EXECUTIVE SUMMARY

Notwithstanding the recent bout of financial volatility, the world economy still looks well set for continued robust growth in 2007 and 2008. While the U.S. economy has slowed more than was expected earlier, spillovers have been limited, growth around the world looks well sustained, and inflation risks have moderated. Overall risks to the outlook seem less threatening than six months ago but remain weighted on the downside, with concerns increasing about financial risks.

Global Economic Environment

The global economy expanded vigorously in 2006, growing by 5.4 percent (Chapter 1). In the United States, the expansion slowed in the face of headwinds from a sharp downturn in the housing market, but oil price declines since August have helped to sustain consumer spending. In the euro area, growth accelerated to its fastest pace in six years as domestic demand strengthened. In Japan, activity regained traction toward year-end, after a soft patch in midyear. Among emerging market and developing countries, rapid growth was led by China and India, while momentum was sustained across other regions as countries benefited from high commodity prices and continued supportive financial conditions.

Strong growth and rising oil prices in the first half of 2006 raised concerns about inflation, but pressures have moderated with the decline in oil prices since August. Against the background of strong growth and reduced concerns about inflation, global financial market conditions have generally been buoyant. Despite a bout of financial volatility in February–March 2007, and rising concerns about the U.S. subprime mortgage market, equity markets remain close to all-time highs, real long-term bond yields have remained below long-term trends, and risk spreads have narrowed in most markets.

In foreign exchange markets, the U.S. dollar has weakened, mainly against the euro and pound sterling. The yen has also depreciated further, in part because prospects for continued low interest rates have encouraged capital outflows, although it recovered some ground in early 2007. The Chinese renminbi has declined modestly in real effective terms despite a mild acceleration in its rate of appreciation against the dollar. The U.S. current account deficit rose to 6½ percent of GDP in 2006, although the non-oil trade deficit declined as a percent of GDP as exports accelerated. Surpluses in Japan, China, and the Middle Eastern oil-exporting countries increased further.

The major central banks have faced differing policy challenges in recent months. The U.S. Federal Reserve has kept policy rates on hold since June 2006, seeking to balance risks from a cooling economy and lingering concerns about inflation. The European Central Bank (ECB) and other central banks in Europe have continued to remove monetary accommodation. The Bank of Japan has raised its policy rate very gradually since exiting its zero interest rate policy in July 2006. Some emerging market countries—including China, India, and Turkey—have also tightened monetary policy.

Advanced economies continued to make progress in strengthening their fiscal positions in 2006. Budget deficits were reduced substantially in Germany, Japan, and the United States. Fiscal gains largely reflected strong growth of tax revenues in the cyclical upswing.

Outlook and Risks

Global growth is expected to moderate to 4.9 percent in 2007 and 2008, some ½ percentage point slower than in 2006. In the United

States, growth is expected to come down to 2.2 percent this year, from 3.3 percent in 2006, although the economy should gather some momentum during the course of the year as the drag from the housing sector dissipates (Chapter 2). Growth is also expected to ease in the euro area, reflecting in part the gradual withdrawal of monetary accommodation and further fiscal consolidation. In Japan, the expansion is projected to continue at about the same pace as in 2006.

Emerging market and developing countries are expected to continue to grow strongly, albeit at a somewhat slower pace than in 2006. These economies will continue to draw support from benign global financial conditions and commodity prices that remain high notwithstanding recent declines. China's growth is projected to remain rapid in 2007 and 2008, albeit a little below the torrid pace in 2006, while India's economy should also continue to grow rapidly. Commodity-rich countries should continue to prosper.

The risks to the growth outlook are less threatening than at the time of the September 2006 *World Economic Outlook,* but are still tilted to the downside. Particular uncertainties include the potential for a sharper slowdown in the United States if the housing sector continues to deteriorate; the risk of a retrenchment from risky assets if financial market volatility were to rise from historically low levels; the risk that inflation pressures could revive as output gaps continue to close, particularly in the event of another spike in oil prices; and the low probability but high cost risk of a disorderly unwinding of large global imbalances.

A key question in assessing the risks to the outlook is whether the global economy would be able to "decouple" from the United States were the latter to slow down more sharply than projected. To date, the cooling of U.S. activity since early 2006 has had a limited impact abroad beyond its immediate neighbors, Canada and Mexico. As discussed in Chapter 4, this reflects a number of factors, including that the U.S. slowdown has been focused in the housing sector, which has a relatively low import content; that spillovers from the United States are typically more muted in the context of a midcycle slowdown than in a full-blown recession; and that the shock has been a U.S.-specific event rather than a common shock. Nevertheless, were the U.S. economy to slow sharply, this would have a more substantial impact on global growth.

From a longer-term perspective, developments that undermined the buoyant productivity performance of recent years would clearly have an adverse affect on global growth. Strong productivity growth has been supported by a combination of technological progress, an increasingly open global trading system, rising cross-country capital flows, and more resilient macroeconomic policy frameworks and financial systems. It is essential that these pillars remain in place, and that trends that could pose challenges to continued strong global economic performance—such as population aging and global warming—are adequately addressed.

