

Global Economic Prospects: Surviving a Mild Case of Stagflation

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Economic growth has recently slowed across much of the world economy following stronger-than-expected performance during the first quarter of 2008. The net result is likely to be that on a year-over-year basis, global real GDP growth for 2008 will be only slightly below the 3.8 percent forecast last April. For 2009, however, growth now looks likely to decelerate to slightly below 3.5 percent rather than accelerate to 4 percent.

Meanwhile, the broad upsurge in commodity prices of earlier this year has been largely if not completely reversed. In particular, the price for light sweet crude has fallen back from a peak of almost \$150 per barrel to about \$100 per barrel but is still above the \$80 per barrel price of late 2007. Recent sharp declines in commodity prices will help to bring down headline inflation rates, at least for a while, although core inflation rates will likely remain uncomfortably high in a number of countries. In some emerging-market countries, where policies have remained lax, inflation will continue to be a critical problem.

Thus, looking to the rest of 2008 and to 2009, the world economy will experience mild stagflation. World real GDP growth (on the basis of the International Monetary Fund's *World Economic Outlook* [WEO]) will be significantly below the 4¾ percent average annual rate achieved from 2004 through 2007 but meaningfully above the 2½ percent rate that marks the borderline of global recession.¹ World consumer price inflation (measured on a 12-month basis) will fall below the recent high of over 6 percent but remain above 4 percent through 2009. Economic policies, therefore, will generally face the dual challenges of ensuring that inflation returns to acceptable rates within reasonable time horizons and of guarding against unnecessarily deep and prolonged slowdowns in output growth.

For most countries, however, these challenges should be significantly less severe than those of the two recent episodes of global stagflation: 1973 to 1976 and 1979 to 1984. In the present episode, industrial countries do not have to confront inflation rates that have been allowed to escalate well into double digits, and accordingly, they do not need to pursue aggressive monetary tightenings likely to pitch their economies into deep and prolonged recessions. Rather, we are likely to see a slowing of industrial-country growth to barely more than 1 percent for 2009—well below potential growth, but not a deep recession.

For most emerging-market countries, growth will also slow somewhat further in 2009, down to 5.7 percent for the aggregate of all of these countries (from 7.4 percent growth for 2007 and compared with an April 2008 forecast of 6.3 percent growth year-over-year for 2009). Slowing of domestic demand growth, due partly to tighter policies to combat

¹ If a “global recession” is defined as a four-quarter period *during which* real GDP growth (on a WEO basis) falls below 2.5 percent, then the four-quarter period ending with the first quarter of 2009 may qualify as such a “global recession.” We know already that (excluding the United States) real GDP growth in many industrial countries and several important emerging-market countries was quite sluggish or even negative in the second quarter of 2008, and many countries are expected to show quite sluggish performance for the next couple of quarters. Thus, the central forecast envisions that growth for the four quarters ending with the first quarter of 2009 will fall below 3 percent and could fall below 2½ percent.

rising inflation, is one reason. Slowing of growth of exports to industrial countries and other emerging-market countries is another reason. However, economic growth in emerging-market countries generally is significantly less dependent on industrial-country growth than it was even a decade ago. Also, the weak economic and financial policies that made many emerging-market countries particularly vulnerable to external economic distress and financial turbulence in the global recessions of the 1970s and 1980s are no longer such widespread and serious problems.

For emerging-market countries that are mainly importers of primary products, the pull back in global commodity prices should help to contain the slowdown in growth, as well as aid in reducing inflation. In contrast, growth in many commodity exporters will be adversely affected. However, this adverse effect is not likely to be as bad as in the commodity price busts of the mid-1970s and early 1980s. Growth of global demand for most primary commodities will likely slow from the rapid pace of recent years, but it is unlikely to collapse as it did during some past global recessions.

Economic Implications of Turmoil in World Financial Markets

Turbulence in major world financial markets remains an important concern for global economic growth prospects. This financial-market turbulence has been dramatized by the media attention focused on recent events in the United States: the government takeover of Fannie Mae and Freddie Mac, the bankruptcy of Lehman Brothers, emergency Federal Reserve loans to avoid bankruptcy of insurance giant AIG, runs on some US money market mutual funds, high stress in interbank markets for US dollars both in the United States and in Europe, and unprecedented policy initiatives by US authorities (and foreign central banks) to contain and reduce the turbulence in financial markets.

Credit markets, especially markets for nonconforming mortgages and related instruments in the United States, continue to be disrupted more than a year after the onset of major difficulties in August 2007. Equity markets around the world have sold off, generally registering losses larger than the 20 percent decline in the US stock market since its peak in October 2007. Recently, equity price declines in a number of emerging markets have been particularly dramatic. Interest rate spreads for emerging-market borrowers have also recently registered significant increases.

