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 September 2, 2005.

Executive Directors welcomed the continued strong expansion of the global economy, which has evolved broadly as was expected at the last discussion of the *World Economic Outlook*. Following the strongest performance seen in three decades in 2004, overall economic growth has moderated to a more sustainable pace during 2005, while inflationary pressures remain subdued. Directors observed that, within this overall favorable picture, growth divergences remain wide—with the United States and China still leading global growth, Japan regaining momentum, and the expansion in the euro area remaining subdued—while global imbalances have increased yet again.

Looking forward—and notwithstanding the impact of higher oil prices and global imbalances—Directors expected global economic conditions to remain favorable, with growth underpinned by still-accommodative macroeconomic policies, benign financial market conditions, and increasingly solid corporate balance sheets. Directors cautioned, nonetheless, that the balance of risks to the outlook is slanted to the downside, with projected global growth still unbalanced and significantly dependent on the United States and China. Other key short-term risks identified by Directors include the possibility that financial market conditions could tighten significantly, contributing to a global weakening of richly valued housing markets, and that rising protectionist sentiments in some countries might lead to a tightening of trade barriers and undermine investor confidence.

Directors acknowledged that the limited impact thus far of oil price increases on the global economy is attributable in part to the falling energy intensity of economic activity as well as to well-anchored inflationary expectations. A number of Directors were nevertheless concerned about the impact of high and volatile oil prices going forward, including on oil-importing developing countries. While sharing the view that the growth impact of recent oil price increases has so far been relatively modest, they thought that a substantial further jump in prices could have more serious adverse effects on the global economy, especially in view of the disruption in the wake of Hurricane Katrina to the already strained refinery capacity in the United States. In this regard, several Directors considered it important to increase investment in refinery capacity. Directors welcomed ongoing staff work to gain a deeper understanding of oil market developments, and encouraged further analysis. The importance of strengthened energy conservation and improved oil market data and transparency was also noted.

Directors considered that the rising global imbalances and their changing distribution remain a central risk to the economic outlook over the medium term. In this context, Directors welcomed the staff's analysis of global saving and investment in Chapter II and of global current account adjustment in Appendix 1.2. They agreed with the assessment that unusually low investment rates for this stage of the economic cycle have resulted in an excess supply of saving at the global level, thereby contributing to low real interest rates and the observed distribution of imbalances across major regions. Directors noted that the continued willingness of foreign investors to hold U.S.

dollar assets has so far enabled the large U.S. current account deficit to be financed without difficulty, but emphasized that this situation will not continue indefinitely. They therefore reiterated their call for determined policy efforts to address global imbalances, and to sustain global growth during the adjustment process. In this context, a few Directors also called for improved data on the currency composition of international reserves.

Directors welcomed the progress in implementing the cooperative policy strategy to address global imbalances agreed at the October 2004 IMFC meeting. They noted in particular the improved fiscal position in the United States, the important steps toward greater exchange rate flexibility in China and Malaysia, and the signs of stronger domestic demand in Japan. Nevertheless, they emphasized that considerable further efforts will be required, including more ambitious fiscal adjustment in the United States, the active use of the scope for greater exchange rate flexibility—combined with financial sector reform—in Asia, and further structural reforms in Japan and the euro area. Pointing to the rapidly rising current account surpluses of oil-exporting countries, Directors emphasized that these countries will also need to play their part, such as taking advantage of higher revenues to boost expenditures in areas where social returns are high or allowing some real exchange rate appreciation over the medium term. In addition, Directors suggested that measures to promote a more investor-friendly environment in a number of emerging market economies, including some in Asia, would contribute to reducing imbalances, in view of the current low levels of investment. While recognizing that each of these individual policy actions would help, Directors broadly agreed with the main staff conclusion that the risks of a disruptive adjustment are minimized—and the benefits of adjustment magnified—when actions in support of the cooperative policy strategy are taken together, especially given the growing size of the global imbalances and the larger number of countries involved.

Directors had an interesting exchange of views on the relative importance, timing, and sequencing of the different actions within the agreed strategy of multilateral cooperation. Most Directors believed that fiscal consolidation in the United States remains key to the adjustment, since in their view the steep decline in U.S. national savings is a central cause of the current imbalances. Exchange rate flexibility, particularly in Asia, will be required to facilitate the necessary accompanying changes in exchange rates. Most Directors saw structural reforms for boosting potential growth in Japan and Europe as being an integral part of the strategy, given their potential role in fostering more balanced global growth and in cushioning any negative impact on global growth of a significant fiscal adjustment in the United States—even if their direct impact on imbalances may be smaller, albeit in the right direction.

Directors reiterated their concerns about long-standing vulnerabilities facing the global economy and stressed the need to implement policies to boost long-run growth. They urged policymakers to use the ongoing expansion to address these challenges.

