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**Statement by IMF Managing Director, Rodrigo de Rato,
to the International Monetary and Financial Committee
on the Global Economy and Financial Markets**

Although the global economy has sustained strong growth in recent quarters, turbulence in financial markets has clouded prospects. So, while growth is expected to remain buoyant, supported by generally sound fundamentals and strong performance in emerging market economies, risks to the outlook lie firmly on the downside, centering around the concern that financial market strains could continue and trigger a more pronounced slowdown. Additional risks include potential inflation pressures, volatile oil markets, the impact on emerging markets of strong capital inflows, and continued large global imbalances.

Inflation remains contained in the advanced economies, but has risen in many emerging market and developing countries, reflecting higher energy and food prices. Prior to the recent financial market turbulence, central banks around the world were generally tightening monetary policy to head off nascent inflationary pressures. In August, however, faced by mounting market disruptions, a number of central banks injected liquidity into money markets. In September, the Federal Reserve cut the Federal funds rate by 50 basis points, and financial markets expect further reductions in the coming months. Expectations of policy tightening by the Bank of England, Bank of Japan, and the ECB have been rolled back since the onset of the financial market turmoil. Among emerging markets, some central banks have also provided liquidity to ease strains in interbank markets, but for others the principal challenge remains to address inflation concerns.

Financial market conditions have become more volatile. Credit conditions have tightened, as increasing concerns about the fallout from strains in the U.S. subprime mortgage market led to a spike in yields on securities collateralized with such loans as well as other higher risk securities. Uncertainty about the distribution of losses, rising concerns about counterparty risk, and banks' expectations that the turbulence would lead to previously unanticipated expansions of their balance sheets saw liquidity dry up in segments of the financial markets. Equity markets initially retreated, led by falling valuations of financial institutions (although prices have since recovered), and yields on short-term government securities declined as investors looked for safe havens. Emerging bond and equity markets have also been affected, although by relatively less than in previous episodes of global financial turbulence, and asset prices remain high by historical standards.

The major currencies have largely continued trends observed since early 2006. The U.S. dollar has weakened, but is still estimated to be above its medium-term fundamental level. The euro has appreciated, but remains broadly consistent with fundamentals. The Japanese yen has rebounded strongly in recent months, but remains under-valued relative to medium-term fundamentals. The renminbi has continued to appreciate gradually, but China's current account surplus has widened further and its international reserves have soared.

Short-Term Prospects

World growth is projected to moderate, from 5.4 percent in 2006 to 5.2 percent in 2007 and 4.8 percent in 2008. The risks around this central outlook, however, are clearly on the downside. In particular, risks emanating from the financial markets and domestic demand in the United States and Western Europe have increased. The recent repricing of risk and increased discipline in credit markets could have significant near-term effects on growth, even as they strengthen the foundations for future expansion. The extent of the impact on growth will depend on how quickly more normal market conditions return, and on the extent of the retrenchment in credit markets. There remains a possibility that financial turbulence could continue for some time, with a greater impact on credit availability. In turn, this could significantly dampen growth, particularly if it puts additional pressure on housing markets in the U.S. and some European countries. Other risks could also affect the global outlook. While inflation concerns in advanced economies have generally been reduced by recent developments, overheating remains a worry in many emerging markets. Oil prices have risen to new highs, despite OPEC's decision to increase production; with spare production capacity remaining limited, a further price spike cannot be ruled out. In addition, persistent global imbalances remain a concern.

Turning to individual countries and regions, in the *United States* growth rebounded strongly in the second quarter, but recent data have painted a weaker picture of the economy going forward, reflecting in part the impact of the turmoil in financial markets. Against this background, U.S. growth is projected at 1.9 percent in both 2007 and 2008. Ongoing difficulties in the mortgage market are expected to extend the decline in residential investment, while house-price declines are likely to encourage households to reduce consumption. Partly offsetting this, exports are expected to grow robustly, benefiting from the continued decline in the dollar and solid growth in partner countries, and healthy corporate balance sheets should support business investment. Risks to the outlook are on the downside, reflecting the potential for a significant pull-back in lending by financial institutions, as well as for a deeper and more protracted housing downturn.

The *euro area* has been expanding at about 3 percent since the middle of 2006, its best economic performance for a decade. However, growth is forecast to slow to 2.5 percent in 2007 and 2.1 percent in 2008, reflecting the lagged effects of euro appreciation, trade spillovers from the United States, and more difficult financing conditions. Risks to the outlook are on the downside. Deteriorating credit conditions could further slow consumption and residential investment spending, particularly in countries that have experienced large house-price increases in recent years. Other risks relate to the potential for volatile oil prices, a protracted U.S. slowdown, and a further sharp appreciation of the euro.

Japan's economy contracted slightly in the second quarter of 2007, largely reflecting declines in investment and weaker consumption growth. Looking ahead, real GDP growth is projected to moderate from 2 percent in 2007 to 1.7 percent in 2008—in line with potential—as exports are expected to slow and offset a pick-up in domestic demand. The risks to the outlook are on the downside. Growth would be dampened by a more significant global

downturn, higher oil prices, or a further yen appreciation, although faster wage growth could boost consumption.