Clearly, the recent renewed turbulence in world financial markets is reason to be somewhat less optimistic about prospects for global economic growth. This is reflected in the reduction of the global economic growth forecast for 2009 to 3.4 percent from 4 percent and in the widening in the range of uncertainty around this central forecast: Global growth outcomes of as high as 4 percent or little below 3 percent should be regarded as within the range of reasonable possibility. More specifically, for the United States the impact on the economy from the financial turmoil that began last year (by prolonging and deepening the downturn in residential investment and negatively impacting both consumption and investment spending) will plausibly depress the level of real GDP by about 1 percent by mid-2009 and will be responsible for a cumulative output loss through 2010 of 2 to 2½ percent of US GDP—or about \$300 billion. This is a sizable figure, but (relative to GDP) it is not comparable to the enormous economic output loss associated with the Great Depression.²

² Losses to institutions and other investors in mortgage-related and other financial claims are not the same thing as losses of real economic output; they are more like transfer payments. Financial losses primarily reflect the recognition that the claims are not worth as much as their owners previously thought. In principle,

The likely economic significance of recent developments in global financial markets should, however, not be overstated. Despite the wailing from Wall Street that the Federal Reserve and the Treasury must act ever more aggressively to save financial firms and hence the US economy from disaster, the fact is that an actual recession has not started through the first half of 2008. And the possibility that the US economy may record modestly negative growth during the second half of this year arguably owes something to the upward spike in oil and gasoline prices as well as to the economic consequences of the continuing turbulence in US financial markets. Provided that the extreme disruptions of short-term credit markets in recent days are substantially resolved with the aid of the new financial support package, severe economic consequences from financial-market turbulence are likely to continue to be avoided.

The losses reported by financial enterprises are impressive both in absolute size and relative to the losses reported in the initial stages of past recessions, including the deep recessions of the mid-1970s and early 1980s. The primary reason why the losses reported by financial firms have been so large in the present episode, however, is that the “mark-to-market” accounting now generally applied to these firms requires much more timely reporting of changes in values of assets and liabilities on their balance sheets. In earlier episodes, generally accepted accounting principles (GAAP) usually allowed financial institutions to value assets at their historical costs, at least until the assets had been nonperforming for a significant period. Regulatory accounting principles (RAP), which were applied for some financial institutions, permitted even longer delays in recognizing losses.

Thus by 1981, the US savings and loan (S&L) industry was already deeply insolvent on a mark-to-market basis but still had significantly positive capital on a GAAP (or RAP) basis. It took seven years, until 1988, before economic reality finally caught up with misguided accounting principles and financial shenanigans and forced the government to admit to taxpayers that they would be stuck with a huge bill for cleaning up the S&L mess. For US commercial banks, the situation was not nearly as bad as for the S&Ls, but nevertheless at end 1981 most major US banks were probably insolvent if their portfolios of domestic and foreign loans had been valued on a mark-to-market basis. Some major US banks were probably once again in this situation in 1991–92. Much of the Japanese banking system went under water on a mark-to-market basis with the collapse of the bubble economy in the early 1990s, but misleading accounting allowed the banks and the Japanese government to deny the truth for a number of years.

From the perspective of these earlier experiences, the present situation is, in some important respects, reassuring. Prompt recognition of losses has forced institutions that were initially quite well capitalized to recruit substantial amounts of new capital, diluting the interests of existing shareholders in order to persuade suppliers of new capital that they are buying a valuable investment at a bargain price. This would not have been possible if potential suppliers of capital had believed that there was a significant probability that they might be investing in an institution that was already under water on a mark-to-market basis.

In the present episode, some financial institutions have already failed and more are likely to do so. The government stepping in limits the losses to some creditors and protects the stability of the financial system—at the expense of transferring some risk and some loss to the taxpayers. Such government “bailouts” contribute to moral hazard in the future. But, there should be less of this than in earlier episodes when initially reported losses were kept

recognition of such losses need not involve any loss of real economic output—although they may imply that the true value of past economic output was overstated.

low relative to the true situation, but ultimately the losses passed on to the general public were much greater.³

If the most recent efforts to support key financial institutions and stabilize key credit markets in the United States fail, there is significant danger that the deepening crisis in financial markets would push the US economy into a deep and prolonged recession. The spillover effects of such a US recession, augmented importantly by financial contagion from a deepening US financial crisis, could push world economic growth below the 2½ percent rate that defines the borderline of global recession. This risk justifies a somewhat lower central forecast for global economic growth, but it is still mainly a risk and not the central scenario for the world economy looking forward.

