Overview

CHAPTER • 1

The IMF's 2006 financial year (FY), the period covered by this *Annual Report*, was significant, as it marked an important turning point in the way the Fund carries out its mandate. The medium-term strategic review set in motion in 2004 by the Managing Director, Rodrigo de Rato, was completed and given broad endorsement by the Fund's Executive Board and subsequently by the ministerial-level International Monetary and Financial Committee (IMFC), which requested that the Fund move rapidly to implementation. As a result, the IMF embarked on some far-reaching changes in its operations and governance.

The subsequent chapters of this *Report* set out the Fund's work during FY2006 in detail. This introductory chapter is intended to provide a brief overview and to set the Fund's work—including the changes that have been taking place—in the context of global economic developments.

The world economy

Global economic growth reached 4.8 percent in 2005, its third successive year above 4 percent (Figure 1.1), in spite of high oil prices, natural disasters, and continuing geopolitical uncertainties. This expansion has been notable for its pace, duration, and increasing breadth—every region experienced rapid growth in the period covered by this *Report*. Emerging market economies grew particularly rapidly, supported by benign financial conditions, improved policy frameworks and, in many cases, high commodity prices. Developing countries also expanded solidly, with sub-Saharan Africa's growth rate exceeding 5 percent for the second consecutive year. The volume of global trade continued to expand rapidly. At the same time, current account imbalances in a number of key economies continued to widen (Figure 1.2). The current account deficit of the United States reached a record 7 percent of GDP in the final quarter of 2005, while oil exporters, Japan, a number of small industrial countries, China, and some other parts of emerging Asia continued to run substantial surpluses.

Growth in the *United States* remained strong in the second and third quarters of 2005. It slowed temporarily in the fourth quarter because of weak domestic demand—owing, in part, to high gasoline prices after Hurricane Katrina—but rebounded in the first quarter of 2006, with strong consumption and corporate investment compensating for a marked slowdown in residential investment.

Figure 1.1 Real GDP growth

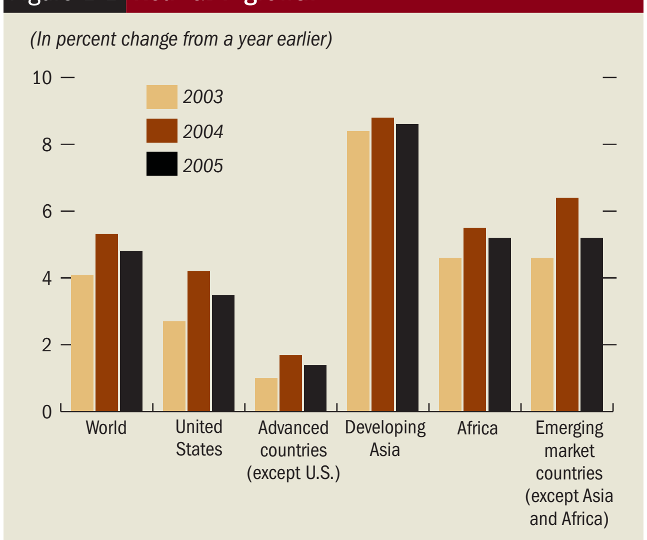
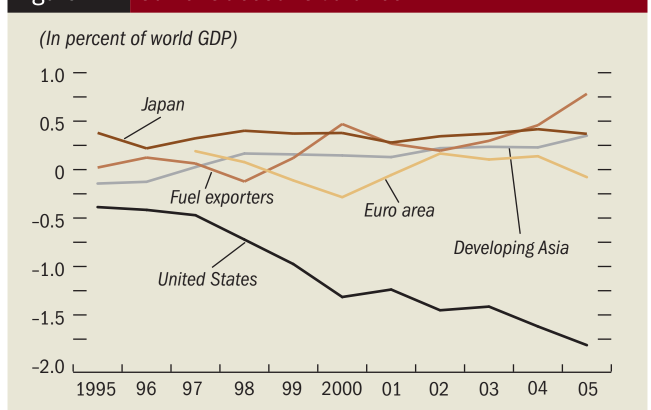


Figure 1.2 Current account balance



Growth in the *euro area* remained subdued throughout 2005. High-frequency indicators, however, suggest that an investment-led recovery may have gained traction in early 2006, especially in Germany.

Japan's economy expanded robustly during 2005. The recovery was increasingly driven by robust domestic demand, underpinned by rising employment, and buoyant corporate profits. Importantly, both consumer price inflation and bank credit growth turned positive at the turn of the year after a long period of contraction.

China's rapid expansion continued unabated; the growth rate was nearly 10 percent in 2005. Recent performance looked even more impressive after GDP data were revised, showing an increase in average annual growth of half a percentage point, to almost 10 percent, between 1993 and 2004. The expansion remained unbalanced, however, driven primarily by investment and net exports.

