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The global economy looks well set for continued strong growth over the next two years, albeit at a somewhat slower pace than in 2006. The U.S. economy has slowed, but is expected to gradually regain momentum based on the assessment that the drag from the housing market will fade and that strong corporate balance sheets and high profitability will underpin a pickup in corporate investment after its recent softness. In the euro area and Japan, growth has gained momentum and is expected to remain robust, underpinned by strong domestic demand, while in Japan activity has regained traction after hitting a soft patch in the middle of 2006. In emerging market and developing countries, rapid growth is being led by expansions in China and India, although momentum is being sustained across other regions as well, with many countries benefiting from continued high commodity prices, generally supportive financial conditions, and sound policy frameworks.

Inflation pressures have moderated since the third quarter of 2006 following the decline in oil prices. In the United States, the Federal Reserve has kept the Federal Funds rate on hold since June 2006, seeking to balance risks from a cooling economy and concerns that core inflation remains above the implicit comfort zone. The European Central Bank and other central banks in Europe have continued to remove monetary accommodation in the context of strong economic growth. The Bank of Japan has raised its policy interest rate only very gradually since exiting its zero interest rate policy. Some emerging market countries—including China, India, and Turkey—have also tightened monetary policy.

Expectations of continued solid economic growth and fading inflation concerns have contributed to buoyant global financial market conditions. Although financial volatility has increased from historically low levels since February 2007, most equity markets remain close to all-time highs, and real long-term bond yields are below long-term trends. Moreover, despite increasing difficulties in the U.S. subprime mortgage market, risk spreads generally remain narrow in most markets. Capital flows to emerging markets were maintained at high levels in 2006 as a whole, with Asia and emerging Europe continuing to attract a large share of the inflows.

Several advanced economies saw a further improvement in their fiscal positions in 2006. Budget deficits were reduced substantially in Germany, Japan, and the United States, although fiscal gains largely reflected strong growth of tax revenues in the cyclical upswing.

Over the past six months, there has been some welcome movement toward containing global imbalances. The U.S. dollar exchange rate has depreciated in real effective terms, there has been some increased flexibility in the currencies of surplus countries in Asia, oil prices have fallen, and a more balanced pattern of domestic demand growth has emerged across the global economy, including a rapid increase in spending in oil exporting countries in the Middle East. The U.S. non-oil trade deficit was reduced as a percent of GDP in 2006.
as exports accelerated, while U.S. net external liabilities are estimated to have again declined modestly. Nevertheless, despite this progress, global imbalances are still expected to remain wide in the years ahead.

Short-Term Prospects

Global growth is expected to moderate to 4.9 percent in 2007 and 2008, around ½ percentage point less than in 2006. The risks around this central outlook seem generally less threatening than at the time of the September 2006 World Economic Outlook, as a decline in oil prices since last August and generally favorable global financial conditions have helped to limit spillovers from the correction in the U.S. housing market and to contain inflation pressures. Nevertheless, recent events have underlined that risks to the outlook remain tilted to the downside. Particular concerns include the potential for a sharper slowdown in the United States if the housing sector continues to deteriorate and business investment weakens further; the risk of a deeper retrenchment from risky assets if global financial market volatility were to increase further; the possibility that inflation pressures may 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.

While global financial stability remains underpinned by the favorable economic outlook, some market developments warrant attention. The rapid deterioration in the U.S. subprime mortgage market has imposed losses on financial institutions most closely involved in this market and raised concerns as to the extent to which lax lending and underwriting standards may have occurred in other credit markets. A weakening of credit discipline may also have been a factor behind the recent rapid increase in leveraged buyouts. More broadly, the environment of low volatility and low interest rates has encouraged increased use of financial leverage. The unwinding of carry trades during the recent period of higher market volatility highlights the vulnerability of some emerging market countries that rely heavily on portfolio inflows to finance large current account deficits. While the recent correction seems now to have run its course and most markets are returning to their previous trajectories, these events are a reminder of the vulnerabilities and risks associated with a sudden increase in financial market volatility.

