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Statement by the Managing Director
The global expansion remained strong in the first half of 2006, notwithstanding headwinds from a tightening of monetary conditions by major central banks and further increases in oil prices. Among the advanced economies, growth was particularly strong in the United States in the first quarter, before slowing in the second quarter, activity in the euro area has gathered momentum, and the expansion in Japan remains well supported. In emerging market economies, growth has remained very strong, with the Chinese economy continuing its rapid expansion. Low-income countries have also maintained an impressive growth performance, helped by strong commodity prices.

Inflationary pressures have been edging up, as sustained high rates of growth have absorbed spare capacity and pushed oil and metals prices to new highs. While headline inflation has been above central bank comfort zones for some time in many countries, there have been signs of increases in core inflation and inflation expectations in a number of countries, most notably the United States, since the start of 2006. In response, major central banks have tightened monetary policy, although in the United States, indications are that further tightening will only be considered after a pause. The Bank of Japan ended its zero interest rate policy in July after increasing evidence that deflation has given way to low inflation.

Uncertainty about the sustainability of global growth amid rising inflationary pressures led to some weakness in advanced economy equity markets in May-June of this year and a series of larger downward moves in some emerging market asset prices. Markets, however, have stabilized since July, with sovereign bond spreads tightening again to near-historic lows.

Global imbalances are large and still rising. Despite an acceleration in export growth, the U.S. current account deficit is expected to reach 6½ percent of GDP this year. Surpluses in oil exporters and a number of Asian countries have remained high, with China’s surplus remaining over 7 percent of GDP. Against this background, the U.S. dollar has tended to weaken, particularly against the euro.

**Short-Term Prospects**

The strong global expansion is expected to continue. The forecast for global growth has been marked up to 5.1 percent in 2006 and 4.9 percent in 2007, both ¼ percentage point higher than at the time of the Spring Meetings in April 2006. The favorable outlook is underpinned by a better-balanced composition of demand across the major advanced economies, robust growth momentum in major emerging market economies, notably China and India, strong balance sheets and profitability in the corporate and financial sectors, and still broadly supportive financial market conditions.
There is some upside potential to the outlook for global growth from even more rapid growth in emerging market economies, notably in China, and the possibility of stronger-than-expected investment in a number of advanced economies. Nevertheless, the balance of risks to the forecast remains tilted to the downside. Key concerns include the possibility of a further build-up of inflationary pressures in advanced economies; the continued potential for supply-side shocks in markets for key commodities, particularly oil; the risk of a more abrupt slowdown in housing markets in advanced economies, notably the United States; weaker-than-expected growth in private consumption in Europe and Japan; a rise in protectionist pressures if multilateral trade talks fail; and the risk of a disorderly adjustment of the large global imbalances. Such developments could lead to more volatile financial market conditions, with financial flows to emerging market countries particularly at risk.

Turning to individual countries and regions, the pace of expansion in the United States has moderated after exceptionally strong growth in early 2006. Private consumption growth has been dampened by higher interest rates, a cooling housing market, high gasoline prices, and modest employment gains. For the year as a whole, growth is projected at 3.4 percent, before slowing to 2.9 percent in 2007. Consumption and residential investment growth are expected to slow further, but business investment should remain resilient in view of strong profits and limited spare capacity. Risks to the outlook are to the downside, particularly from a sharper-than-expected cooling of the housing market.

In the euro area, the recovery has gained further traction, with growth increasingly driven by domestic demand, particularly investment. Current indicators suggest that the expansion is being well sustained during the third quarter of 2006, and real GDP growth is now projected at 2.4 percent for the year, before slowing to 2 percent in 2007. Corporate investment is expected to remain buoyant, as profitability has generally recovered and corporate restructuring is well advanced. Consumption growth is likely to remain moderate given modest employment and wage growth, although the VAT increase scheduled in Germany in early 2007 is expected to bring forward some spending to 2006. The main downside risks include a more abrupt-than-expected slowdown in the United States, a sharp euro appreciation, further energy price increases, and, in a number of countries, elevated house prices susceptible to pressure from rising interest rates. On the upside, robust business confidence could generate stronger-than-expected investment and employment growth.