While the expansion in *Latin America* moderated somewhat in 2005 (to 4.3 percent from 5.6 percent), growth remained significantly above the long-term average, which is less than 3 percent. The region's two largest economies—Brazil and Mexico—accounted for most of the slowdown, owing to subdued investment in Brazil and the weaker performance of the agricultural and manufacturing sectors in Mexico. In contrast, growth remained solid or strengthened even further in Argentina, Paraguay, and Uruguay and in the Andean region, notwithstanding political uncertainties in some countries—notably Bolivia and Ecuador.

Growth in *emerging Asia* excluding China and India eased marginally during the period but remained very strong overall. In the newly industrialized economies (Hong Kong SAR, Korea, Singapore, and Taiwan Province of China), the slowdown was concentrated in the second quarter of 2005 when the information technology sector went through the final phase of a correction. Subsequently, growth accelerated again, supported by stronger investment in industrial countries. The ASEAN-4 economies (Indonesia, Malaysia, the Philippines, and Thailand) also recovered, in spite of periods of financial turbulence in Indonesia and political uncertainties in the Philippines and Thailand. Growth in India remained very rapid, with strong momentum in the manufacturing and services sectors. Although exports performed well, the current account moved into deficit in 2005, as strong domestic demand and high oil prices triggered a surge in imports.

Growth has moderated in *central and eastern Europe*, but there were important differences between subregions. Very rapid growth in the Baltic countries—almost 9 percent in 2005—contrasted with a more moderate pace of expansion in central and southeastern Europe. In spite of appreciating exchange rates, the region's average current account deficit fell modestly. In the Baltic countries and some southeastern European countries, current account deficits remained very high, however, driven by soaring private domestic demand and rapid credit growth. While a significant part of these deficits was financed by foreign direct investment, the share of debt financing has increased. In the *Commonwealth of Independent States,* growth decelerated in 2005. A sharp slowdown in Ukraine accounted for most of this, while growth in Russia was supported by high oil prices.

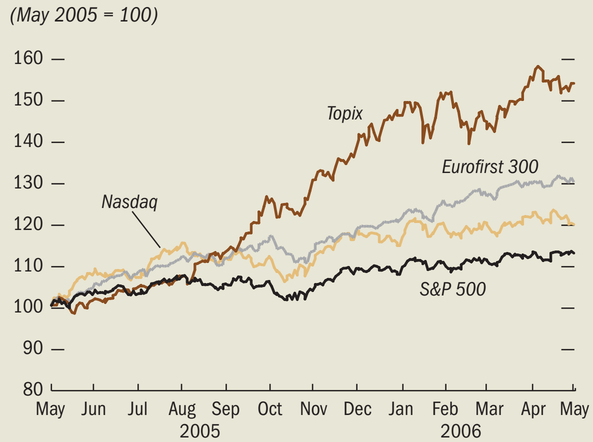
The *Middle East* benefited from rising oil prices. High receipts from oil exports fueled average growth of almost 6 percent and a current account surplus of almost 20 percent of GDP in the oil-exporting countries. Even though a large portion of the increase in oil revenues has been saved, domestic demand strengthened. Money and credit growth expanded sharply, and property and equity prices surged, although many stock markets in the region experienced significant corrections in the first quarter of 2006.

Economic activity in *Africa* continued to expand robustly, supported by generally higher commodity prices and the positive impact of reforms carried out in the 1990s. Some countries were adversely affected by the moderation of prices for food and agricultural raw materials, however, as well as by the removal of textile quotas.

Oil prices remained high and volatile during the period. They reached highs in August 2005 in the wake of hurricanes Katrina and Rita, and again in April 2006 because of geopolitical concerns related to Iran and threats to oil production in Nigeria. Nonfuel commodity prices, especially for metals, also rose strongly. The impact of rising commodity prices, as well as of closing output gaps, on *global inflation* remained surprisingly modest, however. Headline consumer price inflation picked up somewhat but core inflation remained constrained, and inflationary expectations were well under control.

