ANNEX IMF EXECUTIVE BOARD DISCUSSION OF THE OUTLOOK, MARCH 2006

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, 2006.*

Executive Directors welcomed the continued strong expansion of the global economy, which has exceeded expectations at the time of their last discussion of the *World Economic Outlook* in August 2005. Despite higher oil prices and a number of natural disasters, economic activity in the second half of last year and early 2006 was strong, and inflationary pressures remain subdued. The economic expansion has also become more broadly based. While the United States is still the main engine of growth among industrial countries, it is increasingly supported by the ongoing expansion in Japan and signs of a sustained recovery in the euro area. Among emerging markets and developing countries, growth remains strong, with particularly buoyant activity in China, India, and Russia. Directors emphasized that, despite these broadly favorable developments, key vulnerabilities—most notably global current account imbalances—have still not been addressed, raising the risks to the world economy.

Looking ahead, Directors expected that global economic conditions would remain favorable, with a gradual pickup in investment helping to weather the continued headwinds from high oil prices. At the same time, Directors identified a number of uncertainties facing the world economy, and felt that the balance of risks remains slanted to the downside. On the upside, Directors acknowledged that, if growth in some emerging market countries continues to exceed expectations, or the corporate sector in the advanced economies runs down its financial surpluses more rapidly than expected—either through higher investment or increased wages and dividends—the growth outlook could be more positive. On the downside, with the oil market remaining vulnerable to shocks given limited excess production capacity, and with prices increasingly driven by supply side concerns, many Directors felt that the adverse impact of high oil prices on global growth could well be greater going forward than it has been in the recent past. Other risks identified by Directors are an abrupt tightening in financial market conditions and a possible avian flu pandemic.

Of most concern to Directors, however, was the further widening of global imbalances. The U.S. current account deficit has widened further to record levels, which is being matched by large surpluses in oil exporters, a number of small industrialized countries, Japan, China, and a number of other emerging Asian countries. While noting that financing of the U.S. deficit has not been a problem so far, Directors were of the view that these imbalances pose increasing risks over time to the global growth outlook. Directors generally believed that the probability of a disorderly unwinding of imbalances remains low. However, such an outcome, should it occur, could have sizable negative effects for the global economy and the international financial system. Directors considered that this assessment calls for actions aimed at reducing these vulnerabilities, whose implementation should be facilitated by the current favorable environment. Directors believed that a progressive narrowing of imbalances will need to be based on both a significant rebalancing of demand across countries, and adjustments in exchange rates.

Directors emphasized that, while the private sector will play a key role in the resolution of global imbalances, a purely market-driven adjustment carries significant risks. This underscores the importance of more rapid implementation of the agreed policy strategy to address imbalances, including raising national saving in the United States—with measures to reduce the budget deficit and spur private saving; allowing currencies in surplus countries—including in parts of Asia and a number of oil producers—to appreciate; and implementing structural and other reforms to boost domestic demand in countries with large current account surpluses. In this context, the importance of achieving a better balance between externally and domestically led growth and undertaking reforms of domestic financial systems to help boost domestic demand was also noted. Given economic interlinkages, all countries and regions will play a role in the adjustment of imbalances, and countries should therefore increase the flexibility of their domestic economies to adapt better to changing global patterns of domestic and external demand.

Elaborating on the required policy actions in surplus countries, Directors welcomed the staff analysis on the relationship between oil prices and global imbalances. They urged oil exporters to take advantage of the current conjuncture to undertake structural reforms and boost expenditures to support long-term growth, which would also have beneficial effects for reducing global imbalances. Some Directors pointed out that the scope for such spending increases in oil-exporting countries would vary, depending on country-specific circumstances. With regard to exchange rate adjustment as well, a number of Directors observed that the need for, and size of, any exchange rate appreciation would have to be assessed on a case-by-case basis, taking into account the economic fundamentals in individual countries. Some Directors noted that structural measures aimed at improving market flexibility and enhancing economic productivity should complement exchange rate adjustment in these countries in bringing about an effective correction of global imbalances.

Directors considered that the Fund continues to have a central role to play in promoting a coordinated, multilateral, medium-term solution for reducing global imbalances. With the broad strategy espoused by the Fund generally agreed, the challenge now is to work out the precise modalities and accelerate implementation. Directors also underscored the importance of the Fund's advice in urging countries to resist protectionist pressures and in helping them to exploit comparative advantages through deeper integration.