Regarding financial conditions for emerging markets, the recent sell-off in equity markets has come after four years of large price gains in most markets, and the recent declines in these usually highly volatile markets are likely to have generally modest impacts on consumer and investment spending. The rise in spreads for emerging-market borrowers is so far quite limited by the standards of earlier periods and is partly explained by the drop in US Treasury yields in the rush for safety. Many key emerging-market countries have large reserves and/or substantial current account surpluses; few have substantial international debts. That said, there are undoubtedly some (mainly smaller) emerging-market countries with large current account deficits that would be vulnerable to slowdowns in capital inflows. Others could face financing difficulties if revenues from commodity exports were to fall off sharply.

Thus, adding in a reasonable assessment of the situation in global financial markets does not alter the fundamental picture that the world economy is and will remain in a period of slower growth and moderating but still somewhat high inflation—a manageable situation of relatively mild global stagflation.

United States

As the world's largest economy (accounting for 21.5 percent of world GDP at purchasing power parity [PPP] exchange rates) and as the epicenter of recent financial-market turbulence, the United States merits particular attention in the present global forecast. Somewhat surprisingly, especially in view of all the doom and gloom in the media arising from recent financial-market developments, my April forecast of 1.2 percent real GDP growth for the United States in 2008 now appears to be too low! In fact, given the official estimates now available for US real GDP through the second quarter of 2008, we may calculate that zero growth in both the third and fourth quarters of this year would yield year-over-year growth for 2008 of 1.7 percent—which is 0.5 percent higher than my April forecast. Alternatively, one may calculate that for year-over-year growth to be as low as my April forecast (given present estimates of GDP through the second quarter), real GDP would have to decline at almost a 3 percent annual rate during the final two quarters of 2008.

Data so far available for the third quarter indicate that real GDP growth will be well below the 3.3 percent annual rate presently estimated for the second quarter, and it could be

³ Losses to the general public typically have been much larger than those passed on explicitly to taxpayers. By reducing the federal funds rate and keeping it low, the Federal Reserve reduces significantly the interest income of the general public on bank deposits and other bank liabilities. These losses of the general public become benefits for the suppliers of deposits.

slightly negative. Real GDP growth in the fourth quarter (for which no data are yet available) could also be somewhat negative. However, among the 49 professional forecasts reported in the *Blue Chip Economic Indicators* (dated September 10, 2008), only one projects growth for this year of less than 1.5 percent (specifically a forecast of 1.1 percent), and the average forecast is 1.8 percent growth for 2008.

My expectations are slightly more pessimistic than the *Blue Chip* average: Specifically, the central forecast is of 1.5 percent real GDP growth year-over-year for 2008. This central forecast implies that the US economy will turn in modestly negative growth in the second half of 2008. Early next year, as efforts to contain the financial crisis are seen to bear fruit, growth is forecast to turn modestly positive. Subsequently, growth will accelerate to about the potential growth rate of the US economy (about 2.7 percent) during the second half of next year. This scenario implies a central forecast of 1.3 percent growth year-over-year for 2009—slightly below the September *Blue Chip* average forecast of 1.5 percent. My fourth quarter-to-fourth quarter forecasts for 2008 and 2009 are 0.7 and 2.2 percent, respectively. With economic growth projected to remain below potential through the middle of next year, the unemployment rate is projected to rise to 6.5 percent or slightly higher.

If this central forecast is realized, the US economy would be running at the borderline of what the National Bureau of Economic Research (NBER) has previously recognized as a recession (or contraction). However, the unemployment rate is now projected to rise more than 2 percentage points above its recent low in the summer of 2006. All ten previous occasions in the postwar era when the unemployment rate has risen so much have been associated with recessions. Moreover, the decline in actual GDP relative to potential GDP that began in mid-2006 has now reached 1½ to 2 percent and is projected to rise to 3½ percent by mid-2009. For practical purposes, this magnitude of an economic slowdown should probably be regarded as a recession—even if the exact timing of its starting and ending points are hard to specify.

The rationale for this central forecast, as well as some understanding of the attendant risks, can be obtained by examining the likely behavior of the main components of GDP: consumption, private investment, government spending (on goods and services), and net exports.

