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Statement by the IMF Managing Director

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

The global economic expansion remains robust, although growth has slowed since early 2004, reflecting both a return to a more sustainable pace of activity and the adverse impact of higher oil prices. Growth has been stronger than expected in the United States, China, and most emerging market and developing countries, but weaker in Europe and Japan. This, in part, has contributed to a further widening of global current account imbalances. The global economy is expected to grow by 4.3 percent in 2005—unchanged from expectations at the time of the Annual Meetings in October 2004—underpinned by still accommodative macroeconomic policies, improving corporate balance sheets, supportive financial market conditions, a gradual rise in employment, and strong growth in China.

Despite some recent pickup in the more cyclically advanced countries and the impact of rising oil prices, inflationary pressures remain relatively subdued. With inflationary expectations well anchored, inflation is expected to remain moderate in the near future, although inflation pressures can be expected to become more salient as the expansion proceeds and labor market conditions tighten. In addition, in a number of emerging market countries—notably in Asia and the CIS—the operation of monetary policy is increasingly complicated by strong external inflows which, in the absence of greater upward exchange rate flexibility, can be expected to add to inflationary pressures.

Financial market conditions remain benign, with markets thus far successfully navigating the transition to higher policy interest rates in the cyclically advanced countries. Longer-term bond yields in the U.S. have begun to rise, but remain low for this stage of the business cycle. Yields in the euro area and Japan also remain low. In currency markets, the dollar depreciated significantly in the fourth quarter of 2004, but has since recovered some ground against other major currencies. Corporate debt markets also remain well supported by the low interest rate environment, and generally strong earnings and balance sheets in industrial countries, although spreads have started to rise in response to some specific sectoral concerns.

Emerging market financing conditions remain favorable, underpinned by low global interest rates, improving fundamentals, high commodity prices, and prospects for continued strong global growth. Expectations for a faster rise in U.S. policy interest rates and treasury yields have, however, led to some recent widening of spreads. Improved public debt structures and large reserve cushions have put many emerging market countries in a better position to weather future shocks, particularly with a large proportion of 2005 external financing needs having already been met.

Despite this generally encouraging outlook, a number of risks remain, some of which have increased in recent months:

- If there were a sharp increase in U.S. long-run interest rates—which have begun to edge up since mid-February—this could adversely affect domestic demand, prompt a downward adjustment in the price of riskier assets, and lead to a deterioration in emerging market financing conditions. In financial markets, the relatively low risk premia in many asset classes leave little margin for error in current financial market valuations. Further, risk management systems established during periods of ample liquidity have yet to be tested during periods of financial stress.

- Oil prices are another source of risk. They have risen sharply in recent months, reaching new nominal highs in dollar terms, driven by continued strong demand, falling non-OPEC supply, and uncertainties about OPEC production plans, all exacerbated by a very low level of excess capacity in the oil market. With excess capacity expected to remain low going forward—and mainly in the form of heavy crude, for which refining capacity is limited—oil prices are likely to remain high and volatile.

- A continuing increase in U.S. net external liabilities will carry heightened risks of a disorderly adjustment. Global imbalances have widened further over the past year, and while the U.S. external deficit has so far been financed relatively easily, the demand for U.S. assets is not unlimited. An abrupt decline in investors' appetite for dollar-denominated liabilities could engender a rapid dollar depreciation and a sharp increase in U.S. interest rates, with potentially serious adverse consequences for global growth and international financial markets.

Short-Term Prospects

Among *industrial countries*, the slowdown in the *United States* in mid-2004 proved relatively mild. After slowing sharply in the second quarter, consumption growth picked up briskly, while business investment—still below historical norms at this stage of the cycle—grew solidly, aided by buoyant corporate profitability. With recent data generally strong, the outlook for 2005 is encouraging, with GDP expected to grow by 3.6 percent. Against the background of generally strong corporate balance sheets, investment could exceed expectations, but the possibility of a pronounced rebound in household savings, higher long-term interest rates, and continued oil price volatility present downside risks to the outlook.

The modest recovery that had taken place in the *euro area* since mid-2003 lost momentum during the second half of 2004. Domestic demand remained subdued against the backdrop of high oil prices and longstanding structural weaknesses, while slower global growth and the appreciation of the euro have undercut export growth. A modest recovery is projected in 2005, underpinned by a recovery in exports against the background of a favorable global environment, strengthening investment, and a gradual improvement in the labor market with increased consumer spending. Recent data, however, have not been encouraging, and the risks to this outlook lie predominantly on the downside, particularly if oil prices rise further or euro appreciation undercuts export growth.