Directors reiterated their concerns regarding two other long-standing policy challenges facing the global economy.

- *First, unsustainable medium-term fiscal positions remain a key risk.* Among the major industrial countries, underlying fiscal positions—outside Japan—have improved only modestly since 2003, and Directors noted that in many countries little further improvement is projected over the next two years. They underscored the importance of more ambitious fiscal consolidation in order to limit upward pressure on interest rates, reduce risks to macroeconomic stability, and improve the scope for a fiscal response to future shocks.
- *Second, more ambitious efforts are needed to put in place the preconditions for taking advantage of the opportunities from globalization and for supporting growth.* In this context, Directors reiterated the need to resist protectionist pressures that have been rising in a number of countries, while ensuring an ambitious outcome to the Doha Round. Directors regretted the limited flexibility in country positions displayed so far under the trade negotiations and warned of the risks to the global economy and the multilateral trading system from a disappointing outcome of the Doha Round. Directors agreed that, at the national level, advancing the structural reform agenda remains key to removing the impediments to long-run growth.

Another critical question is whether inflation will remain moderate in the face of rapid global growth. In this context, Directors welcomed the staff analysis of the relationship between globalization and inflation, which they noted makes a valuable contribution to the quantification of the effects of globalization. While emphasizing that the impact of globalization on inflation will be temporary unless it changes the objectives of monetary policy, they observed that import price declines have had sizable effects on inflation in industrial countries over one- to two-year periods, particularly when there has been considerable global spare capacity. Directors also noted that globalization has had a significant impact on relative prices, with important implications for some sectors of the economy. Directors agreed, however, that globalization cannot be relied upon to prevent a pickup in inflation and that central banks must remain vigilant for signs of inflationary pressures. Some Directors pointed to the recent rise in producer prices and in non-oil commodity prices, which could feed into higher consumer prices.

Conditions in global financial markets remain very favorable, characterized by unusually low risk premia and volatility. Directors noted that high corporate saving is one factor that has contributed to the low global interest rate environment during the current expansion, and they welcomed the staff's analysis of corporate saving behavior in the G-7 countries. Most Directors agreed with the staff's assessment that corporate excess saving will decline from current high levels over the next few years as investment increases, and that this will likely put upward pressure on long-term interest rates going forward.

Industrial Countries

Directors welcomed the continued strong expansion in the *United States* despite the temporary slowdown in the fourth quarter of 2005. They viewed risks as being broadly balanced in the short term, but slanted to the downside further out. With corporate profits expanding robustly, business investment and employment could be stronger than expected. On the downside, however, the large current account deficit makes the United States vulnerable to a swing in investor sentiment, while a sharp weakening of the housing market and higher energy prices could slow consumption. With core inflation well contained, financial markets expect that the current tightening cycle in the United States is nearly complete, although Directors emphasized the need for vigilance for signs of inflationary pressures as spare capacity diminishes. While welcoming the marked improvement in the federal budget deficit in FY2005, most Directors believed that a much more ambitious fiscal adjustment is needed in FY2006 and beyond, with the aim of achieving broad budget balance (excluding Social Security) by 2010, based on further spending discipline and consideration of revenue enhancements. In this context, a few Directors noted that a rapid decline in the U.S. fiscal deficit could slow U.S. and global growth in the absence of increased domestic demand elsewhere.

Directors were encouraged by the signs of a stronger recovery in the *euro area,* while cautioning that it remains unduly vulnerable to external factors, particularly oil prices and world demand. Against the background of limited underlying inflationary pressures and still fragile domestic demand, most Directors observed that monetary policy needs to remain appropriately supportive of the recovery, with some Directors suggesting that further increases in interest rates should await clear signs of a self sustaining recovery in domestic demand. Directors noted with concern the lack of progress in reducing area-wide budget deficits, and shared the view that most countries should aim for a broadly balanced fiscal position by the end of the decade. With rising fiscal pressures from an aging population, Directors attached particular importance to the need to reform Europe's social systems in line with the objectives of the Lisbon Agenda, and a few expressed concern about the rising resistance to reforms in some countries. Directors noted that examples of successful social policies within Europe could be a useful guide in reforming social models in other countries, but cautioned that reforms will have to take into account important country specific differences. More generally, Directors reiterated the importance of continued structural reforms for enhancing the region's low potential growth rate.

