ANNEX

IMF EXECUTIVE BOARD DISCUSSION OF THE OUTLOOK, SEPTEMBER 2007

The following remarks by the Acting Chair were made at the conclusion of the Executive Board's discussion of the World Economic Outlook *on September 24, 2007.*

Global Prospects and Policies

Executive Directors welcomed the continued strong growth of the global economy in the first half of 2007, while emphasizing that downside risks to the near-term outlook have increased in the face of the ongoing financial market disturbances. They expected global growth in the period ahead to be slower than previously forecast in the July update, although the severity of the slowdown is difficult to predict given the uncertainties regarding the magnitude and duration of the financial stress. Directors were generally of the view that the global economy's strong fundamentals and the continued robust growth of emerging market and other developing economies will cushion the impact of the disturbances. In light of this, many Directors agreed that while the situation was still evolving, at this point the degree of the slowdown seemed likely to be relatively modest and agreed with the staff's baseline forecast. However, a number of Directors cautioned that the slowdown in growth could be more severe.

Directors acknowledged that at the current juncture, the global outlook remains exceptionally uncertain. A number of Directors saw heightened risks of prolonged financial market instability and a broad credit retrenchment, with the possibility of further financial contagion and declining confidence that could weaken the global growth environment. In particular, further downward pressure on house prices in the United States may cause steeper declines in residential investment and consumption growth, with consequently more severe spillovers to the rest of the world. In addition, the risks faced by some countries may be compounded by the rapid appreciation of their currencies. Some emerging market countries with large current account deficits could be particularly at risk from more restricted availability of external financing. Some Directors also stressed that the possibility of a disorderly unwinding of global imbalances remains an important concern. Others saw little risk of a disorderly unwinding.

Against this backdrop, Directors underscored the importance of sound policies and continued vigilance. They saw the task of restoring orderly conditions in financial markets as the immediate policy priority, and generally endorsed the actions by central banks in the major advanced economies to address the continuing squeeze in liquidity. At the same time, they emphasized that it is important to avoid perceptions that central banks will automatically respond to financial distress by taking action to curtail losses, which could raise moral hazard and reduce credit discipline. A number of Directors viewed the repricing of risks and tightening of credit standards as a return toward greater market discipline after a prolonged period of excessive risk-taking in certain market segments. Directors believed that an important lesson to be learned from the financial market turbulence is the need to ensure effective financial regulation, which will call for greater transparency and improved awareness of financial risks.

Directors noted that a slower pace of growth is likely to moderate pressures on capacity and resources, which will help reduce inflationary pressure. At the same time, tight commodities markets and rising food prices will remain important sources of price pressures, especially if growth continues to be strong in emerging markets. Directors agreed that in setting the monetary stance, central banks should focus on achieving price stability in the medium term, and continue to carefully assess the inflation outlook in light of the envisaged downside risks to growth.

Looking toward the medium term, Directors underlined the importance of actions to strengthen the foundations for sustained high growth. Many countries will need to pursue ambitious medium-term fiscal consolidation plans to address rising pressures on health and social security spending. They will also need to advance key reforms—including further liberalizing financial and service sectors in advanced countries and improving infrastructure and the business environment in emerging and developing countries—in order to take full advantage of the opportunities provided by globalization and technological advances.

Directors welcomed the analysis of the role that better monetary and fiscal policies, stronger institutions, and financial development have played over the past two decades in reducing the volatility of economic growth. Some Directors noted that fewer exogenous shocks and the rise of the emerging market economies may have contributed to lower volatility. Directors emphasized, however, that the lower volatility of growth does not mean that future stability should be taken for granted. Policymakers will need to stand ready to adapt to changing circumstances, particularly in light of the increased risk of spillover effects associated with the more synchronized business cycles across countries.