In *Japan*, after a strong start in the first quarter of 2004, the economy recorded near-zero growth during the remainder of the year. Exports and investment growth were affected by weaker global demand for IT products, while consumption spending declined. More recently, there have been some signs of a pickup in activity, and a modest recovery is expected during 2005, underpinned by improved bank and corporate balance sheets. High and volatile oil prices and the possibility than the yen could appreciate sharply and undercut exports do, however, constitute important downside risks. Moreover, while easing, deflation continues.

Growth in emerging market and developing countries exceeded expectations in almost all regions in 2004. Growth was again strongest in *emerging Asia*, where it was led by China and India. In some countries in the region, growth slowed during the course of the year due to the weakening of the semiconductor market and higher oil prices. Continued strong—albeit slower—growth is expected in 2005, with China's economic momentum remaining very strong and India growing robustly. The region, however, remains vulnerable to external developments, particularly a further increase in oil prices or a sharp slowdown in the IT sector. The tension between the costs of sterilizing the large build up of foreign exchange reserves and nominal exchange rate stability remains a key issue in the region. Against the background of continued strong capital inflows, greater exchange rate flexibility would be desirable from the perspective of short-run monetary management, as well as consistent with medium-term fundamentals.

In *Latin America*, growth in 2004 was the strongest since 1980. While the favorable external environment has supported activity, domestic demand is now leading growth. Looking forward, growth is expected to ease to a more sustainable pace in 2005, but the outlook is subject to a number of downside risks, including continued oil price volatility, a sharp rise in industrial country interest rates and an associated widening of emerging market spreads, or slower growth in industrial countries. Many governments have strengthened their fiscal positions, reduced public debt, and improved the structure of their debt. Public debt, however, remains high, and it is important to press ahead with further fiscal consolidation to improve public debt sustainability.

Central and eastern Europe last year enjoyed its strongest growth performance since the beginning of transition. Current account deficits have, however, widened as strong domestic demand boosted imports. Looking ahead, the pace of activity is expected to moderate as the cycle matures in central Europe and the Baltic states, and Turkey's growth returns to a more sustainable pace. Slower growth will help narrow current account deficits, but restraining credit growth and increasing private savings in the Baltic states and southern and southeastern Europe, and ambitious fiscal consolidation in central Europe, will be key to reducing vulnerabilities.

Growth in the *Commonwealth of Independent States* has remained very strong, underpinned by buoyant energy and metals prices and strong domestic demand, reinforced by regional linkages. Looking forward, while growth is expected to moderate this year to more

sustainable levels, the outlook remains favorable as external and commodity price developments are expected to remain supportive. Capacity constraints and inadequate investment, however, are beginning to have an effect, reinforcing the need to improve the investment climate and advance structural reforms. The key upside risk to the outlook is from a further rise in oil prices, while a sustained weakening in growth and investment in Russia poses a potential downside risk.

Sub-Saharan Africa witnessed its strongest growth in almost a decade in 2004, underpinned by the favorable global economic environment, improved domestic macroeconomic policies and progress with structural reforms, and the end of several protracted armed conflicts. Inflation, meanwhile, has declined to historical lows. Growth is expected to remain strong in 2005, although higher oil prices would adversely affect growth and the balance of payments in non-oil producing countries. A further important challenge for a number of countries will be adjusting to the elimination of world textile trade quotas. To sustain and further strengthen the recent growth performance, countries need to continue to deepen reforms by promoting private sector investment, developing infrastructure, and strengthening institutions.

Oil exporting countries in the *Middle East* have experienced a substantial increase in export earnings over the past two years, which together with sound financial policies and progress with structural reforms, has supported strong growth. Non-oil-producing countries in the region have benefited from the growth of the oil producing countries, and in some cases, the positive impact of domestic reforms. The outlook for the region remains positive, with further increases in oil prices presenting an upside risk to the outlook. On the downside, continuing geopolitical uncertainties could hurt growth. The prospect of a sustained period of high oil prices presents an important opportunity for oil exporting countries to press ahead with reforms to boost medium-term growth prospects, increase employment for the rapidly growing working age population, and reduce existing vulnerabilities.

Policy Priorities to Reduce Vulnerabilities and Strengthen Growth Potential

The global economy continues to grow at a brisk pace, and the main short-term policy challenge remains to manage the transition to higher interest rates. Policy interest rates are generally well below neutral levels, but given the divergences in economic cycles, the appropriate timing and pace of monetary tightening differs between countries. There is a strong case for monetary conditions to be tightened in China to prevent a resurgence of investment, while in the United States a measured pace of tightening remains appropriate for the time being. In Japan, in contrast, the quantitative easing policy should remain in place until deflation is firmly beaten; in the euro area, monetary policy should remain accommodative—and not rule out interest rate cuts—until a self-sustaining recovery is evident. In the event of further dollar depreciation, monetary policy should be increasingly differentiated, with an increasing bias toward tightening in the United States to restrain consumption and toward easing in countries with appreciating currencies. In emerging markets, the appropriate response varies, but in many cases greater flexibility in exchange rates will be necessary.

