Global Economic Prospects 2008/2009:
Hoping for a Global Slowdown and a US Recession

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Overview

After four years of average annual global real GDP growth of better than 4 1/2 percent, recent data indicate that the pace of advance is slowing in the major industrial countries, with the US economy on the verge of, and perhaps already in, outright recession. So far, the evidence points to less of a slowdown in other industrial countries, while most emerging-market economies appear likely to maintain quite strong, albeit somewhat slower, growth.

Meanwhile, world consumer price inflation (on a 12-month basis) is up from barely 2 percent seven years ago to nearly 5 percent as of February 2008. Among both industrial (except for Japan) and major emerging-market countries, inflation is now running at, or in most cases somewhat above, rates consistent with policy objectives. Driven by persistently rising global demand, commodity prices continue to surge upward across the board, especially measured in US dollars but also in terms of the rapidly appreciating euro.

In this situation, the world economy really needs what is now forecast for 2008/2009: a significant slowing of economic growth, down to 3.8 percent (year over year) in 2008 from 4.7 percent in 2007.[1] This slowdown will be led by a decline of demand growth in the US economy, which is both pronounced and extends over a considerable period. Indeed, in view of the exceptionally aggressive easing of macroeconomic policies already in place in the United States and the likelihood of monetary policy remaining highly accommodative so long as US financial markets remain under stress, it is now desirable that real GDP growth for 2008 fall to a forecasted rate of barely more than 1 percent (year over year)—an outcome consistent with a very mild and brief recession. Reflecting some risk of a somewhat deeper and more prolonged recession in the United States, the growth forecast for 2009 (year over year) is set at 2 percent.

For the rest of the world, a mild US recession in 2008 will have a modest negative effect on real GDP growth, with more significant impacts in Mexico and Canada. In countries where the slowdown threatens to become excessive and inflation is under control, some easing of monetary and perhaps fiscal policy is both likely and appropriate. More generally, however, it is too soon to call for a general and significant easing of macroeconomic policies. A general slowdown in global economic growth is needed to cool the clearly apparent upsurge in worldwide inflation.

Some countries, including Australia, China, and Sweden, have recently tightened monetary policies in efforts to forestall inflation. Other countries, including Canada and the United Kingdom, have eased monetary policies modestly in response to weakening economic growth. Quite appropriately, however, no country has so far followed the lead of the Federal Reserve in aggressive monetary easing.

As the custodian of the world's second most important currency, the policy of the European Central Bank (ECB) is particularly noteworthy. Inflation in the euro area is running more than a percentage point above the ECB's announced objective. The euro area economy has recently been growing significantly more rapidly than its potential rate of about 1 1/2 percent. The unemployment rate has fallen half a percentage point below the minimum reached in the last expansion. Key monetary aggregates are surging at rates well above their desired target ranges. In this situation, one would normally have expected the ECB to have raised its key policy interest rate a further 100 basis points since last summer.

Instead, with financial turbulence spreading to some extent from the United States to euro area financial markets and institutions, with evidence that euro area economies are beginning to slow, and with a sharp appreciation of the euro against the dollar, which is likely to slow growth and impede inflation, the ECB has wisely held back from further interest rate increases. With the euro area economy now expected to expand by about 1 1/2 percent this year (in line with potential), the timing and direction of future adjustments in ECB interest rates remain—appropriately—dependent upon the evolving balance of risks for inflation and economic growth.

For Japan, the strengthening of the yen against the dollar in recent months and weakening of exports to the United States, together with likely weakness in domestic demand growth, suggest a further write-down in the forecast for real GDP growth for 2008 to 1.2 percent (from 1¾ percent forecast last October). This reflects the assumption that the surprising upsurge of GDP growth in the final quarter of 2007 will be partly offset in the first half of this year.

For the industrial countries as a group, real GDP growth this year is now forecast to be 1.5 percent, and growth for 2009 is projected to be moderately stronger at about 1.9 percent.

In emerging-market economies, circumstances vary and so do appropriate policies, but the general prospect is for continued quite strong economic growth, despite the slowdown in the industrial countries.