Advanced Economies

Most Directors agreed that the risks to the short-term outlook in the United States are firmly on the downside, given the financial market turmoil, weak housing market, softening labor market, and declining productivity growth. They emphasized that the current financial market turmoil could broaden, and a more protracted housing downturn could put pressure on household finances and consumption. They accordingly considered the downward revision in the growth forecast for 2008 to be reasonable. With inflation pressures declining and inflation expectations remaining well anchored, Directors saw room for monetary policy to help cushion the downside risks to the outlook. Directors were encouraged by the recent fiscal overperformance, while stressing that a more ambitious medium-term program of fiscal consolidation will be needed to guarantee long-term fiscal sustainability.

Directors welcomed the relatively strong performance of the euro area economy, but cautioned that the balance of risks to near-term growth has shifted to the downside because of slowing growth in the United States and the financial market turmoil. They noted that the European Central Bank continues to monitor developments closely to ensure inflation objectives are met. Directors welcomed the progress made toward fiscal consolidation, but felt that more ambitious efforts will be necessary given the strength of the cyclical upswing and the looming pressures from population aging. Directors also noted that the euro area's long-term prospects will hinge on its success in accelerating productivity and employment growth, and improving structural flexibility. Enhancing the contestability of services markets will help boost productivity in these sectors, while steps to strengthen incentives to work and improve wage flexibility will be key elements in labor and product market reforms.

Directors noted that after two quarters of very strong growth, the Japanese economy contracted in the second quarter of 2007, driven by a drop in investment and weaker consumption growth. The outlook remains mixed, as growth could be dampened by the recent financial market turmoil and yen appreciation. Directors supported the Bank of Japan's accommodative monetary stance, and suggested that monetary tightening should await clear signs that inflation is moving decisively higher and that risks from recent financial market volatility are waning. Directors were encouraged by the considerable progress made in reducing the fiscal deficit in recent years, but urged a more ambitious fiscal agenda to lower the public debt ratio and meet the challenge of population aging.

Emerging Market and Other Developing Countries

Directors believed that large foreign exchange inflows in emerging market and other developing countries could continue to complicate macroeconomic management in the coming years. They stressed that the nature of the inflows—including their composition and terms—and country circumstances will determine the appropriate policy response to large capital inflows in individual cases. Many Directors agreed that fiscal restraint and increasing exchange rate flexibility, complemented by capital account liberalization, can be helpful in attenuating the impact of these inflows. A number of Directors, however, noted that fiscal adjustment may not always be feasible or effective, and that sustained exchange rate appreciation could cause difficulties. These Directors suggested that temporary capital controls, while not a first-best measure, might be a practical way to deal with capital flows in certain cases, as a useful supplement to macroeconomic policies. A number of Directors considered it important to distinguish between short-term and long-term capital flows, as the policy implications would be different. Directors agreed that fostering financial development and strengthening financial regulation and supervision are also important in the face of capital inflows.

Directors expected growth in emerging market countries in Asia to remain strong, led by China and India. Most Directors viewed the balance of risks as being tilted to the downside, particularly because of the U.S. economic slowdown. Some Directors, however, believed that the risks to growth and inflation in China are on the upside in the absence of additional monetary tightening and more flexible exchange rate management. Against the background of continuing large current account surpluses in many countries in the region, several Directors emphasized that greater exchange rate flexibility and measures to boost domestic demand would help reduce the reliance on export-led growth.

Directors welcomed the favorable economic performance and the reduced external vulnerability in Latin America, which reflect stronger policy frameworks, improved debt management, and development of domestic capital markets. At the same time, they observed that growth remains subject to risks arising from the close trade and financial linkages with the United States and the dependence on commodity exports. They emphasized the importance of reforms to foster investment and productivity growth. Directors noted that in recent years Latin American countries have experienced large foreign exchange flows. They welcomed the greater exchange rate flexibility in many countries that has helped to contain inflation in the face of these inflows.

