FOREWORD

Throughout a turbulent summer, the World Economic Outlook *team at the IMF has worked hard to stay ahead of developments, to refine our analytical work, and to keep our forecasts up to date. Led by Charles Collyns and Tim Callen, the World Economic Studies division has worked closely with other IMF staff to produce a* WEO *that is close to current developments while providing some much-needed longer-term perspective. We hope that it will help you both understand what has happened in the past few months as well as reflect on what might be in store for the next 15 months.*

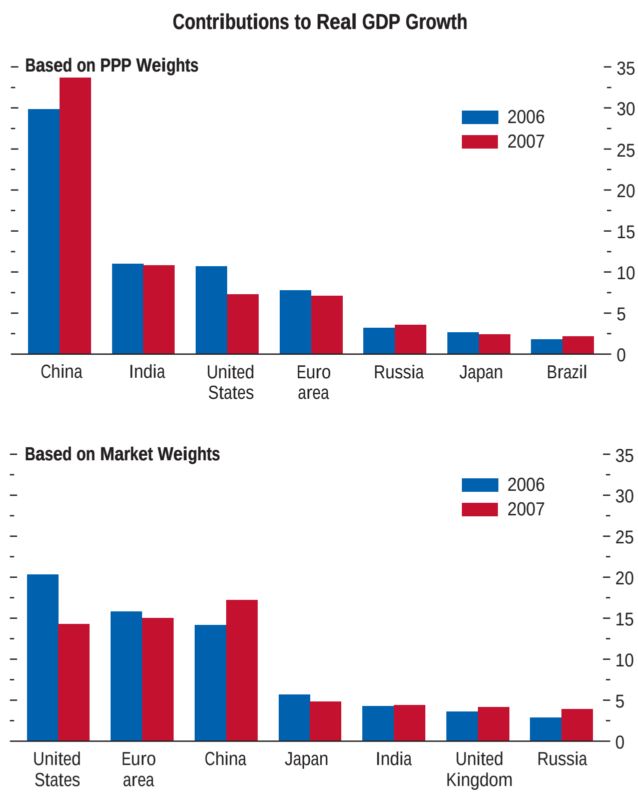
The world economy has entered an uncertain and potentially difficult period. The financial turmoil of August and September threatens to derail what has been an excellent half-decade of global growth. The problems in credit markets have been severe, and while the first phase is now over, we are still waiting to see exactly how the consequences will play out.

Still, the situation at present is one with threats rather than actual major negative outcomes on macroeconomic aggregates. At this point, we expect global growth to slow in 2008, but remain at a buoyant pace. Growth in the United States is expected to remain subdued. Problems in the housing sector are more intense than previously expected, and the disruption of credit is likely to have further impact. We expect some slowing in Japan, where the second quarter was disappointing, and in Europe, where banks were involved to a surprising degree with instruments and vehicles exposed to the U.S. subprime sector.

The good news is that emerging market and developing countries weathered the recent financial storm and are providing the basis for strong global growth in 2008. For the first time, China and India are making the largest country-level contributions to world growth (in purchasing-power-parity terms; see the figure). China is also making the largest contribution at

Emerging Markets Now the Major Engine of Global Growth

(Percent of world growth)



Source: IMF staff calculations.

market prices. More generally, emerging market and developing countries are reaping the benefits of careful macroeconomic management over the past decade. While there are some potential vulnerabilities, and there is no room for complacency going forward, emerging markets should remain strong in the foreseeable future.

In terms of global risks, we see most of these as being on the downside for growth, that is, unexpected developments are more likely to push growth down rather than push it up. Our growth fan chart shows probabilities both above and below our forecast, based on our previous forecast errors, but the skewness of the chart—based on our reading of what could push the global economy away from our central forecast—is almost entirely to the downside.

Some of these risks have received considerable attention, including those in housing markets and financial sectors. But some are more surprising, including the fact that oil prices remain high and that sharp food price increases are contributing to inflation concerns in emerging market and developing countries. A key unknown is what will happen in Europe. Until the events of this summer, Europe was in the upswing of its cycle, with Germany in particular emerging as a driver of growth, moving beyond the long, difficult process of reunification. But the serious disruptions in the market for interbank liquidity and the difficulties experienced by some European banks in recent months were largely unexpected. Quite how these developments will affect the real economy remains to be seen.