Japan appears to have finally escaped from entrenched deflation, and the expansion remains well-founded despite some easing of real GDP growth in the second quarter of 2006, as private final domestic demand continues to grow at a solid pace. Private fixed investment in particular continues to be buoyant, underpinned by robust profits and a turnaround in bank credit. Growth is projected at 2.7 percent for 2006 as a whole, before moderating to just above 2 percent in 2007 as the output gap is expected to close. The near-term risks to the outlook are broadly balanced. On the upside, growth could be boosted by stronger-than-expected domestic demand, as confidence remains high and the pace of household income growth may pick up with the continued expansion. On the downside, the economy is vulnerable to adverse external developments, including a further rise in oil prices, a cooling U.S. economy, or a sharp appreciation of the yen in the context of a disorderly adjustment of global imbalances.
Growth continues to run above 8 percent in emerging Asia, with much of the momentum due to vibrant expansions in India and, especially, China, where investment growth has re-accelerated and net exports remain buoyant. The outlook is for continued strong growth in the region next year, reflecting favorable global economic conditions, and some strengthening of domestic demand. Strong growth in China and India is expected to continue, while growth in the ASEAN-4 is expected to rebound, as the contractionary effects of higher oil prices and monetary policy tightening in response to rising inflation recede. In contrast, growth is set to slow in the newly industrialized economies (NIEs), especially in 2007, when import demand growth in advanced economies is projected to decelerate. Risks to the near-term outlook are broadly balanced. On the upside, there is the possibility of even faster-than-projected growth in China and in India, although this carries the risk of an investment boom-bust cycle in China. With a strengthening in domestic demand growth in many countries of the region and high oil prices, the regional current account surplus is expected to moderate in 2006–07. Nevertheless, sustained policy efforts are required to achieve a better balance between externally and domestically led growth in the surplus countries of the region. In countries, where private investment remains relatively weak, reforms aimed at enhancing the business environment are a priority, whereas in other countries, further steps toward exchange rate appreciation and a continuation of complementary financial sector reforms would help support consumption.

The economic expansion in Latin America gathered momentum in the first half of this year, with regional GDP set to rise by 4¾ percent in 2006 and by 4¼ percent in 2007. Domestic demand has become the main engine of growth, underpinned by supportive monetary conditions and a pro-cyclical pick up in public spending across the region on the back of continued revenue buoyancy. At the same time, high prices for key commodity exports have supported a favorable external performance. Latin America’s expansionary momentum seems to have been little affected by unsettled conditions in global financial markets in May-June 2006, reflecting in part reduced vulnerabilities because of improved macroeconomic and financial policies. Nevertheless, with the external environment likely to become less favorable over time, countries in the region need to take steps to reduce vulnerabilities further through sustained disciplined fiscal policy, notwithstanding populist pressures in some countries.

The economic expansion has remained robust in emerging Europe, underpinned by buoyant domestic demand that is fueled by increasing net capital inflows and rapid credit growth. The outlook is for a continued solid regional expansion, although growth is expected to slow in Turkey after significant increases in policy interest rates to head off a weakening currency and intensifying inflation pressures, and in Hungary in view of the substantial fiscal consolidation that is targeted in 2007. The risks to the growth outlook are slanted to the downside, with the region’s heavy reliance on foreign savings a particular vulnerability if international financial market conditions tighten. Reducing vulnerabilities is a policy priority, not the least in view of possible regional spillovers, given similar risk exposures and common creditors. More broadly, with most countries in the region aiming for euro adoption in the medium term, policymakers need to ensure adequate preparation for the loss of
monetary policy autonomy and the capacity to achieve external adjustment without nominal exchange rate changes.