Is this "decoupling?" Not really. Mexico, Caribbean and Central American countries, and Asian economies that are particularly dependent on exports to the United States are already feeling and will continue to feel the effects of the US economic slowdown. More broadly, however, strong growth of domestic demand in many emerging-market economies will sustain reasonably strong GDP growth, and rising demand for raw materials by key emerging-market economies, most importantly China, will help keep commodity prices strong and aid growth in other emerging-market economies.

Overall, I forecast that growth for developing and emerging-market economies as a group this year will be about 6 1/2 percent, down from almost a 7 1/2 percent advance in 2007. For 2009, I now project slightly slower growth. The slowdown will be more severe, however, if growth in the industrial countries, especially the United States, turns out to be meaningfully below the present forecast. Exports from emerging-market countries would then be hit in volume terms, and prices of commodity exports could take a serious tumble. Some developing countries, especially among the primary commodity exporters, could face serious economic challenges and potential crises.

On this occasion, Arvind Subramanian is available to share his expertise on emerging-market economies, particularly in Asia and especially India. Accordingly, I will limit my remarks on these economies to selected observations on some key emerging-market countries. Then, in view of the departure from the Institute of my colleague Martin Baily and the (at least) temporary absence of Douglas Holtz-Eakin, I will turn to discuss growth prospects in the industrial countries, especially the United States. This should provide background for Morris Goldstein's more in-depth observations on the present financial crisis and proposals for reform.

Sustained Growth in Emerging Markets

China's economy continues to surge forward, so much so that the authorities are tightening policies to cool down inflation. Growth will likely slow from 11 1/2 percent last year to about 10 percent this year and next. On the policy front, the key action that should be taken—but that the Chinese authorities have so far refused—is a significant step appreciation of the renminbi against the dollar and in real effective terms, combined with policies to stimulate domestic demand.

In the rest of emerging Asia, growth will likely moderate somewhat in 2008 and 2009 but stay above 6 percent, with India continuing to grow at nearly 8 percent.

In Latin America, Mexico will suffer spillover effects from the slowing US economy, and growth this year is likely to fall to about 2 1/2 percent before recovering modestly in 2009. In contrast, Brazil should be able to sustain growth of nearly 5 percent, despite the strong appreciation of the real against the dollar. Growth in Argentina and Venezuela is expected to slow from the high rates of recent years, bringing down the growth rate for all of Latin America to about 4 1/2 percent this year and slightly less in 2009.

For Central and Eastern Europe, weak growth in Hungary and Turkey hurt regional performance in 2007 and partly offset strong results in Bulgaria, the Czech Republic, Poland, and Slovakia. For 2008 and 2009, regional growth will likely run about 4 percent, reflecting partly the impact of slower growth in Western Europe.

In the Commonwealth of Independent States, the dominant Russian economy should continue to grow at about 7 percent, and growth rates will likely remain somewhat higher (on average) in the smaller economies.

For the Middle East, high oil prices will help keep growth strong in the energy-exporting countries. The larger and more diversified economies of Egypt and Israel should also maintain growth rates in the 5 percent range.

High commodity prices will continue to benefit many African countries, and growth in the region appears likely to continue at least at a 5 percent rate.

Slowing in Other Industrial Countries

Among the industrial countries other than the United States, growth will slow significantly from the 2 3/4 percent advance of 2007 to barely more than 1 1/2 percent this year. However, aside from the United States, I see significant risk of recession this year only in Japan and possibly Italy. The impact of the yen's recent appreciation and weakening of exports to the United States, together with deteriorating sentiment among Japanese businesses and consumers, could push GDP into a couple of quarters of negative growth, even if year-over-year growth remains slightly positive. And the Japanese policy authorities have little room to provide offsetting stimulus.

In Canada, growth this year will likely fall a little below 2 percent, under the impact of slowing US growth and a strong Canadian dollar. However, solid income growth from strong export revenues should keep domestic demand relatively robust, and the Canadian authorities have considerable room to ease policy should that appear needed to forestall very weak growth or recession.