Regarding consumption (which accounts for about 70 percent of real GDP) several factors point to very sluggish, but not persistently negative, growth over the next few quarters. On the downside, the temporary boost to consumption in the second quarter from the fiscal stimulus package is wearing off, as reflected in the 0.4 percent decline in real consumption spending reported for July. More broadly, even with the stimulus package, the annualized growth rate of real consumer spending over the past four quarters has slowed to 1.4 percent, from an average of 3 percent in the preceding three years. Households are feeling the effects of declining net worth associated with falling home prices and, more recently, falling equity values. Even with the temporary one-time cut in taxes, falling employment since late 2007 and sluggish growth of wages relative to increases in consumer prices have left households with meager gains in real disposable income so far during 2008. Sluggish wage growth and rising unemployment appear likely to keep household real income gains quite limited if not slightly negative through at least the early months of next year.

On the upside for consumer spending, the recent decline in world oil prices from nearly \$150 per barrel to the neighborhood of \$100 per barrel, along with moderation in food prices, should provide modest short-term gains for real household disposable income. Also, consumers have already made significant downward adjustments in purchases of durables, especially motor vehicles and parts. Specifically, sales of automobiles and light

trucks (which include some business purchases) are already down from 17 million vehicles per year in 2006 to 14 million vehicles per year in recent months. Further declines in vehicle purchases to 13 million per year by mid-2009 are plausible, but much steeper further declines are not. More broadly, the postwar record shows that real consumption spending (especially for services) tends to continue to grow even during recessions, including the deep recession of 1981–82. Thus, while an outright decline of consumer spending is certainly possible sometime during the next couple of quarters, it seems reasonable to expect that, on average, real consumption spending will grow at a sluggish pace through 2009.

Regarding gross private domestic investment, it is likely that investment in nonresidential structures (which has continued to grow through mid-2008) will soon peak and begin to decline at a moderate pace. In contrast, residential investment has already suffered a huge decline since its peak at the end of 2005, with almost a 40 percent real decline through the second quarter of 2008. Some further decline in real residential investment is likely through the end of this year. But, with new housing starts now running below 1 million, compared with sustainable trend demand growth of about 1.7 million units, it is reasonable to expect that residential investment will soon bottom out and begin to turn upward by the second half of 2009. The decline in house prices to levels that suggest limited need for further depreciation is already well in hand. By early next year, the drop in the real level of the Case-Shiller residential price index (adjusted by the consumer price index) from its 2006 peak will likely exceed one-third. With the government rescue of Fannie Mae and Freddie Mac and broader efforts to ensure financial stability, the mortgage market will recover sufficiently to support a rebound of home building from extremely depressed levels.

Real business investment in equipment and software has remained essentially steady in the face of recent economic weakness. The need to expand capacity to meet buoyant export demand has offset some investment weakness in more domestically oriented industries. Looking to the next few quarters, some weakening of investment in equipment and software appears likely as overall GDP growth remains very sluggish and export growth moderates. However, businesses do not report exceptionally low levels of capacity utilization and, barring a steep recession, there is no reason to anticipate a sharp downturn in business investment.

Real inventory investment is estimated to have run at an annual rate of minus \$49 billion in the second quarter of 2008, down \$39 billion from the first quarter. Further declines in inventory investment are certainly possible in the next couple of quarters. But with no evidence of an inventory overhang, it should be anticipated that inventory investment will return to normally positive levels during 2009. Between now and the end of 2009, the rebound of inventory investment, together with the beginnings of recovery in residential investment, should significantly outweigh weaknesses in other parts of private investment and yield an overall contribution to real GDP growth of about 1 percent.

Deterioration in the budget positions of state and local governments is likely to slow the growth of government purchases, despite some financial assistance for these governments likely to be passed by Congress early next year. Federal spending on goods and services (which does not include transfer payments, tax rebates, or financial bailouts) will probably continue to show modest growth. Overall, the rise in real government purchases through the end of 2009 will probably contribute about one-half percentage point to real GDP growth.

The improvement in US real net exports over the past two years amounts to \$233 billion, accounting for one-half of the rise in real GDP (of \$448 billion) and more than offsetting the decline in residential investment (of \$200 billion). Without this improvement

in real net exports and its positive multiplier and accelerator effects on consumption and business investment, the US economy would surely have fallen into outright recession. The improvement in US real net exports reflects the combined effects of the downward correction in the foreign exchange value of the US dollar (since its peak in early 2002) and the strong growth of demand in most of the rest of the world economy during a period when domestic demand growth in the United States was relatively weak.

Looking to the remainder of 2008 and to 2009, it appears that demand growth in much of the rest of the world economy will slow significantly from what it has been in recent years but remain (at least in emerging-market countries) somewhat stronger than demand growth in the United States. The downward correction of the dollar should still provide some impetus to further improvements in US net exports, but probably somewhat less so than in the past two years. Between now and the end of 2009, further improvement in real net exports should reasonably be expected to contribute one-half percentage point to the rise in real GDP.