Turning to individual countries and regions, the pace of expansion in the United States has slowed noticeably over the past year. While private consumption has continued to grow robustly, the housing sector has been a substantial drag on growth. Business investment has also softened recently, although underlying corporate finances remain solid. Real GDP growth is expected to come down to 2.2 percent this year, from 3.3 percent in 2006, although the economy should regain some momentum during the course of the year as the drag from the housing sector gradually dissipates and corporate investment picks up after its recent softness. Risks to the outlook appear on the downside, with weaker than expected residential and business investment the most likely sources of additional headwinds to growth in the near term, particularly if the deterioration in credit quality in the sub-prime mortgage market were to undermine credit availability more broadly and slow consumption growth.
In the *euro area*, growth accelerated to 2.6 percent in 2006, its fastest pace in six years. Domestic demand was boosted by increasing business confidence, improving labor markets, and strong credit growth, as well as special factors—including the bringing forward of consumption ahead of the VAT increase in Germany in January 2007. Growth is projected to moderate to 2.3 percent in 2007 and 2008, reflecting the continued gradual withdrawal of monetary accommodation, further fiscal consolidation, and a smaller contribution from net exports. The risks to the outlook seem evenly balanced, with domestic risks on the upside, given strong confidence, rising housing prices, improving employment and productivity, and strong corporate profitability, but external risks on the downside.

*Japan’s* economy rebounded strongly in the fourth quarter of 2006, following a soft patch in the middle of the year. For the year as a whole, real GDP expanded at a somewhat above potential rate of 2.2 percent. The economy’s underlying momentum remains robust, and growth is expected to be maintained around 2¼ percent this year as a recovery in consumption largely offsets some slowing in exports. Risks to the outlook appear broadly balanced. On the upside, the strength of business sector indicators could translate into stronger than anticipated investment and hiring, but on the downside the underlying strength of consumer spending remains uncertain, while a sharper than expected slowing in the U.S. could weaken net exports.

Activity in *emerging Asia* continues to expand at a brisk pace, led by very strong growth in China and India. In China, real GDP expanded by 10.7 percent in 2006 on the strength of rapid investment and export growth, although the pace of fixed asset investment cooled in the second half of the year in response to monetary policy tightening. In India, real GDP growth of 9.2 percent was supported by the strength of consumption, investment, and exports. The resilience of external demand, particularly in the electronics sector, has supported overall economic activity in the newly industrialized economies (NIEs). The pace of expansion in the region is expected to ease modestly this year and next, reflecting some slowing in growth in China and India in response to policy tightening, and weaker growth among the NIEs as global demand for exports softens. A pickup in activity, however, is expected in the ASEAN-4 economies as the effects of earlier monetary tightening fade. Upside risks to the outlook include the possibility that the projected slowdowns in China and India do not materialize if recent monetary tightening proves less effective than expected. On the downside, a sharper than anticipated slowdown in the demand for exports in general, and electronics goods in particular, could undercut growth.

Growth in *Latin America* reached 5½ percent in 2006, supported by a strong external environment and sound domestic policies, but is expected to ease in 2007 and 2008 as global growth moderates and prices of oil and metals decline from 2006 record levels. Risks to the outlook at this stage are slanted to the downside. A sharper than expected slowing in the United States would hit Latin America harder than other regions, given the close trade and financial linkages, while a more pronounced decline in commodity prices or tighter financing conditions in international markets would also adversely affect growth prospects.

Growth in *Emerging Europe* accelerated to 6 percent in 2006 supported by rising exports and strong domestic demand, but current account deficits in a number of countries
remained large. The expansion is expected to slow moderately to 5½ percent in 2007, partly reflecting slower growth in western Europe. The principal downside risks to this continued strong performance are external. The region is vulnerable to both a marked deceleration in growth in western Europe and to a deterioration in global financial conditions that reduced investors’ willingness to continue financing its large current account deficits.

Economic activity in the Commonwealth of Independent States has continued to expand briskly, reflecting the solid performance of energy exporters and a pickup in activity among energy importers, many of whom have benefited from rising nonfuel commodity prices and strengthened domestic demand. Looking forward, real GDP growth is expected to moderate, but the pace is still expected to be second only to emerging Asia among the major regions. Tighter monetary policy, and in some cases greater exchange rate flexibility, is needed to contain inflationary pressures. Moreover, reforms aimed at attracting greater private investment are needed to diversify the sources of growth away from the export of primary commodities.