Growth in *emerging Asia* remained exceptionally rapid in the first half of 2007. The regional expansion was led by China, where real GDP grew by 11½ percent in the first half of 2007 as exports and investment accelerated, and by India where gains in domestic demand, particularly investment, underpinned 9¼ percent growth in the first half. Going forward, the weaker outlook for advanced country economies is likely to affect exports, and regional growth, projected at 9.2 percent this year, is therefore expected to ease to 8.3 percent in 2008. Risks to the outlook are broadly balanced. Particular downside concerns include slower demand for Asian exports, and electronic goods in particular, and the possibility of further global financial turbulence. On the upside, the projected easing of growth in China may not materialize unless the authorities tighten monetary policy more decisively and allow greater exchange rate appreciation. Faster growth in the near term, however, would come at the cost of increased medium term downside risks related to overinvestment. Growth in India could also be stronger than projected, particularly if robust corporate profits further boost investment spending.

Growth in *Latin America* reached 5.5 percent in 2006, but is projected to moderate to 5 percent in 2007 and to 4.3 percent in 2008. This easing partly reflects spillovers from the U.S. slowdown on Mexico and Central America, mainly through trade linkages as well as somewhat slower growth of migrant remittances. In a number of commodity-exporting countries, growth is expected to come down from the very high 2006 rates, in part because of increasing supply constraints. In Brazil, growth picked up in 2007, responding to monetary easing after inflation was brought on track, but is expected to moderate in 2008. Risks to these projections are moderately on the downside, as continued global financial turbulence could exert negative spillovers on Latin America through both trade and financial channels.

Growth in *emerging Europe* accelerated to 6.3 percent in 2006, and the pace moderated only slightly in the first half of 2007, supported by rising exports (mainly to western Europe) and strong domestic demand. Strong growth has been accompanied by widening external imbalances and overheating, particularly in the Baltics and in southern and southeastern Europe. Regional growth is forecast to soften to 5.8 percent in 2007 and 5.2 percent in 2008, reflecting some monetary and fiscal tightening, tighter global credit conditions, and weakening external demand from western Europe. Risks to this outlook are to the downside, largely owing to the possibility of a sharper-than-expected squeeze on credit, and a disorderly unwinding of large external imbalances in some countries, with spillovers to the rest of the region.

Growth in the *Commonwealth of Independent States* remained strong in the first half of 2007, led by Russia, although economic activity in other countries has also remained buoyant. The robust regional expansion has been underpinned by high commodity prices and strong capital inflows, as well as continuing productivity gains. Growth momentum is expected to ease from 7¾ percent in 2006–07 to 7 percent in 2008, largely owing to tightening credit conditions and a weakening external environment. Risks to growth are tilted to the downside, owing to a possibly stronger impact of financial turbulence on the

availability of foreign and domestic financing, as well as the impact of slower global growth on commodity prices and export demand.

Africa is enjoying another strong year, with growth projected to rise to 5.7 percent this year and 6.5 percent in 2008. The expected growth acceleration largely reflects the coming onstream of new production facilities in oil-exporting countries. But most other countries in the region are projected to maintain relatively high rates of growth and make progress in reducing poverty. This success reflects a combination of a favorable external environment (in particular, improving terms of trade), the benefits of ongoing economic reforms, improved macroeconomic policies, and the rising openness of African economies. Nevertheless, risks to the forecast are somewhat to the downside, reflecting mainly the possibility of a weaker global outturn, which would weaken demand for African commodity exports, as well as risks from domestic political developments in individual countries.

In the *Middle East*, growth reached 5.6 percent in 2006, and should pick up further to around 6 percent in both 2007 and 2008, supported by high oil prices and expansionary fiscal policy. In oil-exporting countries, a buildup of government spending on infrastructure and social projects, as well as investment programs to expand oil production and refining capacity, narrowed the fiscal and current account surpluses, despite higher oil prices. At this stage, risks to the outlook appear broadly balanced. Slower global growth, increased financial market volatility, and regional geopolitical risks could adversely affect growth, but the continued strength of oil prices provides upside potential. Over the longer term, the diversification strategy of oil exporters hinges on reforms to improve the business climate and make investment in non-oil sectors more attractive. These policies are also germane to oil-importing countries, which share rapid population growth and the challenge of reducing unemployment.

Policy Issues

Policymakers around the world face the immediate challenge of safeguarding the continued expansion of activity in the face of the risks posed by recent turbulent global financial conditions, while remaining alert to inflationary pressures.

In the advanced countries, after a period of tightening that brought monetary stances close to or above neutral, central banks have had to address the recent drying-up of market liquidity, and associated financial sector risks, while continuing to base monetary policy decisions on judgments about the economic fundamentals. In the United States, further signs that growth would be significantly below trend would justify additional interest rate reductions, provided that inflation risks remain contained. In the euro area, monetary policy can stay on hold over the near term reflecting downside risks to growth and inflation from financial market turmoil. However, as these risks dissipate, further tightening eventually may be required. In the event of a more protracted slowdown, an easing of monetary policy would need to be considered. In Japan, while interest rates will eventually need to return to more normal levels, such increases should await clear signs that prospective inflation is moving decisively higher and that concerns over the global economy have waned.