Adding up the likely contributions from the four main components of GDP yields an estimated rise in real GDP between the second quarter of 2008 and the fourth quarter of 2009 of about \$350 billion in 2000 chained dollars. In contrast, the central forecast of year-over-year real GDP growth of 1.5 percent for 2008 and 1.3 percent for 2009 envisions a rise of only about \$250 billion in 2000 chained dollars by the fourth quarter of 2009. Two key factors account for the \$100 billion difference between these two approximate figures. First, in my judgment, present official estimates overstate reasonable figures for nominal and real GDP through the second quarter of 2008. Likely revisions of these estimates, which will become available over the next year, will pull down the figures for GDP and GDP growth through the second quarter of 2008 and the likely figures for GDP in 2009. Second, with the ongoing crisis in US and global financial markets, there is, on balance, a net downside risk to the forecast of US real GDP growth derived from adding up reasonable forecasts of the four main components of GDP. The central forecast reflects my allowances for these factors.

Turning to US economic policy, the Federal Reserve is likely to keep monetary policy on hold through at least the first quarter of 2009. Headline inflation will come down, but core inflation will remain above the Fed's previously suggested comfort zone. However, in view of weakness in the economy and worries about financial markets, the Fed will rightly be reluctant to undertake any monetary policy tightening. On the other hand, with massive efforts to deal with the financial crisis being undertaken by the Treasury, the Federal Reserve will not need to use further its primary monetary policy instrument to address these problems. Evidence of a deepening recession continuing into 2009 would, however, probably provoke further Fed easing.

For traditional fiscal policy (excluding the financial-sector bailout), some action will likely be taken early next year to provide modest tax cuts and financial support to state and local governments and to homeowners facing foreclosure. Efforts to deal with the massive federal deficit will be put off to future years.

Rest of the Americas

The Canadian economy weakened in the first quarter of 2008, reflecting a sharp decline in real domestic demand after several quarters of very rapid advance. The first quarter drop in real domestic demand was reversed in the second quarter but still left second quarter real GDP growth quite sluggish. The Bank of Canada responded to economic weakening (and to

the very strong Canadian dollar) with further easing of the official financing rate down to 3 percent.

Looking forward, very weak growth in the United States and a still very strong Canadian dollar imply significant drags on Canadian real GDP growth. In view of the weak results for the first and second quarters, real GDP growth (year-over-year) for 2008 is likely to be only about 1 percent for Canada versus 1.5 percent forecast for the United States. However, the Canadian economy is not fundamentally weaker than the US economy. Despite the drag from south of the border, Canadian real GDP growth during the second half of 2008 is likely to recover 2.5 percent at an annual rate and yield a 2 percent gain year-over-year for 2009.

As expected, the US slowdown has also been a serious drag for the Mexican economy, and growth this year is now forecast to be marginally less than the 2.5 percent projected in April. With consumer price inflation running above its announced target of 3 percent, the Banco de México has raised policy interest rates to over 8 percent, and this may be expected to exert some downward pressure on growth of domestic demand. With the weakening of growth and declining oil production (which delivers substantial revenues to the government), the government's budget position has worsened. This situation does not (yet) raise concerns about fiscal sustainability, but it does remove latitude for fiscal stimulus to help spur growth. The prospects for a modest uptick in Mexico's economic growth for 2009 depend largely on the projection of some recovery in the US economy during the course of next year.

Brazil's economy grew by 6 percent during the year ending in the second quarter and registered 6.6 percent annualized growth during that quarter. Meanwhile, however, inflation has been picking up in Brazil as capacity utilization rates have reached new multiyear highs. Responding aggressively to the inflationary threat, the Banco Central do Brasil has pushed the Selic rate once again above 13 percent (which is about 8 percent in real terms based on expectations of 2009 consumer price inflation).

The combination of policy efforts to cool the domestic economy and weakening demand growth in several of Brazil's key export markets suggests that growth will slow somewhat in the second half of 2008 and in 2009. Nevertheless, Brazil's growth this year should reach almost 5 percent. For 2009, many forecasters expect that Brazil's growth will fall below 4 percent to about 3½ percent. I am more optimistic. With declining global commodity prices helping to bring down headline inflation in Brazil, and with the central bank having reinforced its inflation fighting credentials, some easing of the Selic rate should be possible by early next year. Growth next year is still likely to be less than this year but slightly above 4 percent.

