

Amid Credit Market Crunch, Calls for Stronger IMF

With market turbulence exposing fault lines in parts of the international financial system, the IMF wrapped up its 2007 Annual Meetings amid calls for the multilateral institution to strengthen its role as a global financial watchdog and revamp its governance.

Finance ministers and central bank governors from around the world met October 20–22 in Washington, D.C., for the IMF-World Bank meetings at a time of renewed concerns about the fallout from the U.S. subprime mortgage meltdown. Outgoing IMF Managing Director Rodrigo de Rato told delegates from the 185 member countries on October 22 that the resulting market turbulence was akin to “an earthquake in the credit markets.”

The meetings also coincided with a watershed in global economic growth. Three major emerging markets—China, India, and Russia—now account for more than half of world growth, according to the just-released IMF *World Economic Outlook*.

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Chris Hondros/Getty

A sudden flight from risk, caused by the U.S. subprime mortgage meltdown, caused credit markets to seize up.

IMF Sees World Growth Slowing

World economic growth is expected to slow next year, with recent turbulence in financial markets triggered by the fallout from the U.S. subprime mortgage market clouding prospects, the IMF said in the October 2007 *World Economic Outlook (WEO)* released on October 17.

Before the turbulence erupted in August, the global economy had been expanding vigorously, with growth running above 5 percent in the first half of 2007, according to the *WEO*. China's economy gained further momentum, growing by 11½ percent. India also continued to grow very strongly at more than 9 percent, and Russia grew by almost 8 percent. In fact, these three countries alone have accounted for one-half of global growth over the past year. Robust expansions also continued in other emerging market and developing economies, including low-income countries in Africa.

Rapid growth in the emerging markets counterbalanced continued moderate growth of about 2¼ percent in the United States in the first half of 2007, as the housing sector continued to exert considerable drag. Among the advanced economies,

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Strauss-Kahn Takes Over as New IMF Head

Former French Finance Minister Dominique Strauss-Kahn began his job as the new IMF Managing Director on November 1 determined to put fresh vigor into reform of the 185-member institution that oversees the global economy. He was welcomed with a handshake at the front door of the IMF by outgoing Managing Director Rodrigo de Rato.

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Johnson: The greatest risk to world growth is continued turbulence in the financial markets.



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Subprime fallout clouding prospects

World growth is slowing but is expected to remain solid, supported by the strong momentum of major emerging markets.

(real GDP, annual percent change)

	2005	2006	Projected	
			2007	2008
World output	4.8	5.4	5.2	4.8
United States	3.1	2.9	1.9	1.9
Euro area	1.5	2.8	2.5	2.1
Germany	0.8	2.9	2.4	2.0
Japan	1.9	2.2	2.0	1.7
Africa	5.6	5.6	5.7	6.5
China	10.4	11.1	11.5	10.0
India	9.0	9.7	8.9	8.4

Source: IMF, *World Economic Outlook*, October 2007.

Note: Real effective exchange rates are assumed to remain constant at the levels prevailing during August 22–September 19, 2007.

growth in the euro area and Japan slowed in the second quarter of 2007 after two quarters of strong gains.

Solid growth ahead despite turmoil

The IMF expects healthy growth to continue into 2008 (see table), with emerging market economies continuing to serve as the main growth engine of the world economy (see

chart, next page). According to the latest forecast, global growth would slow from 5.2 percent in 2007 to 4.8 percent in 2008, down from the 5.4 percent rate registered in 2006. The largest downward revisions to growth are in the United States, and in countries where financial and trade spillovers from the United States are likely to be the largest.

In the United States, growth is now projected to remain at 1.9 percent in 2008, the same rate as in 2007 and a markdown of almost 1 percentage point compared with the IMF's previous projections. The U.S. economy grew by 2.9 percent in 2006. Ongoing difficulties in the mortgage market are expected to extend the decline in residential investment, while higher energy prices and weaker house prices are likely to dampen consumption spending, the IMF said. In the euro area, growth has been marked down to 2.1 percent in 2008, and in Japan it is now expected to be 1.7 percent.

In the emerging markets, economies are expected to continue to expand strongly, although growth is expected to slow from the heady pace of the past two years. The

Higher Food Prices Raise Questions About Biofuel

Commodity prices have risen sharply during 2007, with oil and a number of metal and food items setting new record highs. The rise in food prices raises questions about how to manage growing demand for biofuel.

Futures markets indicate that high prices are likely to continue over the medium term, providing incentives for a surge in biofuel production as a supplement to transportation fuels. This, together with droughts and animal disease, has pushed up food prices and inflation across the globe.

Using biofuel to supplement transportation fuels at modest blends—under current technology—has its pros and cons. Biofuel can supplement traditional fuels while contributing to rural development. However, until new technologies are developed, using food to produce biofuel might further strain already tight supplies of arable land and water all over the world, thereby pushing food prices up even more.

Realizing the potential benefits of biofuel requires better policies. Brazilian ethanol

derived from sugarcane, for example, is less costly to produce than corn-based ethanol in the United States, and also yields greater environmental benefits. However, generous tax credits for blenders, tariffs on imported biofuel, and agricultural support for grain farmers in the United States and the European Union make it difficult for low-cost foreign biofuel producers to compete in these markets.

If tariffs and subsidies in the United States and EU were eliminated, biofuel would likely be produced largely by lower-cost producers such as Brazil and other Latin American countries. Similarly, under such a scenario, biodiesel would be produced mostly by Malaysia, Indonesia, India, and some African countries.

In sum, while we wait for more efficient fuel technologies to emerge, the first-best policy would be to allow free trade in biofuel. This would benefit the environment as well as make biofuel economically more viable. ■

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