- *First, unsustainable medium-term fiscal positions remain a key risk.* Among the major industrial countries, fiscal deficits are generally expected to decline only modestly over the medium term, and Directors viewed rising public debt in some industrial countries with concern. Encouragingly, emerging market countries have improved fiscal positions, although several Directors thought that public debt still remains too high.
- *Second, more ambitious efforts are required to address constraints to long-run growth.* Directors noted that, despite some welcome progress, most countries and regions face significant structural impediments to stronger growth. Broad-based reforms will therefore be needed, including product and labor market reforms in the euro area; financial and corporate reforms in Japan and much of emerging Asia; strengthened banking supervision in central and eastern Europe; and further improve-

ments in the investment climate in many emerging market economies.

- *Third, successful completion of the Doha Round will be crucial.* Directors agreed that it will be imperative to reach agreement on ambitious trade liberalization at the upcoming WTO Ministerial meeting in Hong Kong SAR in December, including on modalities for eliminating export subsidies and for tariff cuts on agricultural products.
- *Fourth, actions to persevere with efforts to reduce poverty will be key for low-income countries.* Directors welcomed the improvement in growth prospects in many of the world's poorest countries over the last few years. They emphasized that these developing countries must press ahead with the policy reforms needed for sustainable growth and poverty reduction, while the international community must follow through expeditiously on its commitment to provide additional resources and market access.
- *Fifth, there is a role for building sound institutions.* Directors welcomed the staff's analysis of institutions in strengthening developing country prospects. Over the past 30 years, many emerging market and developing countries have made progress in improving their institutions, and this has generally been followed by stronger growth and higher investment. Directors concurred that there is no single road to success, and that institution-building policies should be geared to country-specific circumstances. They took note of the staff's conclusions regarding the variety of conditions under which good institutions appear to flourish. In particular, good institutions are found to be most likely to develop in an environment of openness to the outside world. Several Directors saw a role for Fund technical assistance in institution building in the core areas of the Fund's expertise.

Industrial Countries

Directors welcomed the continued strong expansion of the *U.S.* economy. With household saving at record lows, a sharp slowdown in private consumption growth remains a risk, especially if the housing market weakens. With core inflation well restrained, Directors agreed that further measured withdrawal of monetary stimulus is likely to be appropriate, but emphasized that careful monitoring will be needed of the evolution of unit labor costs that have risen steadily, as well as of possible second-round effects from higher oil prices. The potential risk implicit in households' exposure to the housing market will also merit attention. Directors were encouraged by the improvement in the unified budget deficit, while noting that much of this reflects an exceptional rebound in revenues that is unlikely to continue. Many Directors considered that the relatively favorable outlook and medium-term pressures arising from demographic change call for a more ambitious fiscal adjustment path than currently envisaged. They underscored that this will require consideration of measures to raise revenues—given the already stringent spending discipline assumed in the U.S. Administration's budget proposals—and suggested in this context that consideration should be given to broadening the income tax base, or to taxing consumption more directly through a national consumption tax or an energy tax.

Directors expected the expansion in the *euro area* to regain momentum gradually in the second half of 2005—while noting the risks of a more extended period of weakness, given continuing uncertainty about future structural reforms and oil prices. Against this background, while most Directors viewed the current monetary stance as appropriate, a number thought that an interest rate cut will need to be considered if inflationary pressures remain restrained and the expected pickup in growth fails to materialize. Directors shared the view that, with fiscal pressures from an aging population set to accelerate, most countries should aim for a broadly balanced fiscal position by the end of the decade—requiring an average improvement in structural balances of about ½ percentage point of GDP annually—accompanied by further progress in pension and health reforms. Directors attached particular importance to the need to enhance structural reforms in labor and product markets for improving the growth potential, and highlighted the importance of leadership and determination on the part of national authorities for their effective implementation.

Directors welcomed the rebound in the *Japanese* economy in the first half of 2005. They noted that the expansion is being driven by solid private consumption growth and buoyant business investment. Directors expected the positive growth momentum to continue, although they saw some downside risks—notably, high and volatile oil prices, and the possibility of renewed upward pressures on the yen in an environment of large global current account imbalances. Directors welcomed the considerable progress made in addressing weaknesses in the bank and corporate sectors, which has put the economy in a better position to sustain an expansion. This reform momentum will need to be maintained. Regarding monetary policy, Directors emphasized that the Bank of Japan should maintain its accommodative monetary policy stance until deflation is decisively overcome. Directors agreed that sustained fiscal consolidation will be needed to reverse the ongoing rise in public debt and to accommodate the budgetary pressures arising from population aging.