Lessons will need to continue to be drawn from the recent financial turbulence so as to reduce vulnerabilities to future strains in both advanced and developing economies. One set of issues concerns the provision of liquidity by central banks to relieve financial strains, and how this ties into broader financial safety nets. A series of regulatory issues will need to be addressed. Greater attention will need to be given to ensuring adequate transparency and disclosure by systemically important institutions. It will also be relevant to examine the regulatory approach to treating liquidity risk, the relevant perimeter around financial institutions for risk consolidation, the approach to rating complex financial products, and whether the existing incentive structure ensures adequate risk assessment throughout the supply chain of structured products.

A number of emerging markets still face overheating pressures and rising food prices, and further monetary tightening may be required. Moreover, despite recent financial market developments, strong foreign exchange inflows may continue to complicate the task of policymakers. There is no simple formula for dealing with such inflows. Still, fiscal policy will in general play a key role. While fiscal positions have improved, this reflects strong revenue growth partly generated by high commodity prices that may not be sustained. At the same time, government spending in many countries has accelerated. The avoidance of public spending booms, particularly in emerging Europe but also in Latin America, would help in both managing inflows and reducing public debt levels. That said, in fuel-exporting countries in the Middle East there is scope to further increase spending, subject to absorptive capacities. A tightening of prudential standards in financial systems, and steps to liberalize controls on capital outflows, can also play useful roles. In some cases, greater exchange rate flexibility would provide more room for better monetary control. For China, further renminbi appreciation would also contribute to a necessary rebalancing of economic growth and to an orderly unwinding of global imbalances.

At the same time, greater progress is needed in tackling the deeper obstacles to sustaining long term growth and reducing poverty. The most important challenges are:

- *To make further progress toward fiscal consolidation in advanced countries to ensure fiscal sustainability in the face of population aging.* Much of the recent fiscal improvement has reflected rapid revenue growth, driven by strong growth in profits and high-end incomes, and it is not clear to what extent these gains will be sustained. Further, current budgetary plans envisage limited additional progress in reducing debt ratios from current levels over the next few years. Governments should adopt more ambitious medium term consolidation plans, together with reforms to tackle the rising pressures on health and social security spending, although in most countries there is scope to let automatic fiscal stabilizers operate in the event of a downturn.
- *To take advantage of the opportunities created by globalization and technological advances, while doing more to ensure that the benefits of these ongoing changes are well distributed across the broad population.* A key part of this agenda is to make sure that markets work well, with priorities being measures to boost productivity in the financial and service sectors in Europe and Japan, and steps to improve infrastructure, develop financial systems, and strengthen the business environment in

emerging market and developing countries. Reforms to strengthen education and training would help ensure that workers have the appropriate skills for the emerging “knowledge-based” global economy. Policies that increase the availability of finance to the poor would also help.

- *To move decisively in the direction of further multilateral trade liberalization.* Liberalization that boosts export prospects for developing countries, including to other developing countries, would help reduce global poverty and inequality. In this context, the uneven progress with the Doha Trade Round is deeply disappointing. Major developed and developing countries should demonstrate leadership in resisting protectionist pressures and re-energizing the process of multilateral liberalization. This will require a more flexible approach to reductions in agricultural tariffs and subsidies by the advanced countries, significant cuts in nonagricultural tariffs, and more ambitious efforts in other areas such as services, trade rules, and trade facilitation.
- *To tackle concerns about climate change and energy security through a multilateral approach.* Global warming may be the world’s largest collective action problem, where the negative consequences of individual activities are felt largely by others. It is important that countries come together to develop a market-based framework that balances the long-term costs of carbon emissions against the immediate economic costs of mitigation. Energy policy should focus less on trying to secure national sources of energy, and more on ensuring the smooth operation of oil and other energy markets, encouraging diversification of energy sources (for example, by reducing barriers to trade in biofuels), and paying greater attention to price-based incentives to curb the growth of energy consumption.
- *To follow through on the agreed strategy for tackling global imbalances.* There has been some welcome narrowing of the U.S. current account deficit, and the dollar has depreciated further in an orderly manner. Nevertheless, the deficit remains large, and the dollar depreciation remains focused on a relatively limited number of currencies. Looking forward, it will be important for the burden of currency adjustment to be shared more broadly across countries. In this context, the Multilateral Consultation on Global Imbalances held by the IMF with key countries represents the first use of an innovative approach to addressing systemic global challenges. The Consultation provided a forum to strengthen mutual understanding of the issues, to reaffirm support for the IMFC strategy, and for each country to indicate specific policies consistent with the strategy. The result of the Consultation was a set of mutually consistent policy plans, which will make a significant contribution toward achieving the goals of the IMFC strategy of sustaining global growth while reducing imbalances. With the agreement of the participants in the Consultation, the implementation of the policy plans will be the subject of regular Fund surveillance.