ANNEX SUMMING UP BY THE ACTING CHAIR

The following remarks by the Acting Chair were made at the conclusion of the Executive Board's discussion of the World Economic Outlook on March 31, 2004.

Executive Directors welcomed the recent strengthening and broadening of the global economic recovery, which has been marked by an especially rapid upturn in the United States and emerging Asia. Industrial production and global trade have picked up sharply; business and consumer confidence have strengthened; and investment growth has turned solidly positive in most regions. The recovery is being supported by a broad-based rally in financial markets, including a rise in equity prices, a further drop in bond spreads, and a rebound in private financing flows to emerging markets. Although growth has picked up and oil and commodity prices have moved up, worldwide inflation has remained subdued, reflecting continued excess capacity, still-weak labor markets, and competitive pricing in both domestic and global markets.

Directors noted the significant upward revision to the global growth forecasts for 2004 and 2005, with the strength of the ongoing recovery pointing to upside risks in the short run. However, Directors also highlighted a number of downside risks, which will require continued vigilance in the period ahead. The terrorist attacks in Madrid and recent developments in the Middle East are a sobering reminder of the continuing geopolitical uncertainties under which the global outlook is being shaped. Some Directors considered that greater stability in oil prices going forward will require reduced geopolitical uncertainties, combined with closer cooperation between oil producer and consumer countries. Directors recognized that recent exchange rate adjustments have been helpful given the large global current account imbalances. However, most Directors cautioned that these imbalances will still remain large, thereby posing risks of potentially disorderly currency movements and increased protectionist pressures. Most Directors also pointed to the possible increased market volatility and adverse consequences for private consumption in countries with buoyant housing markets that could result from an abrupt increase in interest rates from their currently very low levels.

Against the backdrop of the improved global outlook, Directors agreed that priority should now be given to pressing ahead with the medium-term policy measures that will help underpin the sustainability of the recovery going forward, while rebuilding room for maneuver to respond to possible future shocks. A key challenge facing monetary policy in the period ahead will be to manage the transition to a higher interest rate environment that will eventually need to take place in countries where growth is strengthening. While in the near term the situation is likely to vary significantly among countries depending on the evolving pace and nature of the recovery, Directors expected that as the recovery continues, interest rates in most countries will need to rise toward more neutral levels. In this context, they considered it especially important that central banks communicate their policy intentions clearly to the financial markets to reduce the risk of abrupt changes in expectations, and that rate increases when they actually occur be well-anchored on fundamentals. It was noted that a gradual increase in interest rates in tandem with the expected pickup in investment demand should not hamper the recovery.

To support an orderly resolution of the global imbalances in the context of sustained growth in the world economy, Directors called for the membership to adopt a credible and cooperative strategy that would facilitate the medium-term rebalancing of demand across countries and regions. The main pillars of this strategy should be a credible medium-term fiscal consolidation effort in the United States; an acceleration of structural reforms in the euro area; further banking and corporate reforms in Japan; and a gradual shift toward more exchange rate flexibility, combined with additional structural reforms to support domestic demand, in most of emerging Asia. Some Directors also suggested that stronger international policy coordination will be needed to help enhance prospects for a sustained implementation of this cooperative strategy. Reiterating the critical importance of open markets for supporting broad-based global economic growth and poverty reduction in low-income countries, Directors called for a timely resumption and successful conclusion of multilateral trade negotiations under the Doha Round.

Directors emphasized that the relatively benign economic outlook provides an advantageous window of opportunity to address vulnerabilities. In particular, efforts to restore sustainable medium-term fiscal positions should be pursued vigorously. In most industrial countries, these will need to involve, in addition to timely fiscal consolidation, credible and high-quality measures to reform pension and health care systems. In addition, for emerging market and other developing countries the priority should be to address remaining public debt sustainability concerns through tax reforms to reduce revenue volatility, steps to strengthen fiscal institutions, and measures to improve the structure of debt.