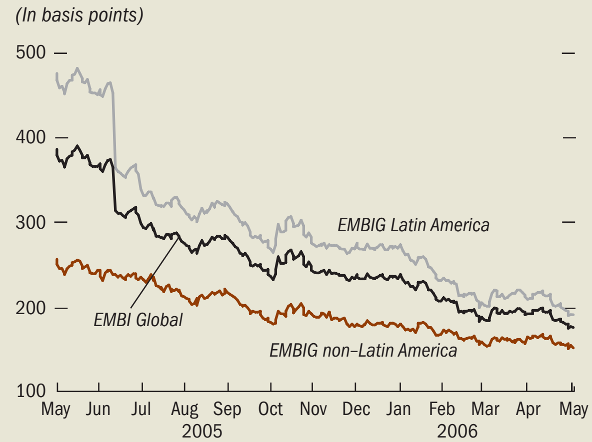
Monetary policies tightened in most industrial countries, starting to dry up some of the abundant global liquidity. The speed and timing of the tightening differed, however, reflecting the countries' different cyclical positions. In the United States, the Federal Reserve's tightening cycle con-

Figure 1.3 Equity market performance



Source: Bloomberg LP.

Figure 1.4 Sovereign spreads



Source: JPMorgan Emerging Markets Bond Index Global.

tinued, with the federal funds rate rising 175 basis points over the period. The European Central Bank began to raise interest rates at end-2005, and the Bank of Japan ended its longstanding policy of quantitative easing in March 2006, with markets anticipating policy rate hikes later in 2006. *Fiscal policies* were varied, but little progress was made in industrial countries outside Canada and Japan toward strengthening medium-term fiscal balances (and Japan's fiscal deficit remains very large).

Despite a growing U.S. current account deficit, the U.S. dollar appreciated somewhat in trade-weighted terms: a depreciation against emerging market currencies was offset by appreciations against the euro and the yen. The dollar remained well supported by continued strong foreign demand, including from oil exporters, for U.S. dollar financial assets (particularly bonds). However, toward the end of the financial year, the dollar began to weaken against other major currencies as it became evident that the yield advantages of dollar-based assets would start to narrow, and as the official sector raised concerns about the need for currency flexibility to help foster adjustment of global imbalances.

Conditions in mature and emerging financial markets remained favorable, supported by sustained and broadening global growth and subdued inflation. High liquidity, in turn, continued to foster a search for yield, notwithstanding the tightening by key central banks and signs that monetary policy would continue to firm. Long-term interest rates rose more modestly, leading to a marked flattening of yield curves, mainly in the United States. Long-term yields were also supported by high institutional investor demand for long-term fixed-income assets. Against this backdrop, financial market volatility, government bond yields in mature markets, and global credit spreads remained low by historical standards.

Global equity markets rallied as strong corporate profitability further strengthened balance sheets globally. In Japan, continuing signs of economic recovery saw the Nikkei index gain 53.6 percent during the financial year. European equities also made steady gains, rising 29.9 percent during the financial year while, in the United States, the S&P 500 rose 13.1 percent (Figure 1.3). Actual market volatility and the expected volatility implied in options prices stayed low. There were signs, particularly toward the end of the period, that the corporate credit cycle had begun to turn. Corporations started to draw down their ample cash balances and increase balance sheet leverage, taking advantage of relatively low long-term yields and spreads. Partly as a result, there was a surge in global mergers and acquisitions.

Emerging market economies continued to enjoy an exceptionally favorable economic and financing environment during the period. Solid global growth boosted export demand and commodity prices. Interest rates and credit spreads remained low, with spreads compressing even as yields in mature markets rose. With abundant liquidity continuing to spur a search for yield, investor appetite for new issues from emerging market borrowers was exceptionally strong. At the same time, the investor base for emerging market assets continued to expand, reflecting past outperformance and the improved credit quality of emerging market borrowers. The market was also supported by emerging economies' continuing active debt management aimed at reducing the vulnerability of their debt structure. The spread on the EMBIG index declined 205 basis points during the Fund's financial year, ending the period at a record low of 179 basis points (Figure 1.4). Emerging market bond issuance in the primary market reached record levels in 2005 and totaled some $28 billion in January–April 2006. Nearly one-half of total bond issuance during this period was from nonsovereign entities. Primary issuance of equities in emerging markets was also strong during the financial year and continued to be dominated by Asia, in particular, China.

Global economic risks

Although growth remained strong in 2005, risks to global growth continued to be slanted to the downside because of rising oil prices, continuing global payments imbalances, and other issues. The problem of global imbalances that was discussed in the *Annual Report 2005* continued to raise concerns about the sustainability of global growth. The difficulties in making progress in the Doha Round of multinational trade negotiations raised concerns that the benefits for the world economy of a successful and ambitious outcome to the negotiations would prove elusive. And there was increasing concern about the potential consequences for the global economy of a widespread outbreak of avian flu. These issues were the focus of attention both in the IMF's discussions with its individual member countries and in the Fund's multilateral surveillance work, as it assessed the possible global implications. The fact that these risks did not undermine global growth during the year did not alleviate concerns about them.