In the United Kingdom, growth this year is also likely to slow to slightly less than 2 percent. But this is not entirely unwelcome in view of the need to curb inflationary pressures, and the Bank of England has plenty of room to ease further should that appear warranted. The Reserve Bank of Australia has continued to tighten in recent months and would surely welcome the forecasted slowing of growth to 3 percent this year.

In the euro area, as previously noted, the projected slowing of growth this year to 1.6 percent from 2.6 percent last year involves nothing more than slowing to the potential growth rate. The slowdown will affect all countries in the area. The Italian economy looks likely to be extremely sluggish and is at some risk of falling into recession. Growth should remain stronger in Germany, sustained by good export performance in the face of weaker consumer demand. France will lag slightly behind Germany, while Spain will slow considerably due to a sharp downturn in home building. The slowdown will probably be reflected in a small uptick in unemployment and will be unpopular with most politicians. However, with inflation running well above the ECB's tolerance rate of 2 percent, the central bank is likely to see the slowing of growth more as a solution than as a problem.

A Mild US Recession

Despite signs of increasing financial strains, the US economy achieved almost 5 percent annualized growth in the third quarter of last year. Economic data that became available through Christmas indicated that the economy was still expanding through November. The data since late December, however, suggest that economic activity has been no better than flat and probably modestly declining since very late last year. The economic data do not indicate an economy that is crashing into steep recession.

The three most recent monthly employment reports have shown small declines in private-sector jobs. Weekly initial unemployment claims have risen from around 300,000 to slightly over 350,000. Residential investment continues to decline. The boom in nonresidential construction appears to have peaked. Data on durable goods orders and shipments suggest weak or even declining business equipment investment. As should be expected in the face of falling home prices and household wealth, sharp increases in energy and food prices, and stagnating employment, real consumer spending has not increased since November—but it has not declined.

Net exports are probably continuing to improve, but this will not be enough to offset weakness in the other components of final demand. Annualized real GDP growth in the first quarter will likely be modestly negative—probably between minus one-half and minus one percent in the first quarter. (And, if there is a modestly positive result, it will probably reflect an upsurge in inventory investment, which is not a positive sign for future growth.)

The second quarter may see moderation in the pace of decline of residential investment, but the other elements of domestic demand are likely to remain weak. Another quarter of modestly negative real GDP growth now seems to be the most likely outcome. Whether this will be enough to persuade the National Bureau of Economic Research (NBER) to proclaim an official recession is not clear, but I would now put the likelihood of such a recession at over 50 percent.

By June, the tax cuts from the recently passed fiscal package will be flowing into consumers pockets, bumping up consumer spending mainly in the third quarter. Some, not unreasonable, forecasts suggest that the stimulus could induce as much as a 5 percent annualized gain of real consumer spending in the third quarter, implying a considerable temporary boost to GDP growth. My view is more restrained, partly because I expect that businesses will absorb some of any surge in consumption spending (particularly for durables) into reductions in inventories.

On the other hand, businesses have kept inventories quite lean for the past three years, and there is no indication of a general inventory overhang (aside from the stockpile of unsold homes, which is not counted in business inventories). Sharp declines of inventory investment into negative territory have been a feature of all ten postwar recessions. It is a positive sign that the magnitude of any inventory correction in the present episode appears likely to be limited.

In sum, the prospect is that with the benefit of the fiscal stimulus, the US economy will bounce back to moderately positive growth this summer. By then the massive contraction of residential investment, which began two years ago, should be complete—with new home building running just below one million units, less than half of its recent peak level. Growth of consumer spending is likely to be weak after the effects of the stimulus are spent, but inventory investment should bounce back, and net exports may be expected to continue to make positive contributions to GDP growth. During the second half of 2008, it is reasonable to expect growth to rebound to 2 to 3 percent.

The suggested pattern of modestly falling GDP in the first half and moderate rebound in the second half implies that real GDP will show a very meager advance of about one-half percent on a fourth-quarter-to-fourth-quarter basis. Year-over-year real GDP growth would be barely more than 1 percent. In comparison, in the 2001 recession—the mildest of the postwar era—fourth-quarter-to-fourth-quarter growth was 0.4 percent and year-over-year growth was 0.8 percent.