Major Currency Areas

Directors welcomed the recent strong growth in the *United States*. With the impact of past fiscal and monetary stimulus gradually waning, they considered that the sustainability of the recovery will increasingly depend on continued solid investment and productivity growth and a pickup in employment, which has so far been lagging. In view of the weak labor market and the low inflation, Directors supported the Federal Reserve's decision to maintain a very accommodative monetary policy stance for the time being. Going forward, the ground should continue to be laid for starting a move toward a more neutral monetary policy stance. While recognizing that the expansionary fiscal policy pursued by the U.S. authorities in recent years has provided valuable support to U.S. growth, with a positive impact on global output, Directors underscored that the priority now is sustained fiscal consolidation. On the basis of the staff's analysis of the global impact of U.S. fiscal policy, most Directors supported the conclusion that a more ambitious fiscal consolidation path than currently envisaged would produce significant benefits, in particular by containing the risk that higher real interest rates would crowd out productive investments. Accordingly, these Directors urged the U.S. authorities to move ahead with establishing a viable fiscal framework with the clear objective of returning the budget to balance (excluding Social Security) over the medium term, along with reforms to strengthen the financial position of social security and health care programs.

The recovery in the *euro area* has so far remained subdued. While prospects for stronger domestic-led growth are being supported by an expected pickup in fixed investment, Directors saw the pass-through effects of euro appreciation, the ongoing balance sheet restructurings, and the possible impact on confidence of the Madrid bombings as factors that may continue to dampen the outlook. In view of this fragile environment, Directors supported the continuation of the current monetary policy stance until convincing signs of a self-sustaining recovery in domestic demand emerge. A number of Directors felt that, given the current low-inflation environment, the ECB should stand ready to cut interest rates further should domestic demand fail to pick up. Regarding fiscal policy, Directors agreed that countries with weak budget positions should aim for a sustained adjustment of underlying imbalances, based on high-quality measures, to achieve fiscal consolidation within the Stability and Growth Pact framework. Directors welcomed the recent progress on structural reforms, including the Agenda 2010 initiative in Germany and the pension reforms in France. They considered, however, that to increase sustainable long-term growth and improve the euro area's ability to adjust to shocks, more will need to be done. In particular, in anticipation of future demographic changes, product and labor markets should be strengthened further, and labor force participation and productivity growth increased.

In *Japan*, the strength of the recovery has continued to substantially exceed expectations, with welcome signs of a pickup in private consumption to complement exports and business investment as the main engines of growth. Deflationary pressures have also eased, and progress has been made with strengthening the bank and corporate sectors. Directors encouraged the Japanese authorities to build on these achievements by making further strong efforts to sustain the recovery. In this context, they recommended continued quantitative monetary easing to bring a decisive end to deflation, adoption of a well-defined fiscal consolidation plan to tackle the very difficult budgetary situation, and further reforms of the financial and corporate sectors, particularly among smaller banks and enterprises.

Directors felt that the staff's analysis of the industrial countries' experiences with structural reforms provides useful insights on how to move forward with the implementation of key structural reforms. While reforms have in general progressed fastest in those areas that yielded the most immediate benefits, the experience over the past two decades also shows that the end of a protracted period of slow growth provides a particularly favorable environment to embark on the more difficult reforms. In such an environment, policymakers and voters remain cognizant of the costs of weak growth, while at the same time the economic recovery that is under way helps to mitigate any short-term adjustment costs. Directors accordingly encouraged policymakers to take advantage of the current recovery to press ahead with their structural reform agendas, including by carefully exploiting the complementarities between different reform areas. Some Directors also highlighted the positive role that international cooperation can play in supporting the implementation of national reform agendas.

Emerging Market and Other Developing Countries

Directors welcomed the recovery in *emerging market and other developing countries*, which has been aided by improved fundamentals, strong private capital inflows, and historically low spreads. GDP growth is expected to strengthen in most regions, although the outlook—particularly in countries where public debt remains high—could be affected by a deterioration in external financing conditions, for example as a result of an abrupt or unexpected increase in interest rates. Directors acknowledged that, in addition to abundant liquidity in global financial markets, the decline in emerging market bond spreads also reflects the considerable progress being made by many countries in strengthening their fundamentals and improving the structure of their public debt.