I would also stress that the implications for global imbalances remain uncertain. It seems likely that the U.S. current account deficit will decline relative to GDP, in part because the dollar has depreciated further since the summer—its value is down more than 20 percent from its recent peak in 2002. Fortunately, we have in place a framework for cooperative actions by the key countries involved with imbalances; this was a major outcome of the IMF's Multilateral Consultation this year. Oil producers continue to scale up their spending on infrastructure and investments. China remains determined to rebalance its demand so as to lower its current account surplus. Europe and Japan continue with the process of structural reform, which should help with restructuring and boost domestic demand. We expect that this framework will facilitate the gradual decline of imbalances and reduce risks of disruptive changes in exchange rates, but this situation requires continued careful attention.

Turning to our analytical chapters, Chapter 3 highlights a major challenge for many emerging market and developing countries—how to manage large capital inflows. These inflows slowed this summer, but recent indications are that they are again picking up. The chapter assesses what we can learn from recent episodes of capital inflows around the world, and it looks at what kinds of macroeconomic policies help to ensure that growth post-inflows remains strong. It turns out that intervening in exchange markets, either with or without sterilization, has not been successful in limiting real exchange rate appreciation or avoiding a deceleration in post-inflow growth. What really helps is being careful with fiscal spending. The lesson here is not that a country needs to cut spending when there are inflows, but rather that it needs to exercise fiscal restraint. The greater caution of some leading emerging markets in this regard since the late 1990s is commendable and has definitely contributed in part to their resilience today. I hope other countries will learn the same lesson.

Chapter 4 takes a longer-term perspective and looks at what has happened to inequality around the world, particularly during the recent surge in various forms of globalization. While we have written extensively, including in the April 2007 *World Economic Outlook*, about the benefits of globalization, the findings in this chapter should be seen as more cautionary. In almost all countries, inequality has increased in recent years. The authors find that increased trade is not the culprit. Rather, it seems likely that the spread of new technology around the world, both in general and through foreign direct investment, has disproportionately benefited people who are better educated. The implication, of course, is not to try to prevent the adoption of new technology—such an approach would be sure to derail growth. Rather the policy objective should be to provide the education and other social services (such as affordable health care, a reasonable-cost pension system, and so on) to ensure that as many people as possible can find and keep high-productivity jobs. It would be unwise to ignore the issue of growing inequality; globalization is a key source of rising world prosperity, but more effective policy actions are needed to make sure that these benefits are well shared.

Chapter 5 offers hope but also some caution regarding the longer-term prospects of the global economy. Looking back as far as possible with comparable data (which takes us to around 1960), it is clear that the past half-decade has seen the strongest and most broadly based run of global growth since the 1960s. This was not a fluke, but rather the result of improved frameworks for both monetary and fiscal policies, as well as serious institutional improvements in many middle- and lower-income countries. At the same time, there was some luck involved—inflation has been low, globally, in part because of low-cost manufactured goods (part of the globalization process) and because private capital flows have been relatively stable. It would be unwise to expect that there will not be shocks going forward, and the chapter makes recommendations that should help ensure that these shocks do not have major repercussions.

In sum, the main message of this *World Economic Outlook* is that, as long as policy fundamentals remain strong and institutions are not undermined, the global economy should grow rapidly, with the continued involvement of almost all countries. Events of the past few months have been a major test of global financial stability, and some unexpected weaknesses have emerged. As long as those remain contained within a few industrial countries and are addressed in a timely fashion, the impact on world growth should be small.

The key, in the years ahead, is to make sure that emerging market and developing countries can continue to grow rapidly and without major disruptions. Macroeconomic stability is necessary but not sufficient for economic growth. We have to continue the process of trade liberalization, allow capital to flow to more productive opportunities in poorer countries, and—most important—make sure that the benefits of growth are widely shared across all countries and by as many people as possible within countries. We would do well to anticipate further serious shocks, both downside and upside, and to work harder to make sure that the policies and institutions in place can withstand these shocks.

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