The 2001 recession was followed by an initially weak recovery, with real GDP growing at only a 1.7 percent rate during the six quarters after the official end of recession, and with the unemployment rate continuing to rise to a peak of 6.3 percent in May 2003. On this occasion, I expect that the economy will remain quite sluggish through 2009, with growth proceeding at about a 2 percent annual rate. Weak growth of consumer spending in the face of significant losses of household net worth associated with lower real home values will be the key reason for this sluggishness.

Partly offsetting weak consumer spending growth will be continued improvement in US net exports, reflecting both slow import growth and continued rapid export growth. With the usual lag, the substantial depreciation of the dollar over the past year will contribute to the improvement in US net exports in 2009 and beyond.

We see here what I earlier called "reverse coupling." From 1995 through 2004, relatively strong growth of domestic demand in the United States and the effects of a strong dollar (with lags extending this effect) led to persistent deterioration in US real net exports. Thus, the United States was exporting demand to the rest of the world at a time when domestic demand growth in the rest of the world was relatively sluggish.

This process has been operating in reverse since the summer of 2006. Slower domestic demand growth in the United States, combined with stronger demand growth abroad and the effects of a significantly weaker dollar, have begun to significantly improve US real net exports. Thus, during the past year and a half, the rest of the world economy has been helping to pull the US economy along. This process may continue for several years as consumer spending growth in the United States remains restrained by the effects of lower household wealth, making room for expanding the supply of US net exports without contributing to inflationary pressures in the United States. For this process to continue relatively smoothly, however, the rest of the world needs to sustain reasonably robust demand growth and the United States needs to avoid too sharp a decline in domestic demand. The adjustment of the foreign exchange value of the dollar, which is essential for this process, is now largely complete, except for the needed appreciations of some Asian currencies, most notably the Chinese renminbi.

Turmoil in Global Financial Markets

A key feature and source of uncertainty in the present economic situation is the continuing turmoil in financial markets, especially in the United States but with spillovers to Europe and to a limited extent (so far) to Japan and emerging markets. Global equity markets have sold off amidst the turmoil, but markets for credit instruments and financial institutions dealing in such instruments have been most affected.

Three issues concerning this financial-market turmoil deserve special attention: (1) What has caused this financial turmoil, notwithstanding strenuous efforts by the Federal Reserve and other central banks to contain it? (2) What risks does it pose to the global economy? (3) Have the policy responses been adequate and appropriate?

Regarding the causes of the turmoil, it is noteworthy that it has been most severe in US financial markets and institutions. Europe and, to a lesser extent, Canada and Japan have also been affected.

In these other countries, a few institutions (such as the mortgage lender Northern Rock in the United Kingdom) have gotten into trouble on their own, related to their domestic activities. But most of the problems faced by non-US institutions have arisen because of their involvement with financial instruments originating in the United States.

In the United States, the initial underlying difficulties arose from subprime mortgages and financial instruments involving such mortgages. However, the crisis is much broader and deeper and has gone on longer than can plausibly be explained by this underlying cause. Across quite a broad spectrum, credit markets have become illiquid and dysfunctional. Interest rate spreads relative to US Treasury obligations have shot up and remained high and volatile even for higher-quality credits. Markets for important classes of bundled instruments have frozen up, and values for some of these instruments—to the extent that they can be determined—have plummeted. All this turmoil, well beyond what can plausibly be explained by developments in the real economy, indicates that financial markets and institutions themselves are mainly responsible for the crisis.

The extent of this crisis in credit markets is even more remarkable in view of the exceedingly aggressive actions taken by the Federal Reserve and the important but less aggressive actions of other leading central banks. Contrary to the nonsense spoken by many financial-market commentators, the Federal Reserve has not been "behind the curve" in its policy response. In fact, the easing of US monetary policy in the present possible recession has far outstripped the pace of easing in past actual recessions. On top of this, the Federal Reserve has recently taken truly extraordinary actions to extend specific liquidity support to a wide range of US financial institutions.