Directors were encouraged by the improved outlook for *Latin America*, with stronger domestic demand beginning to contribute to an initially export-led recovery. To sustain the prospects for a further firming of the recovery, countries will need to continue to make strong efforts to reduce vulnerabilities to a possible deterioration in the global financial market environment, and further strengthen investor confidence. Directors noted the challenge that a number of countries in the region are facing in addressing pressing social needs against a backdrop of still-high public debt levels. They stressed the importance, in this context, of implementing broad-based reform strategies aimed at achieving strong and sustained growth, combined with well-targeted social programs and investments.

Directors highlighted the exceptionally strong growth in *emerging Asia*, which is underpinned by accommodative macroeconomic policies, growing domestic demand, competitive exchange rates, and the recovery in the information technology sector. Buoyant growth in China is providing important support to economic activity in the region. With growth accelerating and some financial imbalances emerging, Directors considered that many countries in the region will need to gradually tighten macroeconomic policies in the coming year. In a number of countries, accelerated fiscal consolidation may be warranted, along with strengthened prudential oversight of the banking system to ensure that lenders appropriately evaluate and manage risks. Most Directors considered that timely, gradual steps by China toward greater exchange rate flexibility—combined with progress on developing the exchange markets and strengthening the banking sector—will help underpin price stability over the longer term by containing the continuous build up of international reserves. Such steps would also facilitate similar moves by other countries in the region facing a need for monetary tightening, and allow the region as a whole to contribute to more balanced growth globally. Directors welcomed the staff's analysis of the implications of China's rapid growth and integration for the global economy. While China itself clearly stands to gain most from this process, the rest of the world will also continue to enjoy long-term benefits from China's economic emergence, as already evidenced by the dynamic productivity gains. To maximize these gains, Directors underscored the importance of continued further efforts by all countries to increase the flexibility of their economies to foster the mobility of resources between sectors.

Directors welcomed the robust economic performance in most other emerging market countries. Prospects for continued strong growth remain favorable across regions, provided timely actions continue to be taken to address vulnerabilities and further strengthen the foundations for private sector–led growth. For many countries of *central and eastern Europe*, Directors highlighted the importance of pressing ahead with fiscal consolidation efforts, in particular in those countries where a sharp widening in the current account deficit calls for firm action to reestablish budgetary discipline. In the *CIS* countries, the priority should be to continue with reforms to improve the investment environment, strengthen banking systems and judicial frameworks, and dismantle intraregional trade barriers. For most oil-exporting countries in the *Middle East*, Directors highlighted the importance of fiscal consolidation to reduce their vulnerability to oil price fluctuations. For the region as a whole, a more stable security situation and reduced geopolitical tensions will—along with employment generating reforms—be key to accelerating medium-term growth.

Directors welcomed the work undertaken by the staff on credit booms in emerging market economies, given the risk that such booms may presage sharp economic downturns and financial crises. While credit booms are difficult to identify ex ante, authorities need to remain vigilant, especially in situations where rapid credit growth is accompanied by other signs of macroeconomic imbalance, such as current account deficits, investment booms, and increases in the relative price of nontradables. Some Directors cautioned against drawing too many policy conclusions from the analysis. Nevertheless, Directors agreed that strengthened surveillance of the banking system and close scrutiny of corporate borrowing during periods of rapid growth will need to be at the center of policy measures to contain credit booms in nearly all cases.

Directors were encouraged by the continued improvement in *Africa's* economic performance, and the expectation that growth will accelerate further in the period ahead. A sustained further effort to accelerate growth and reach the Millennium Development Goal of halving poverty by 2015 remains nevertheless a pressing priority. This will need to involve steps to promote stronger private sector activity and investment, reduce the vulnerability to exogenous shocks, develop infrastructure, and strengthen institutions, governance, and transparency, along with strong efforts to avoid the resurgence of civil conflicts. Directors welcomed recent regional initiatives to accelerate progress in these areas, including the African Peer Review Mechanism and the African Union's adoption of a Convention on Preventing and Combating Corruption. They also emphasized that additional assistance from the international community will remain critical for Africa's development, and called for increased aid, continued debt relief, and—most importantly—greater access to industrial country markets.