Argentina continues to report quite robust real GDP growth of slightly over 6 percent. There is less reason to doubt the reliability of these data than officially reported inflation rates, where recent "consensus" estimates of the true consumer price inflation place the rate at 25 percent year-over-year versus the officially reported rate of 9.1 percent. It is possible, however, that repression of reported inflation leads to a situation in which some reported gains in nominal GDP are really due to price increases rather than to reported increases in real GDP. Without the distortions due to misreporting of inflation, it is entirely possible that a true measure of Argentina's real GDP growth this year would put the figure below 6 percent. In any event, the increasing distortions within the Argentine economy arising from a host of government policies, together with the recent decline in global commodity prices and the rapidly rising real effective exchange rate of the Argentine peso, point to a significant slowing of GDP growth in 2009.

In Chile, indicators of economic activity have been somewhat erratic, but on balance growth appears to have slowed somewhat from the 5 percent rate achieved in 2007. Inflation, which recently has risen above 9 percent on a 12-month basis, has been much more of a policy concern than the slowdown in growth. The central bank has boosted its benchmark interest rate sharply in order to drive inflation back down to its 3 percent target rate within two years. The commitment of the central bank to do whatever is necessary to achieve this target suggests that expansion of the Chilean economy is likely to slow in the period ahead down to a rate of about 4 percent.

Elsewhere in Latin America, growth this year appears to be reasonably in line with the April forecast. For 2009, growth is likely to be somewhat lower, about 4.2 percent (including Chile), due primarily to somewhat less robust performance in the larger economies of Colombia, Peru, and Venezuela.

Europe

In Western Europe, real GDP growth was unexpectedly strong in the first quarter of 2008 due primarily to a better than 5 percent annualized GDP gain in Germany and a rebound from moderately negative to moderately positive growth in Italy. In the second quarter, economic activity suddenly slowed, with Germany, France, Italy, and the euro area as a whole all recording negative real GDP growth and with the UK economy flat. Data so far available for the third quarter indicate that the second quarter slowdown was more than simply payback for the unexpectedly rapid advance in the first quarter. Leading economic indicators for the United Kingdom and all of the main euro area countries (including Spain) point to weak growth or even output declines through the remainder of this year.

Because of the moderately strong growth in the first quarter and the carry-over effect from moderately strong growth during 2007, the forecast for year-over-year growth for Western Europe in 2008 is reduced only to 1.4 percent from the April forecast of 1.7 percent. The forecasts for particular countries are reduced as follows: Germany from 1.7 to 1.2 percent; France from 1.6 to 1.2 percent; Italy from 0.8 to 0.5 percent; Spain from 2.3 to 1.5 percent; euro area from 1.6 to 1.3 percent; and the United Kingdom from 1.8 to 1.3 percent.

The sluggish performance of Western European economies now apparent or very likely for the final three quarters of 2008 also pulls down the forecasts for year-over-year growth for 2009—despite the expectation that growth will accelerate somewhat in Western Europe during the course of 2009. The forecasts for particular countries for 2009 are revised as follows: for Germany from 1.8 to 1.2 percent; for France from 1.7 to 1 percent; for Italy from 1.2 to 0.5 percent; for Spain from 2.3 to 0.8 percent; for the euro area from 1.7 to 1.1 percent; and for the United Kingdom from 2 to 1.2 percent.

The reasons for the growth slowdown in Western Europe and the downward revisions in growth forecasts vary considerably from country to country. However, one common element across most countries both inside and outside the euro area is rising inflation and the monetary policy response to it. Overall rates of consumer price inflation (which are the focus of monetary policy across Europe) have escalated significantly over the past couple of years, rising well above the targets of European monetary authorities. In response, monetary policies were tightened to varying degrees by the European Central Bank (ECB), the Bank of England, the Swedish Riksbank, and the Swiss National Bank.

With evidence of significant weakening in the UK economy, difficulties in the financial system (most notably the failure of Northern Rock), and some moderation of

inflationary pressures, the Bank of England began to dial back its tight monetary policy last December, taking the bank rate down to 5 percent by this April. Facing continued solid economic growth, unusually low unemployment, surging inflation, and rapid expansion of monetary aggregates, the ECB continued to tighten its policy with a 25 basis point increase in the repurchase rate to 4.25 percent this July. Other independent European central banks have either tightened policy rates in recent months or held them constant as concerns about inflation have outweighed worries about economic weakening.

If inflation rates come down as expected with the aid of weakening of world commodity prices and if economic growth continues to slow as now expected across most of Western Europe, it may reasonably be expected that European central banks will ease back on their monetary policies. This should help provide some stimulus to growth by the second half of 2009. However, it would be imprudent to expect an aggressive easing of European monetary policies similar to the 325 basis point reduction in the federal funds rate that the US Federal Reserve implemented in the seven months from September 2007 to April 2008. The conditions in Western Europe do not appear to merit such a monetary policy response—no matter what may be heard from some economic commentators on the other side of the Atlantic.