The official explanation for these extraordinary actions is not that they are motivated primarily by the desire to protect financial institutions from losses but rather to head off the risk of major damage to the general economy spreading from difficulties in the financial sector. So far, however, there is little indication that the general economy is suffering much damage from the credit market turmoil—beyond some deepening of the downturn in US residential investment. In particular, the present slowdown in the US economy and around the world is not much more than what we would normally have expected in view of falling home values, higher food and energy prices, and other developments aside from the turmoil in credit markets.

Does this imply that the Federal Reserve, in its efforts to protect the financial sector, has overreacted to the credit market turmoil? Has it eased too aggressively, unduly raising the risk of inflation down the road? Has its rescue of the financial sector by cutting massively the cost of funds and the provision of specific liquidity support generated far too much moral hazard relative to the value of the protective effect of these actions against real hazards faced by the general economy?

At this point, the answers to these questions are not entirely clear, but two conclusions can be reached with high confidence. First, given the massive easing already undertaken by the Federal Reserve and the likelihood of some modest further easing, the US economy now needs to undergo at least a near recession if the Federal Reserve's easing is not to be excessive. Second, if the Federal Reserve's highly aggressive actions have really been warranted to protect the economy from substantial harm, then deep reforms of the financial system, including the Federal Reserve's policies and practices, are clearly needed to reduce the likelihood of such problems in the future. The Federal Reserve cannot pose only as the hero riding to the rescue of the economy and the financial system. Its role as one of the villains whose earlier actions and inactions contributed to the present crisis needs to be fully and carefully assessed.

Table 1
Real GDP growth projections as of April 3, 2008 (percent change, year over year)

Country/region	**Weight**	**2007**	**2008**	**2009**
Industrial countries	52.5	2.5	1.5	1.9
United States	21.5	2.2	1.2	2.0
Canada	2.0	2.7	1.8	2.2
Japan	6.7	2.0	1.2	1.5
Australia and New Zealand	1.3	3.7	3.0	3.0
Western Europe	21.0	2.8	1.7	1.9
United Kingdom	3.3	3.0	1.8	2.0
Other (non euro area)	1.4	3.8	2.7	2.5
Euro area	16.0	2.6	1.6	1.7
Germany	4.3	2.6	1.7	1.8
France	3.2	1.9	1.6	1.7
Italy	2.7	1.5	0.8	1.2
Other	5.8	3.5	2.4	2.6
Emerging markets	47.5	7.4	6.4	6.3
Asia	25.0	9.0	7.8	7.7
China	10.5	11.5	10.0	9.5
India	4.5	8.7	7.8	7.8
Other	10.0	6.7	6.0	6.2
Latin America	7.8	5.2	4.4	4.2
Argentina	0.8	8.7	6.5	4.5
Brazil	2.9	5.4	4.7	4.5
Mexico	2.1	3.2	2.5	2.8
Other	2.0	6.5	5.0	4.5
Central and Eastern Europe	3.9	4.8	4.2	4.2
Commonwealth of Independent States	4.4	8.0	7.5	7.0
Russia	3.2	7.5	7.0	6.0
Middle East	2.9	6.0	5.5	5.5
Africa	3.4	5.7	5.0	5.0
World PPP	100.0	4.7	3.8	4.0

Note

1. The figures for global GDP growth are aggregated from the growth rates for individual countries using purchasing power parity (PPP)–based measures of exchange rates employed by the International Monetary Fund (IMF) in its World Economic Outlook (WEO). Based on a major study supported by the World Bank, estimates of PPP exchange rates have recently been substantially revised, with the general result that the weights in world GDP of the industrial countries have been somewhat increased while those of emerging-market economies have been correspondingly reduced. Because emerging-market economies, most notably China and India, have been growing far more rapidly than most industrial countries in recent years, the effect of the revision in PPP exchange rates is to lower the figure for global growth (without changing growth rates for individual countries) by about 1/2 percentage point. Thus the present estimate for global growth of 4 3/4 percent in 2007 under the new PPP-based exchange rates corresponds to an estimate of 5 1/4 percent growth under the old weights. The weights used in table 1 are estimates of the weights that the IMF will use for the forecast to be reported in the current WEO.