Directors welcomed the increasingly well established economic recovery in *Japan*. They noted that the expansion is being driven by domestic demand, and underpinned by rising employment, buoyant corporate profits, and a turnaround in bank credit growth. Directors expected the positive growth momentum to continue, with potential risks to the upside from stronger-than-anticipated private consumption in response to rising employment and labor income. Directors welcomed that core CPI inflation has turned slightly positive, and that the Bank of Japan has been able to move away from its quantitative easing framework, but they emphasized that interest rates should be kept at zero until deflation is decisively beaten. Directors acknowledged the reduction in the general government budget deficit, but called for more rapid progress in improving the fiscal position going forward, in order to stabilize public debt and accommodate the budgetary pressures from an aging population. Directors underscored the need to complete the remaining agenda of structural reforms to boost productivity, particularly in the nontraded sector, and to complete financial and corporate restructuring.

Emerging Market and Developing Countries

Directors welcomed the continued rapid growth in *emerging Asia*. With global economic conditions—now supported by the ongoing recovery in domestic demand in Japan—expected to remain favorable, Directors expected the expansion to maintain momentum in 2006, once again led by China and India. Directors emphasized the need for more balanced growth in the region, and encouraged policymakers to strengthen the pace of structural reforms, emphasizing the key objectives of increasing household consumption in China and domestic investment in much of the rest of the region. Most Directors also considered that exchange rates would need to be allowed to appreciate in the surplus countries in the region.

Directors expected the robust economic expansion in *Latin America* to continue in 2006, with external demand continuing to remain an important driver of growth. While welcoming the disciplined fiscal policies in much of the region, many Directors called for further progress in debt reduction in a number of these countries. Directors accordingly called on policymakers in these countries to focus on further reducing these vulnerabilities through continued tight fiscal policies—which could be challenging in some countries given the electoral schedule—and structural reforms that raise the long-term growth potential, including steps to improve the business climate in order to attract greater investment.

In *emerging Europe*, growth is expected to remain firm, although Directors cautioned that the expansion will depend on the strength of the recovery of demand in the euro area. Directors saw downside risks to the outlook arising mainly from the region's large current account deficits, and the rapid expansion of credit growth in a number of countries. Directors urged increased fiscal consolidation in central Europe to reduce external deficits, while in the Baltics and southern Europe, several Directors saw a role for policies to reduce the rapid pace of credit expansion.

In the *Commonwealth of Independent States*, real GDP growth slowed noticeably, reflecting primarily the sharp slowdown in Ukraine, but also more moderate growth elsewhere. Looking forward, Directors emphasized that monetary policy will need to play a more active role in containing inflation, including through allowing greater nominal exchange rate appreciation where necessary. While countries benefiting from higher oil revenues have scope to raise productive spending, Directors cautioned that such spending should be consistent with broader macroeconomic objectives and cyclical considerations. They stressed the need for structural reforms to strengthen the role of the private sector and deepen market institutions.

Directors welcomed the robust economic expansion in *sub-Saharan Africa,* and expected that growth in the region would strengthen in 2006 to its strongest pace in three decades, underpinned by high commodity prices, improved macroeconomic policies, and structural reforms. They stressed that maintaining high long-term growth rates will be crucial to reducing the incidence of poverty in the region and making progress toward the Millennium Development Goals. In this regard, Directors underscored the importance of continued reforms to improve the institutional environment, along with structural reforms designed to encourage greater private investment and make economies less dependent on global commodity cycles. Directors also called on the international community to support Africa's reform efforts, including by following through on commitments for greater resource flows and improved market access.

In the *Middle East*, led by substantially higher export earnings among oil-exporting countries, growth remains robust. Despite a strengthening in domestic demand, inflation has remained subdued as countries have saved a larger proportion of the increase in oil revenues compared with previous oil cycles. Some Directors expressed concern about the rise in property and stock market prices in the region, underscoring the need for careful monitoring of potential risks from any abrupt market corrections. Directors emphasized that with a significant proportion of higher oil revenues expected to be permanent, increased consideration should be given to carefully planned expenditures to raise potential growth in both the oil and non-oil economy and provide increased employment opportunities for the growing working-age population.