

# EXECUTIVE SUMMARY

## Global Economic Environment

- The global expansion remained buoyant in the first half of 2006, with activity in most regions meeting or exceeding expectations (Chapter 1). Growth was particularly strong in the United States in the first quarter of 2006, although it has slowed subsequently. The expansion gathered momentum in the euro area, and continued in Japan. Emerging markets have grown rapidly, especially China, and low-income countries have also maintained an impressive growth performance, helped by strong commodity prices.
- At the same time, there are signs that inflationary pressures are edging up in some countries as sustained high rates of growth have absorbed spare capacity. Headline inflation in a number of advanced economies has for some time been above central bank comfort zones, pushed up by rising oil prices, but there are now signs of increases in core inflation and inflation expectations, most notably in the United States. In Japan, there is increasing evidence that deflation has finally ended.
- Oil and metals prices have hit new highs. Prices have been supported by tight spare capacity in global markets against the background of buoyant GDP growth, and in the case of oil, rising geopolitical tensions in the Middle East and risks to production in some other large producers (notably Nigeria). Futures markets suggest that oil prices will remain elevated for the foreseeable future.
- Major central banks have responded by tightening monetary policy. The U.S. Federal Reserve continued to raise interest rates through June, although pausing in August; the European Central Bank has raised interest rates further in recent months; and the Bank of Japan ended its zero interest rate policy in July. The U.S. dollar has weakened against the euro, and to a lesser extent the yen, while long-term interest rates have firmed.
- Rising inflation concerns and tighter monetary conditions led to some weakness in advanced-economy equity markets and a series of larger moves in some emerging market asset prices in May–June, although markets have been more stable since July. These moves appear to largely represent corrections after major price run-ups, rather than a fundamental reassessment of economic risks, and seem unlikely to have a major growth impact, although growth in some individual countries may be dampened as their central banks have raised interest rates to calm financial market conditions and head off inflationary pressures.
- Global imbalances remain large. Despite an acceleration in export growth, the U.S. current account deficit is expected to near 7 percent of GDP in 2007. Surpluses in oil exporters and a number of Asian countries are expected to stay high, with China's surplus remaining in excess of 7 percent of GDP.

## Outlook and Risks

- The forecast for global growth has been marked up to 5.1 percent in 2006 and 4.9 percent in 2007, both  $\frac{1}{4}$  of a percentage point higher than in the April 2006 *World Economic Outlook*.
- Growth in the United States is expected to slow from 3.4 percent in 2006 to 2.9 percent in 2007, amid a cooling housing market. Growth in Japan will also ease as the cycle matures. In the euro area, the recovery is projected to sustain its momentum this year, although growth in Germany will be reduced in 2007 by the planned tax increase. Among emerging markets and developing countries,

growth is expected to remain very strong, with the Chinese economy continuing its recent rapid expansion.

- The balance of risks to the global outlook is slanted to the downside, with IMF staff estimates suggesting a one in six chance that growth could fall to 3¼ percent or less in 2007. The most notable risks are that inflationary pressures could intensify, requiring monetary policy to be tightened more than currently expected; that oil prices could increase further against the background of limited spare capacity and geopolitical uncertainties; and that the U.S. housing market could cool more rapidly than expected, triggering a more abrupt slowdown of the U.S. economy.
- The potential for a disorderly unwinding of global imbalances remains a concern. A smooth, market-led unwinding of these imbalances is the most likely outcome, although investors would need to continue increasing the share of U.S. assets in their portfolios for many years to allow this to happen. The depth and sophistication of U.S. financial markets has facilitated the financing of recent large current account deficits. However, there remains some risk of a disorderly adjustment, which could impose heavy costs on the global economy.

## Policy Challenges

### Advanced Economies

- Central banks in advanced economies will need to carefully weigh the relative risks to growth and inflation in the period ahead. The U.S. Federal Reserve faces a difficult situation of rising inflation in a slowing economy, but given the importance of keeping inflation expectations in check, some further policy tightening may still be needed (Chapter 2). In Japan, interest rate increases should be gradual, as there is little danger of an inflationary surge, while the reemergence of deflation would be costly. In the euro area, further increases in interest rates are likely to be needed if the expansion develops as expected, but for now inflation pressures seem broadly contained, and faced with continuing downside risks to growth, policymakers can afford to be cautious in tightening monetary policy further.
- In most of the large advanced economies, fiscal consolidation in the face of aging populations remains a huge challenge. Fiscal consolidation is envisaged in many countries in the coming years, but it is neither ambitious enough nor backed up by clearly identified policy measures. Social security systems need to be put on sounder footings, and effective ways found to contain the inexorable rise in health care costs.
- Structural reforms to improve the business environment and global competitiveness remain essential to bolster growth prospects. In the euro area, faster progress to advance the Lisbon agenda—particularly more open competition in services, more flexible labor markets, and financial sector reforms—remain key to boost productivity growth and improve job opportunities. In Japan, priorities include public sector reforms, steps to enhance labor market flexibility and financial sector efficiency, and reforms to improve productivity in the services sector.
- Chapter 4 examines how differences in financial systems can affect economic cycles in advanced economies. A new index is constructed that characterizes financial systems according to the degree to which transactions are based on long-term relationships between borrowers and lenders or are conducted at “arm’s length.” The chapter finds that while there has been a general trend toward bank disintermediation and a greater role for financial markets, the pace has differed across countries, and there are still important differences in financial systems. The chapter offers some evidence that such differences in financial systems may affect cyclical behavior. Specifically, in more arm’s length systems, households may be able to better smooth consumption in response to changes in income, but their

spending may be more sensitive to changes in asset prices. Corporate investment appears to react more smoothly to cyclical downturns in relationship-based systems, but arm's length systems seem better at reallocating resources in response to structural changes.