Directors welcomed the continued rapid economic convergence of emerging Europe, supported by robust productivity growth, but expressed concern about overheating in some countries. They observed that the recent financial market turbulence has heightened concerns about the vulnerability of some countries in the region to reversals of capital flows, especially given the heavy reliance on foreign-currency borrowing and the potential for spillover effects. In this context, Directors underscored the importance of prudent macroeconomic policies, structural reforms to improve economic flexibility, and vigilant bank supervision.

Directors observed that economic activity in the Commonwealth of Independent States continues to expand rapidly, supported by high commodity prices and large capital inflows. Growth prospects appear to be generally positive, although global credit retrenchment has affected the outlook in some countries. Directors welcomed the region's ability to attract large inflows of foreign private capital, but underscored that limited exchange rate flexibility in many countries has resulted in upward price pressures. They saw a need for more flexible exchange rates, and for continued efforts to strengthen institutions, the business climate, and bank regulation and supervision.

Directors were encouraged by the sustained expansion in sub-Saharan Africa, which is being led by high commodity prices, improved policy implementation, reforms to strengthen the business environment, and debt reduction. Growth is expected to accelerate in a number of countries in 2008 as new oil projects come on stream. Sustaining the growth performance and promoting export diversification will require continued macroeconomic stability and a vibrant private sector, supported by further trade liberalization, improved market access for regional exports, and fulfillment of aid commitments by advanced economies.

In the Middle East, high oil prices have supported buoyant growth and strong external and fiscal balances in oil-exporting countries, and are expected to continue to do so in the near term. At the same time, Directors noted that resource utilization and import prices are rising, leading to inflationary pressures in many oil-exporting and oil-importing countries. The challenge for fiscal policy in oil-exporting countries is to strike the right balance between using the oil revenues to pursue long-term development objectives and exercising restraint in the short term to counterbalance strong private demand growth. While welcoming the ongoing build-up of investment in the petroleum sector in a number of oil-exporting countries, Directors underscored the importance of continuing to foster private investment in both the oil and the non-oil sectors of these economies.

Multilateral and Other Issues

Directors welcomed the analysis of the relationship between globalization and inequality, while noting the importance of interpreting the results in the context of individual country circumstances. Most Directors accepted the two main findings of the study: first, that technological change is more important than globalization in explaining rising inequality in many countries; and, second, that contrary to popular belief, trade liberalization appears to reduce inequality while financial globalization appears to increase it. Directors cautioned that the solution to rising inequality would be not to restrict foreign direct investment, but rather to strengthen education to ensure that workers have the appropriate skills in the emerging "knowledge-based" global economy. Labor market reforms will be needed to ensure that jobs are created flexibly in the most dynamic sectors. Also, social safety nets should be enhanced to provide greater protection for those who may be adversely affected by globalization, and policies will be needed to increase the availability of finance to the poor.

Directors emphasized that multilateral action to ensure a smooth unwinding of global imbalances remains a critical task. During the Fund's Multilateral Consultation, the participants indicated their policy plans that are consistent with the strategy endorsed by the IMFC for reducing global imbalances. These comprise steps to boost national saving in the United States, including fiscal consolidation; further progress on growth-enhancing reforms in Europe; further structural reforms, including fiscal consolidation, in Japan; reforms to boost domestic demand in emerging Asia, together with greater exchange rate flexibility in a number of surplus countries; and increased spending consistent with absorptive capacity and macroeconomic stability in oil-producing countries. Full implementation of these policy plans is needed to reduce imbalances while sustaining growth. While Directors acknowledged that there has been some progress toward realignment of major world currencies, they noted the staff's analysis that the U.S. dollar is still overvalued and that the yen, the renminbi, and the currencies of the oil-exporting countries are still undervalued relative to their medium-term fundamentals.

Directors expressed concern about the continued lack of progress with the Doha multilateral trade round, and the risk that this would encourage protectionist measures. They expressed hope that countries would find a way to re-energize the process of multilateral trade liberalization. Directors also agreed that global issues such as climate change and energy security would also require a multilateral approach.