Emerging Market and Developing Countries

Directors welcomed the continued rapid growth in *emerging Asia*, while noting the marked increase in intraregional divergences. Growth in China and India remains strong. The expansion in much of the rest of the region has slowed, reflecting the impact of higher oil prices and of a correction in the information technology sector. Directors expected the expansion in the region to strengthen during the remainder of 2005. However, downside risks include further increases in oil prices and weak domestic demand. Looking forward, Directors shared the view that the region has an important stake in fostering an orderly reduction of global imbalances and in promoting open markets. They agreed that the key remaining challenge facing the region is to achieve an appropriate balance between growth in domestic and external demand. In this context, they welcomed the recent exchange rate reforms in China and Malaysia, and urged the authorities to make full use of the increased flexibility. These actions will facilitate domestic macroeconomic management, as well as contribute to the unwinding of global imbalances. Further financial sector reforms and prudent supervision of the banking sector also remain important.

In *Latin America*, Directors expected the expansion to continue at a solid pace, with growth—underpinned by both external and domestic demand—remaining above the average of the last decade through 2005–06. Directors saw some downside risks to the near-term outlook, including from a larger-than-expected increase in interest rates in industrial countries and from political uncertainties in the region. They underscored that managing these risks will call for continued sound policy implementation and cautious debt management. Despite these risks, the current expansion appears to be more resilient than earlier ones, reflecting a combination of improved monetary, fiscal, and external debt management policies, and strong global growth and commodity prices. Directors underscored that it will be important to build on these foundations, and to use the present benign environment in global financial markets for undertaking reforms to address long-standing impediments to faster growth while further strengthening the fiscal and debt positions.

In *emerging Europe,* growth remains firm, although Directors observed that weak confidence in the euro area and rising oil prices pose downside risks. Some Directors were concerned about possible overheating in some countries, given the combination of exceptionally strong credit growth, surging property prices, and large external current account deficits. Directors urged policymakers to adopt measures to reduce the pace of credit growth and the associated risks. In addition, fiscal consolidation will be needed to manage demand pressures and help reduce the large current account deficits—thereby paving the way for the adoption of the euro.

In the *Commonwealth of Independent States*, real GDP growth slowed noticeably in early 2005, primarily reflecting sluggish investment and lower oil sector growth, while inflation picked up after a long period of sustained disinflation. Directors emphasized that a combination of tighter monetary policy and exchange rate appreciation will be needed to keep inflation in check. Depending on each country's absorptive capacity and progress with structural reforms, monetary tightening will provide room for using revenues from oil and commodity exports to increase high-priority expenditures and implement tax reforms. Directors called for greater resolve in advancing reforms to develop fully the institutions and structures to support property rights and competition, with rule-based government interventions guided by transparent objectives.

Directors welcomed the robust economic performance in *sub-Saharan Africa,* which has been underpinned by the strength of global demand, improved domestic macroeconomic policies, progress with structural reforms, and a reduced number of armed conflicts. They emphasized, however, that most African countries still face enormous challenges in achieving the strong growth rates that are needed to reduce poverty substantially and meet the Millennium Development Goals. Directors underscored that further reforms will be necessary to strengthen the investment environment, including building the institutions that will be critical for underpinning a vibrant private sector–based economy. Directors also called on the global community to support Africa's reform efforts. The renewed commitment of the international community to provide additional resources to Africa, reflected in the G-8 agreement at Gleneagles in July, was particularly welcomed by Directors.

The *Middle East* region continues to enjoy favorable prospects, with buoyant oil export revenue. Despite strong domestic demand, inflation has generally remained subdued. Directors emphasized that, with a significant proportion of higher oil revenue expected to be permanent, managing this revenue will be a central policy challenge. The revenue will provide the opportunity to address some of the long-standing economic problems in the region, including the financing of reforms aimed at generating employment opportunities for the rapidly growing working-age population. Directors underscored, however, that fiscal and structural policies will need to be managed carefully to ensure effective absorption of higher oil revenues.

Directors welcomed the staff's analysis of inflation targeting, which has become an increasingly favored monetary policy strategy in emerging markets. Many Directors considered that inflation targeting can bring important benefits for emerging market countries by lowering inflation and better anchoring inflation expectations, although some other Directors cautioned that—given the relatively short experience with inflation targeting, and the success of some countries with stabilization without adopting an inflation-targeting framework—it is difficult to draw definitive conclusions. Directors also noted the staff's finding that successful adoption of inflation targeting appears to depend less on meeting institutional, technical, and economic preconditions, and more on the authorities' commitment and ability to plan and implement institutional change after the introduction of the regime. While seeing some scope for the necessary conditions to be developed after a country adopts inflation targeting, several Directors nevertheless felt that certain preconditions—especially central bank credibility and independence—remain important for success.