The short-term economic outlook in Africa remains positive against the backdrop of continued progress in cementing macroeconomic stability, the beneficial impact of debt relief, increased capital inflows, rising oil production in a number of countries, and strong world demand for nonfuel commodities. Real GDP growth is expected to accelerate from 5.5 percent in 2006 to 6.2 percent this year, before slowing to 5.8 percent in 2008. Despite this positive outlook, risks are tilted somewhat to the downside. In particular, a sharper-than-expected slowing in global growth would hurt the region, particularly through its impact on commodity prices. In order to maintain strong growth momentum over the medium term, sustaining the recent improvement in macroeconomic stability will be crucial, together with structural reforms to foster vibrant market-based economies.

Middle Eastern oil-exporters enjoyed another year of solid growth in 2006, accompanied by strong current account and fiscal balances, while growth also accelerated in non-oil-exporting countries in the region. The outlook is favorable, although growth is expected to moderate slightly this year. The region remains heavily dependent on the hydrocarbons sector, and rising populations continue to contribute to high unemployment and low employment-to-population ratios. In this context, it is crucial to foster greater private investment in the non-oil sector to balance the sources of growth and increase employment opportunities.

Policy Issues

The immediate challenge for policymakers is to continue to steer the global economy on a sustainable path that is consistent with low inflation as the expansion enters its fifth year. Early and decisive steps to begin to address a number of longer-term trends that could undermine the buoyant productivity that has underpinned recent strong growth are also warranted. Specifically, the most important challenges are:

- To ensure inflation remains well contained. The major central banks face distinct 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. The path of monetary policy going forward will depend on how incoming data affect the 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, a further interest rate increase to 4 percent by the summer would seem warranted. Beyond this, additional policy action could still be required if growth momentum remains above trend and risks to wages and prices intensify. In Japan, monetary accommodation should be removed only gradually and on the basis of evidence confirming the continuing strength of the expansion.

To ensure medium-term budget sustainability. In advanced economies, fiscal policy should be directed at achieving the necessary consolidation and reform to maintain viability in the face of aging populations and the potential budgetary costs of climate change, while allowing 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.

To maintain stable macroeconomic and financial conditions in emerging market and developing countries. Recent strong private capital inflows to emerging market and developing countries are welcome, although in some cases they have complicated macroeconomic management, by boosting liquidity and fueling rapid credit growth. Countries need to develop balanced and flexible approaches to macroeconomic management suitable for their circumstances, while avoiding steps that could undermine confidence in, or distort, markets. 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.

To ensure adequate monitoring of financial system risks. The persistence of low risk premia in the context of continuing global imbalances and growth uncertainty suggests the potential for risk to be under priced. Accordingly, policymakers need to monitor systemic vulnerabilities and be alert to the possibility of sudden price adjustments. Moreover, supervisors should ensure that systemically important financial intermediaries are maintaining credit discipline and appropriate risk management, particularly as regards their investment in the rapid growth areas of hedge fund activities, leveraged buyout activities, and structured credit products.

To sustain productivity growth. 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 enhancing alternatives to employer-based health care coverage to help increase labor mobility. 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. In commodity exporting countries, 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 serious impediments to long-term growth. More generally, strengthening institutions and improving the business environment will help to spur private activity and reduce reliance on commodity exports. Improved market access for exports, and delivery on aid commitments by advanced economies, will support reform efforts in developing countries.

- To further foster global trade integration. 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. A particular challenge in both advanced and developing countries 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.

- To help ensure a smooth unwinding of global imbalances. Important elements of the agreed approach—as discussed in the context of the Multilateral Consultations—include efforts to raise saving in the United States, including through continued fiscal consolidation and steps to reduce disincentives to private savings; advancing growth-enhancing reforms in the euro area and Japan; measures to boost consumption and increase upward exchange rate flexibility in emerging Asia, especially China; and continuing efforts to boost investment by oil exporters, especially in the Middle East, consistent with absorptive capacity constraints. While the necessary policy steps are in each country’s long-term self-interest, concurrent actions across a range of fronts would generate synergies, since adjustment that may bring some short-term costs or have distributional consequences should be easier to advance in an environment of continued global prosperity and one in which countries are seen to be acting together to achieve common goals.