With the ongoing expansion and the positive outlook for the global economy, the policy priority must be to address key vulnerabilities and challenges to pave the way for strong and sustained growth over the medium term. Among the most important are:

- *Global imbalances have deepened, increasing the risk of abrupt changes in exchange rates and capital flows in the absence of credible measures to address the underlying causes of these imbalances going forward.* Projections based on current and expected policy settings suggest little improvement in external imbalances going forward, and although the current account deficit in the U.S. has been financed relatively smoothly thus far, a continuing rise in external liabilities will carry increasing risks. The strategy to address imbalances is widely agreed, namely fiscal consolidation in the United States, steps toward greater exchange rate flexibility, supported by continued financial sector reform in emerging Asia, and continued structural reforms to boost growth and domestic demand in Europe and Japan. These reforms are also essential to foster sustained medium-term growth in these regions. To date, however, implementation of these policies has lagged, and renewed reform efforts, including establishing clear policy details and implementation timetables, are needed across all countries. The pace at which oil-producing countries utilize their higher oil revenues will also play an important role in determining how global imbalances unwind.

- *Fiscal positions in many countries remain very difficult, posing a significant medium-term threat to macroeconomic stability.* In the largest industrial countries—except Canada—fiscal deficits remain high, while projected improvements are unambitious, and in many cases not underpinned by credible measures. In emerging markets, fiscal indicators have improved, but many countries have a long way to go to bring public debt ratios to sustainable levels. Despite some progress, most industrial and emerging market countries remain ill-prepared for coming pressures from aging populations, with health care systems in particular requiring greater attention.

- *Structural weaknesses constrain growth in key areas and increase vulnerabilities to shocks.* In both industrial and developing economies, structural reforms need to be advanced to remove rigidities and enable domestic economies to take full advantage of the opportunities provided by globalization and to make global growth more evenly balanced across the world. Challenges vary widely across regions, but include accelerating labor and product market reform in the euro area; addressing remaining corporate and financial sector weaknesses in Japan and much of emerging Asia; strengthening the investment climate in Latin America and sub-Saharan Africa; improving banking supervision in central and eastern Europe; and developing the institutional infrastructure for non-oil sector development in the Middle East.

- *Successful trade liberalization on the part of all countries under the Doha Round will be critical to support medium-term global growth.* Not only is trade openness beneficial for growth, but countries that are more open are also generally better able

to handle economic volatility. The urgent priority in this regard is to translate the mid-2004 framework agreements into a viable policy package to be taken up at the December 2005 WTO Ministerial Conference. While there has been considerable progress in agriculture, some key issues remain to be resolved, which would in turn facilitate more ambitious agreements in areas such as services, where progress has so far been slow.

- *Potential financial market risks need to be carefully monitored*. New and complex interlinkages between market participants underline the importance of understanding and monitoring how financial risks flow among market participants. For example, the risk profile of the household sector has changed as a result of the reallocation and improved management of financial risks by banks, insurance companies, and pension funds. This appears to have contributed to a greater resilience and stability of financial systems as a whole. However, the subsequent flow of risks to households and their ability to understand, absorb, and manage such risks needs to be carefully assessed.

- *Conditions in the oil market will likely remain tight for the foreseeable future, and consideration needs to be given to measures that could help minimize the volatility of oil prices*. Such measures include: steps to make the oil market work better, including strengthening transparency in the market by improving the quality of data on oil consumption, supply, and inventories; policies to reduce existing obstacles to investment in the oil sector, including to alleviate possible bottlenecks in the refining sector in oil consuming countries; increases in excess capacity and strategic reserves to provide a buffer against unexpected developments; and improvements in the efficiency with which oil is used.

Finally, the recent strong growth performance in emerging market and developing countries is welcome, but—with the exception of China and India—most countries are at risk of falling well short of the Millennium Development Goal targets. With macroeconomic stability generally achieved, the key challenge is to press ahead with policy and governance reforms to strengthen the investment environment and foster private sector-led growth. The global community, in turn, needs to support strengthened reform efforts with substantially increased and better coordinated financial assistance and by improving market access for developing countries, particularly for agricultural goods.

In sum, the current strength of the global economy provides a window of opportunity for policymakers to address the current challenges facing the global economy. It is vital that this opportunity is seized as needed policy measures will be more difficult to implement in a less supportive global environment.