- The move toward more arm's length financial systems that has been under way in most countries over the past decade is set to continue, given technological innovations and the removal of regulatory barriers. Policymakers will need to maximize the benefits from this ongoing change, including by implementing complementary reforms to increase labor market flexibility, improve the portability of employee pension plans, and strengthen bankruptcy procedures. Supervisory and regulatory policies will need to keep up with the increasing sophistication of the financial sector, while macroeconomic policy management will need to adapt to reflect possible changes in cyclical behavior.

### Emerging Market and Developing Economies

- In emerging market and developing economies, policymakers must adjust to the more challenging global environment by continuing to reduce vulnerabilities and by putting in place reforms that will help sustain the current growth momentum. Recent developments have provided a reminder that emerging market economies remain susceptible to turbulence in global financial markets. Countries at risk include those with still weak public sector balance sheets, large current account deficits, and less well-anchored inflation expectations. In a number of countries in emerging Europe, the increasing reliance on private debt flows to finance large current account deficits is a concern. More also needs to be done in emerging market and developing economies to advance market-oriented reforms, particularly by reducing barriers to competition, to create the climate for vigorous private sector-led growth.

- Chapter 3 analyzes Asia's remarkable growth performance, and focuses on what needs to be done to sustain strong growth in the future. The chapter finds that the favorable policy environment in Asia has been the key to strong total factor productivity growth and rapid accumulation of physical and human capital in the region. Indeed, the importance of establishing a favorable policy environment is the key lesson that late developing countries—both within Asia and in other parts of the world—can learn from the successful early developers such as Japan and the newly industrialized economies (NIEs). Trade liberalization, improved access to education, and steps to promote financial development and encourage entrepreneurship would facilitate the ongoing shift of resources out of agriculture and into industry and services. Efforts to boost productivity growth in industry, and particularly the relatively more sheltered services sector, will also pay important dividends. Policies to encourage increased competition in services include removing barriers to entry, encouraging foreign investment, and streamlining regulations.
- Chapter 5 examines the outlook for prices of nonfuel commodities. These prices—particularly for metals—have risen sharply in recent years, defraying the losses from higher oil import bills for exporters of these commodities. The chapter finds that price increases have largely been driven by strong demand, particularly from China, as well as supply bottlenecks. In addition, the chapter finds that speculative activity does not seem to have been a significant driver leading commodity price movements, although speculators may have played a role in providing liquidity to markets. Metals prices are expected to come down over the medium term as new production comes on stream to meet rising demand. The key policy message for countries that export commodities—particularly metals—is that they should not assume that high prices will be sustained.

Current revenue windfalls should be saved or invested to support future growth in noncommodity sectors, rather than used to increase spending in areas that will be difficult to reverse later.

### Multilateral Initiatives

- Joint policy efforts would help to ensure a smooth reduction of global imbalances. An orderly private sector–led adjustment, involving a rebalancing of demand across countries, with accompanying further depreciation of the U.S. dollar and exchange rate appreciations in many surplus countries (notably in parts of Asia and oil producers), remains the most likely outcome. However, there remains a risk of a more disorderly unwinding that would imply a heavy cost for the global economy. The risks of such a disorderly adjustment would be considerably reduced by sustained policy actions across the major players in the world economy involving steps to boost national saving in the United States, including through fiscal consolidation; greater progress on structural reforms in Europe and Japan; reforms to boost domestic demand in emerging Asia (consumption in China, investment elsewhere) together with greater exchange rate flexibility; and increased spending in oil-producing countries in high-return areas, consistent with absorptive capacity constraints, especially in the Middle East, where the large buildup of investment projects already in train is welcome. Taking a joint, multilateral approach may help to advance implementation by providing assurance that possible risks associated with individual actions would be alleviated by simultaneous policy initiatives elsewhere. The present multilateral consultation by the IMF can contribute to this process.
- Efforts are needed to reinvigorate the process of multilateral trade liberalization. The apparent deadlock in the Doha Round is deeply disappointing. Trade liberalization on a nondiscriminatory (most favored nation, or MFN) basis remains the best way to open up new global growth opportunities. The threat of protectionist pressures needs to be firmly resisted.
- High and volatile prices in world energy markets remain a major concern that will require sustained efforts from all sides to address. Increased investment is needed to build up adequate production and refining capacity, while appropriate incentives for consumers would encourage improved energy conservation.