Real GDP growth in the Commonwealth of Independent States is on course to reach close to 7 percent in 2006, before easing to about 6½ percent in 2007, reflecting high commodity prices and, in several countries, substantial capital inflows and/or remittances. While these factors have relaxed short-term budgetary constraints, the fiscal policy stance should recognize risks of commodity price reversals. In countries with scope for fiscal easing, higher government spending should be accompanied by renewed efforts at reforms to ensure that this spending boosts investment and potential GDP growth. With the favorable external environment and limited exchange rate flexibility, inflation has generally remained high despite some recent declines, and tighter monetary control and greater willingness to accept further nominal exchange rate appreciation would help to avoid inflationary pressures becoming entrenched.

Sub-Saharan Africa is enjoying its strongest period of sustained economic expansion since the early 1970s. Oil-exporting countries have contributed significantly to this performance, but growth in oil-importing countries has also been robust, despite higher oil prices. Key risks to the outlook include sustained elevated oil prices, slower global growth, falling export prices for nonfuel commodities, and political uncertainties in a number of countries. While improved, the recent growth performance in sub-Saharan Africa still falls well short of the 7 percent annual growth needed to meet the Millennium Development Goal of halving poverty by 2015, and it is important that governments in the region continue to press ahead with reforms to promote private sector investment, including foreign investment, and employment. Such efforts should continue to be supported by the international community, including through debt relief, meeting recent commitments to further boost aid, and bold market opening initiatives.

The Middle East has enjoyed robust growth with booming oil revenues. The outlook generally remains favorable, given prospects of continued high oil prices. Risks to growth are broadly balanced. On the upside, surging oil revenues could provide for higher-than-expected government expenditure, while possible further asset prices corrections are a downside risk. Geopolitical risks remain a serious concern. Countries have appropriately begun to use the opportunity provided by higher revenues to increase spending to address long-standing structural problems. While there seems ample scope for this build-up of spending given generally high unemployment and low inflation, risks of overheating need to be monitored with continued rapid credit growth. Capacity-enhancing reforms need to accompany higher expenditure to ensure lasting productivity and employment gains.

**Policy Priorities to Reduce Vulnerabilities and Strengthen Growth Potential**

After four years of a strong global upswing, closing output gaps, the heightened uncertainty about economic prospects, the associated increased volatility in financial markets, and concerns over global imbalances underscore the need for policymakers to respond flexibly to events, to act with foresight to head off potential strains, and to take a joint approach to managing global risks. Moreover, key medium-term policy challenges must
remain high on the agenda. Among the most important areas where policy actions are needed are:

- **Anchoring inflation expectations in the major advanced economies.** The U.S. Federal Reserve faces the difficult situation of rising inflation in a slowing economy and, with risks delicately balanced, the recent pause in interest rate increases provides an opportunity to judge the impact of previous policy tightening and the cooling of the housing market on growth. Nevertheless, given the importance of keeping inflation expectations firmly in check, some further policy tightening may still be needed. In Japan, further interest rate increases should be gradual since there is little danger of an inflationary surge, while the reemergence of deflation would be costly. In the euro area, further interest rate increases are likely to be needed if the expansion develops as expected, but for now inflation pressures seem broadly contained, and faced by downside risks to growth, policymakers can afford to be cautious in tightening the monetary policy stance.

- **Ensuring medium-term budget sustainability.** In most of the major advanced economies, fiscal consolidation in the face of aging populations remains a huge challenge. Some welcome progress has been made in reducing fiscal deficits, and further fiscal consolidation is envisaged in many countries in the coming years. However, medium-term budget plans are often neither ambitious enough nor backed up by clearly identified policy measures. Tackling these fiscal concerns effectively will require setting suitably ambitious medium-term budget objectives, as well as addressing politically difficult issues, including putting social security systems on a sound footing and finding effective ways to contain rising health care costs.

- **Raising potential growth in advanced economies.** Structural reforms to improve business environments and competitiveness remain essential to bolster medium-term prospects in the advanced economies. In the euro area, faster progress to advance the Lisbon agenda—particularly more open competition in services and more flexible labor markets—and financial sector reforms remain key to raising productivity prospects and improving job opportunities. In Japan, priorities include public sector reforms, steps to enhance labor market flexibility and financial sector efficiency, and measures to improve productivity performance in services.

