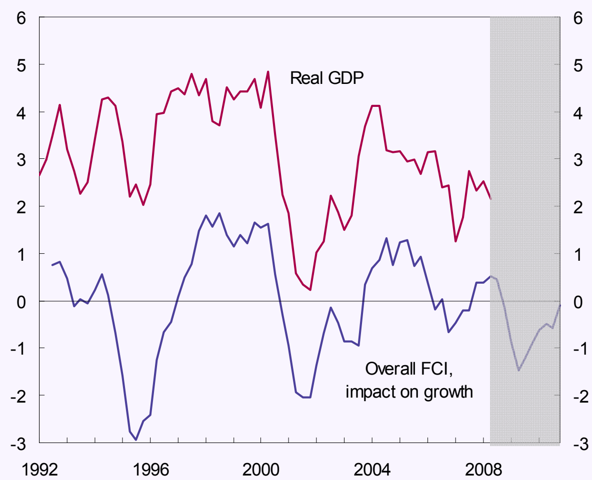
Box 1.1. United States: Quantifying Macrofinancial Linkages

Financial conditions have changed dramatically since mid-2007, and while analysts generally agree that these changes will weigh on growth, there is less agreement on the likely size and timing of these effects. In order to produce a well-founded macroeconomic forecast, IMF staff have thus developed two alternative tools to assess the linkages between financial conditions and demand in the United States.

The IMF staff's financial conditions index (FCI) analyzes the interaction between an array of financial indicators and real GDP, based on impulse-response coefficients from vector autoregressions. The financial variables include short-term interest rates, bond spreads, equity prices, real effective exchange rates, and, importantly, bank lending standards. Tighter lending standards over recent quarters have compounded the effects of higher spreads in curtailing credit. The model suggests that, despite aggressive policy rate cuts by the Fed and dollar depreciation, financial conditions have tightened since mid-2007 and will, given lags, slow growth by around 1¼ percentage points over the remainder of this year. Further financial tightening envisaged in the staff's forecast implies an additional slowdown in 2009.

United States: Financial Conditions and Growth

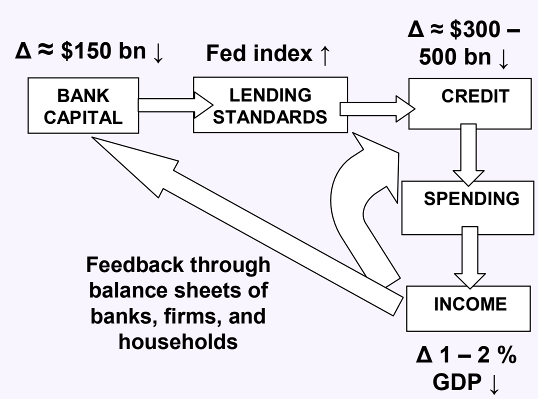
(Four quarter percent change)



Sources: Haver Analytics; and IMF staff calculations.

Taking a somewhat more structural view, the IMF staff also estimates a *banking model* that traces how strains on bank capital lead to tighter lending standards, a reduction in the volume of consumer, mortgage, and corporate credit, and thus diminished spending and income growth (which in turn puts further strains on capital adequacy). This very different approach yields estimates of macrofinancial linkages that are remarkably similar to those from the FCI. A 1-percentage-point shock to banks' capital-asset ratio—in line with U.S. banking sector losses reported in the April 2008 *Global Financial Stability Report*—subtracts some 1 to 2 percentage points from the baseline GDP path, with the maximum impact occurring after a year or so. The model can also be run in reverse, with credit and bank lending channels doubling the impact of an initial fall in spending/GDP and prolonging the response.

Impact of Shock to Bank Capital



Note: This box was prepared by Ravi Balakrishnan.

United States, and a deeper-than-anticipated slowdown in the housing sector.

Canada's inflation experience has so far been a notable and welcome exception to international trends, allowing the government to announce tax reductions in late 2007, which gave a fortuitous stimulus to the economy of about ¾ percent of GDP in 2008. Headline inflation remained within he Bank of Canada's (BoC) target range of 1–3 percent for most of the year, providing space for the BoC to cut its policy rate by 150 basis points beginning in December 2007. With inflationary risks likely diminishing from a weakening economy and declining global commodity prices, the BoC also participated in a globally coordinated move (with other major central banks) and cut its policy rate by a further ½ percentage point to 2½ percent on October 8. Similarly to other major central banks, the BoC provided ample liquidity in recent weeks and expanded its swap facility with the Fed to US$30 billion in late September. Looking ahead, the projected slow economic recovery should temper inflation expectations and provide space for further stimulus if needed, although continuing currency depreciation could pose upside risks.