In this regard, it is relevant to note that slowing of economic growth in Western Europe does not primarily reflect spillovers from either the economic slowdown or the financial turmoil in the United States. Some European-based financial institutions (especially in the United Kingdom and Switzerland) have taken substantial losses on their US-based assets. But the problems of mortgage banks in the United Kingdom primarily reflect inadequate risk management by these institutions in the face of the downturn in UK real estate markets. Similarly, the downturns in real estate and residential investment in Ireland and in Spain reflect natural and necessary cooling off of these overheated markets rather than any spillover from the United States. The improvement in the US trade balance vis-à-vis Europe has had some negative effect on European growth, but the magnitude of this effect appears to be no more than one-tenth of one percent of GDP.

Aside from Hungary and Turkey, growth has been well sustained through the second quarter in most of Central and Eastern Europe, and performance for the region appears to be on track to reach the April forecast of 4.2 percent growth this year. Industrial production data, however, suggest significant slowing in recent months, as should be expected with the slowdown in Western Europe. With Western Europe expected to remain quite sluggish and taking account of the high real effective exchange rates of most countries in Central and Eastern Europe, growth in the region should be expected to slow below 4 percent in 2009. Reductions in the inflows of foreign capital to the region would likely slow growth further in those countries that need to finance already large current account deficits, and there is some threat of potential balance-of-payments financing crises. In this regard, the situation in Hungary is somewhat less worrying than a year ago, but the situations in the Baltic states, Bulgaria, Romania, and Turkey are more worrying. In Turkey there is also concern that efforts to contain the rise of inflation may prove too timid, especially if politicians successfully pressure the central bank to hold back on necessary monetary tightening.

Asia

In Japan, second quarter GDP growth was –3 percent, following growth rates of 2.4 and 2.8 percent, respectively, in the preceding two quarters. The negative result in the second quarter was partly payback for earlier positive results, and it may reasonably be expected to be offset

somewhat by a bounce-back in third quarter GDP growth. Nevertheless, the forecast for Japanese GDP growth in 2008 needs to be written down from 1.2 percent in April to 1 percent now.

The growth forecast for 2009 also needs to be written down to 1 percent (from 1.5 percent in April) to take account of three negative influences on Japanese growth: (i) World oil prices are now higher than was assumed in April and high oil prices exert a negative influence on Japanese economic growth; (ii) Demand growth in Japan's key export markets (including the United States and China) appears likely to be more sluggish than was earlier assumed; (iii) Very sluggish growth in household real incomes and in business expectations of needs to invest in expanding capacity suggest continued weak growth of domestic demand.

Meanwhile, overall and core consumer price inflation in Japan have risen to modestly positive levels. Ordinarily, this might tempt the Bank of Japan to increase short-term interest rates, but actual and prospective economic weakness will likely and rightly deter such actions. The new Japanese prime minister has suggested expansionary fiscal policy to combat the economic slowdown, but as in the past such efforts are unlikely to accomplish very much.

In China, the real GDP growth rate has been gradually decelerating when measured as growth from the same quarter a year ago. Nevertheless, very strong economic growth in the first quarter virtually assures that year-over-year growth for 2008 will reach the April forecast of 10 percent. For 2009, a reduction in the April forecast, from 9.5 to 9 percent appears warranted in view of evidence that the pace of advance of the Chinese economy is continuing to moderate.

Notably, China's trade surplus appears to have leveled off this year after five years of spectacular growth. This is partly due to rising import costs (for energy and other primary products), which do not affect the real trade balance in volume terms. However, there is now little doubt that further improvements in the real trade balance will make significantly less of a contribution to real GDP growth than they have for the past couple of years. This is a welcome development from a global perspective.

China's economic growth also appears to be moderating because of a cooling off of investment growth, especially in the property sector. This is due partly to the government's efforts to contain a significant rise of inflation and to restrain speculative overinvestment in real estate. As inflation moderates with the aid of falling prices of some key food items, the government may relax some of its recent tightening actions in order to ensure economic growth sufficient to employ an expanding labor force in the nonagricultural sectors of the economy. Growth somewhat below the average pace of the past five years but still in the 9 to 10 percent range is a reasonable prospect.

For India, there are also indications that growth is slowing somewhat from the over 9 percent pace of the past couple of years. The April forecast of year-over-year growth of slightly below 8 percent still appears to be realistic for 2008. For 2009, some reduction in the growth forecast, down to 7 percent, is reasonable. This slowing of growth in the Indian economy partly reflects policy efforts to contain and reverse a sharp rise of inflation, which is particularly politically sensitive in India. Despite the recent moderation in world food prices, the Reserve Bank of India will be reluctant to back away from its recent tightening unless the slowdown in the economy becomes more pronounced. The recent depreciation of the Indian rupee is further reason to be cautious about easing back on India's monetary policy.