One particular concern is that protectionist forces could undercut trade and foreign investment. If this happens, there is a danger that some of the gains from an increasingly integrated global economy will be reversed. Chapter 5 discusses how the rapid growth of international trade and the introduction of new technologies have fostered an increasingly integrated global labor market that has produced gains in growth and incomes in both source and host countries, while at the same time affecting distributional outcomes. Against this background, more could be done to help those whose jobs may be particularly affected by recent trends in technology and trade, including through better education systems, more flexible labor markets, and welfare systems that cushion the impact of, but do not obstruct, economic change.

Policy Issues

Advanced Economies

The major central banks face varying challenges in managing monetary policy, reflecting differing cyclical positions and degrees of inflation pressure in their economies. In the United States, the Federal Reserve's approach of holding its rates steady remains appropriate for now, and the path of monetary policy should depend on how incoming data affect the perceived balance of risks between growth and inflation. In the euro area, with growth projected to remain close to or above potential and the possibility of some further upward pressure on factor utilization and prices, raising interest rates further to 4 percent by the summer would seem warranted. In Japan, monetary accommodation should be removed only gradually and on the basis of evidence confirming the continuing strength of the expansion.

Fiscal policy should be directed at achieving the necessary consolidation and reform to maintain viability in the face of aging populations, while providing room for automatic stabilizers to work as needed. Sustained progress toward fiscal consolidation will depend on fundamental reforms to contain increasing outlays as populations age, particularly in areas such as health care and pensions, and to avoid the erosion of revenue bases.

With expansions now firmly established, this is the time to further advance structural reforms aimed at sustaining potential growth. A particular challenge is to ensure that adequate employment opportunities are created within the increasingly global economy and that the less well-off share more in the prosperity created by rising trade and the introduction of new technologies. Some progress has been made in implementing productivity-enhancing reforms in the euro area and Japan, but more needs to be done, particularly in the services and financial sectors. There is also scope to improve the flexibility of the U.S. economy, including by reducing the close link between health care coverage and employment to increase labor mobility.

Emerging Market and Developing Economies

Many emerging market and developing countries face the challenge of maintaining stable macroeconomic and financial conditions in the face of strong foreign exchange inflows. Exchange rates in several Asian countries have appreciated markedly over the past six months, but China would benefit from a more flexible regime that provides a more secure basis for monetary policy management. In emerging Europe, policies need to minimize risks associated with large current account deficits and rapid credit growth. In Latin America, the task is to consolidate recent progress toward strengthening public sector balance sheets. In commodity-exporting countries, the rapid rise in export receipts and government revenues needs to continue to be carefully managed to avoid overheating.

Recent progress on structural reforms has generally been patchy and the “to do” list remains long. Further progress in liberalizing service sectors in Asia and elsewhere would help sustain and extend productivity improvements. Accelerating labor market reforms in Latin America would help boost the region's poor productivity performance. Establishing stable, transparent, and balanced regimes for infrastructure provision and for the exploitation of natural resources would help to reduce risks of bottlenecks, corruption, and lack of investment that could prove to be serious impediments to long-term growth.

Multilateral Initiatives and Policies

Cooperative policy actions are necessary to support the smooth unwinding of large global imbalances. Important elements of such an approach—which are being discussed in the context of the IMF's Multilateral Consultations—include efforts to raise saving in the United States, including through more ambitious fiscal consolidation and steps to reduce disincentives to private savings; advancing growth-enhancing reforms in the euro area and Japan; and measures to boost consumption and increase upward exchange rate flexibility in some parts of emerging Asia, especially China. Among Middle Eastern oil exporters, lower oil prices and increased spending are expected to reduce external surpluses, although there is still scope to continue to boost spending, subject to absorptive capacity constraints.

As emphasized in Chapter 3, market-led movements in real effective exchange rates could potentially play an important supportive role in the adjustment of global imbalances. Currency depreciation could help to contain the output costs that may accompany the demand rebalancing needed to lower current account deficits by encouraging a smooth shift in resources across sectors. Encouragingly, the chapter finds that concerns about "elasticity pessimism"—that U.S. trade flows are unresponsive to real exchange rate changes—are exaggerated, consistent with the view that a real effective depreciation of the dollar over the medium term could contribute to reducing the U.S. current account deficit. To be most effective, the counterpart to this realignment of the U.S. dollar would be real exchange rate appreciations in countries with persistent current account surpluses, including China, Japan, and Middle Eastern oil exporters.

The recent revival in the Doha Round of multilateral trade negotiations is welcome. Reaching a Doha Round conclusion that achieves ambitious multilateral trade reform and further strengthens multilateral rules so as to reduce the risks of protectionism would provide an important boost to the global outlook. Prospects for a sustained global expansion and a gradual unwinding of global imbalances would also benefit from initiatives to remove obstacles to the smooth reallocation of resources in response to exchange rate movements, including through trade reform.