- **Reducing vulnerabilities in emerging market economies.** Policymakers in emerging market economies must be fully prepared for the prospect of a more testing global financial environment ahead. A major challenge in China, some other emerging Asian countries, Russia, and some other oil exporters is to manage a transition to more flexible exchange rates that would allow necessary appreciation to take place and provide more room for monetary policy to respond to shifts in the global environment and in domestic conditions. Emerging market economies that rely heavily on external financing (such as those in Eastern Europe), still have weak fiscal positions and high public debt (in Latin America and elsewhere), or do not yet have well-established monetary and fiscal policy credibility will need to reduce these vulnerabilities further. Emerging market economies also need to stand ready to respond to adverse developments to maintain market confidence and preserve hard-won inflation-
fighting credentials. The sharp increase in private sector debt inflows in a number of these economies, particularly bank flows to private borrowers including households in Central and Southeastern Europe, and the corresponding rapid growth in private credit call for a close monitoring of the associated risks by financial regulatory and supervisory authorities.

- **Reforms to sustain and raise medium-term growth prospects in emerging market and developing countries.** Further efforts are needed to move forward market-oriented reforms, particularly by reducing barriers to competition, to enhance the climate for vigorous private sector-led growth, while also taking steps to ensure that the opportunities and the benefits of growth are broadly shared. Financial sector reforms and capital market development would increase the efficiency of investment in China, while improved provision of social services could help support consumption growth. Reforms to raise openness and competition, and to reduce budget rigidities to improve fiscal policy management and the composition of public spending, would substantially improve prospects for Latin America. In low-income countries, particularly in sub-Saharan Africa, reforms aimed at improving private sector growth and investment should encompass further liberalization of their economies, especially of trade, financial sector reform, and the continued building of economic institutions to strengthen capacity and governance.

- **Joint policy efforts to help ensure a smooth resolution of the large global imbalances.** While an orderly private sector led adjustment of these imbalances remains the most likely outcome, there is a risk of a more disorderly unwinding that would imply a heavy cost for the global economy, especially given that foreign investors’ exposures to losses from a U.S. dollar decline are large and growing. 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, together with greater exchange rate flexibility to allow for currency appreciation; and increased spending by oil-exporting countries in high return areas, consistent with absorptive capacity constraints, particularly in the Middle East, where the large buildup of investment projects already in train is welcome. There have been some welcome developments in recent months that over time will be helpful in reducing imbalances. Nevertheless, progress in advancing toward these goals has been slower than desirable, hampered in part by the difficulty of developing national political consensus on policy changes that will have distributional consequences. A joint, multilateral approach may help to advance implementation by providing additional reassurance that possible risks associated with individual actions would be alleviated by policy initiatives elsewhere. The multilateral consultation being undertaken by the International Monetary Fund aims to facilitate such a joint approach.

- **Reduce risks from high and volatile energy prices.** Policy efforts need to focus on ensuring that world energy markets function well by providing appropriate and predictable incentives for producers to invest, particularly in riskier and higher cost
sources of energy, and to ensure adequate spare capacity. Moreover, conservation efforts by consumers should be encouraged through pricing that reflects the full social costs of energy use, although in developing countries this will need to go hand-in-hand with efforts to strengthen the social safety net to assist the poor who are disproportionately affected by high energy prices. Further efforts to improve energy statistics, including more consistent and reliable measures of petroleum reserves, would encourage more rational and far-sighted decision-making.

The rapid expansion of world trade has played a critical role in spurring strong global growth in recent years. Given the link between trade and growth, the suspension of the Doha Round is therefore deeply disappointing. Not only is it an opportunity wasted to provide a sustained stimulus to the global economy, and especially to developing country growth, it also raises concerns about a resurgence of protectionism. Given the current risks to the global expansion, this is the wrong time to let an obvious source of sustained growth slip away. WTO members should maintain their commitment to the rules-based multilateral trading system, resist protectionist calls, preserve progress that has already been made, and return to the negotiating table to create the basis for an ambitious and successful agreement. In the meantime, it is important to proceed with the Aid-for-Trade agenda, including following through on donor commitments, in order to help poor countries exploit the advantages of open markets.