In the rest of the Asian emerging markets, after a generally solid first quarter, growth has slowed dramatically in the second quarter, with Hong Kong, Singapore, and Taiwan all

reporting significantly negative GDP growth and with South Korea continuing to show quite sluggish growth. The slowdown forecast in April is certainly upon us—and then some. Declining exports of manufactured products to the industrial countries and China are an important reason for the slowdown. Slowing of domestic demand is also relevant, particularly in Korea. Monetary policy responses to higher inflation are partly responsible.

The Commonwealth of Independent States (CIS), the Middle East, and Africa

These three very different regions share the common characteristic that their recent strong growth performances are closely tied to the upsurge in global commodity prices, especially for energy. Commodity prices have retreated significantly from their peaks earlier this year but remain at very high levels. The implication is that growth will not continue to accelerate and will likely moderate somewhat, but it will not collapse provided that global commodity prices remain reasonably strong. This stipulation appears likely to be met under the central forecast that global growth will slow to around 3½ percent in 2009. A significantly larger slowdown would imply real trouble for a number of countries heavily dependent on commodity exports.

More specifically, for Russia (the dominant economy in the CIS) world oil prices in the neighborhood of \$100 per barrel are consistent with continued growth of 6 percent or better through 2009. The oil price is not the only thing that matters for the Russian economy, but developments other than a sharp further drop in oil prices, which would cause near-term trouble for economic growth, appear unlikely. In particular, the Russian authorities appear unlikely to tighten monetary policy significantly in order to combat inflation that is running in the low double digits.

For the rest of the CIS, the situation is mixed. The Ukraine is suffering from high inflation, political turmoil, and uncertainty about policy management. Growth is likely to be below the performance of recent years. Georgia is feeling the effects of its conflict with Russia. In contrast, the oil-exporting states are likely to continue to turn in strong growth so long as world oil prices remain high.

The oil-exporting countries of the Middle East will continue to grow comfortably with oil prices in the neighborhood of \$100 per barrel. To the extent that inflation is a matter of concern, it can be addressed by allowing some nominal currency appreciation without much of a negative impact on growth. For Israel and Egypt (the largest of the diversified economies of the Middle East), the slowdown in industrial-country growth means slower export growth and somewhat slower domestic economic growth. (If Pakistan is included in the Middle East region rather than Asia, then it is relevant to note here that recent political turmoil and uncertainties about economic policy are likely to be reflected in a considerable slowdown from Pakistan's generally strong performance in recent years.)

For Africa, reasonable political stability (including avoidance of civil and international wars) and strong commodity prices have been key to the better than 5 percent annual growth rates achieved for the past six years. So far, it appears that these critical factors remain in place, with at least the hope that the situation in Zimbabwe may finally begin to improve.

Table 1 Real GDP growth projections as of September 26, 2008
(percent change, year over year)

Country/region	Weight	2007	2008	2009
Industrial countries	52.5	2.5	1.5	1.2
United States	21.5	2.2	1.5	1.3
Canada	2.0	2.7	1.0	2.0
Japan	6.7	2.0	1.0	1.0
Australia and New Zealand	1.3	3.7	2.7	2.5
Western Europe	21.0	2.8	1.4	1.1
United Kingdom	3.3	3.0	1.3	1.2
Other (non euro area)	1.4	3.8	2.0	1.6
Euro area	16.0	2.6	1.4	1.1
Germany	4.3	2.6	1.8	1.2
France	3.2	1.9	1.2	1.0
Italy	2.7	1.5	0.5	0.5
Other	5.8	3.5	2.0	1.6
Emerging markets	47.5	7.4	6.4	5.7
Asia	25.0	9.0	7.8	7.1
China	10.5	11.9	10.0	9.0
India	4.5	8.7	7.7	7.0
Other	10.0	6.7	5.5	5.2
Latin America	7.8	5.7	4.4	3.8
Argentina	0.8	8.7	6.0	4.2
Brazil	2.9	5.4	4.8	4.3
Mexico	2.1	3.2	2.4	2.6
Other	2.0	6.5	4.8	4.4
Central and Eastern Europe	3.9	5.5	4.2	3.8
Commonwealth of Independent States	4.4	8.5	7.5	6.2
Russia	3.2	7.5	7.2	6.0
Middle East	2.9	6.0	6.5	6.0
Africa	3.4	6.0	5.5	5.0
World (at PPP exchange rates)	100	4.9	3.8	3.4