As global payments imbalances continued to widen during FY2006, discussions about ways to resolve them became more intense. Several factors account for the very large imbalances that were a feature of the global economy during the period covered by this report: low consumption and rising external current account surpluses in much of Asia; the large and growing U.S. current account deficit; sluggish growth in Europe; and rapidly increasing surpluses in the main oil-exporting countries.

For some years the IMF has argued that these imbalances were a global problem and that a multilateral response—a coordinated package of policies across the regions involved—would bring much larger gains than would be possible from unilateral actions. During FY2006 this view gained increasingly broad support, accompanied by growing consensus on the shape of the multilateral response that was needed. This would include increasing consumption and exchange rate flexibility in a number of countries with current account surpluses in emerging Asia; raising national saving in the United States, with measures to reduce the fiscal deficit and spur private saving; implementing structural reforms to increase flexibility and growth in the euro area and several other countries; undertaking fiscal consolidation and further structural reforms in Japan; and promoting the efficient absorption of higher oil revenues in oil-exporting countries with strong macroeconomic policies.

As the imbalances have grown so has the importance of developing a multilateral approach. Unilateral action by any one country or by one group of countries could have negative consequences for the rest of the world. Promoting a multilateral response therefore assumed a high priority for the Fund.

Prospects for a successful and ambitious outcome to the Doha Round also raised concerns, which intensified after the disappointing outcome of the World Trade Organization (WTO) Ministerial Meeting in Hong Kong SAR in December 2005. The Fund continued to support the WTO in its efforts to reach a satisfactory outcome to the negotiations, including through provision of strong support for the Aid for Trade initiative. A successful outcome to the Doha Round would greatly strengthen the multilateral trading system and so strengthen the prospects for global growth. Conversely, failure to reach an agreement, or an unambitious outcome, would act as a brake on global growth and could also fuel protectionist pressures that would further undermine growth prospects.

FY2006 saw much contingency planning for an outbreak of avian flu, with increasing concern about the impact on the world economy of such an outbreak. The IMF played an active role in this process (see Chapter 4).

A period of rapid global growth is perhaps naturally accompanied by concern about the factors that might undermine it. But a prolonged, rapid, and widespread global expansion, such as the one that continued in FY2006, also offers policymakers a rare opportunity to make current growth rates sustainable and to put in place the measures necessary to raise potential growth rates in the future. Fiscal policies that cut budget deficits and make possible countercyclical, supportive policy during downturns; measures to reduce public debt burdens; structural reforms that free up labor and product markets; and trade liberalization: all these are policies that will strengthen growth prospects and benefit industrial and developing countries alike.

Such policy actions can be implemented more readily during a period of expansion, when support is easier to marshal and policy measures can be planned more carefully and coherently. Deferring such actions until the economy is slowing and pressure for adjustment is more urgent can result in hastily implemented reforms that might not command widespread support or achieve their full potential. Moreover, taking preemptive policy action can make economies more resilient and so less vulnerable to global downturns in the first place. The greater the number of national economies that have implemented reforms raising their growth potential and reducing their vulnerabilities, the more moderate and short-lived any downturn at the global level, as well as at the country level, is likely to be.

The work of the Fund

This, then, was the global economic environment in which the IMF operated during FY2006: a period of remarkably resilient global expansion but one in which the downside risks to future growth increasingly engaged the attention of policymakers. As such it provided the Fund with an opportunity to sharpen the focus of its work and reorient its role in the modern global economy.

The Fund's principal duties are set out clearly in its Articles of Agreement: to promote macroeconomic and financial stability at the global and national levels; to promote international monetary cooperation in the interests of all its members; to foster a liberal system of trade and payments; to prevent international crises, as far as possible; and to help resolve balance of payments problems when they occur, including through the provision of temporary financial assistance.

During FY2006, the IMF continued to urge its member countries to adopt policies that would foster macroeconomic stability, raise growth and promote higher living standards, and help reduce poverty. Given the global environment, the Fund also made the case for preemptive action, to take full advantage of the window of opportunity presented by the expansion.

The Fund continued its efforts to help low-income countries achieve more rapid growth and poverty reduction, introducing a new facility to help low-income countries deal with exogenous shocks, and also a new Policy Support Instrument designed to help low-income countries that do not want or need financial support enjoy the benefits of IMF endorsement of their policy programs. In July 2005, the leaders of the G-8 countries proposed a Multilateral Debt Reduction Initiative, writing off the debts owed to international financial institutions by some of the poorest, most heavily indebted countries; and the IMF responded quickly, putting in place in January 2006 mechanisms to cancel the debts owed to it by 19 countries. The IMF also sought to play its role in helping low-income countries meet the Millennium Development Goals, particularly through its advice on macroeconomic policies, including policies appropriate in the context of the current scaling-up of aid (see Chapter 6).

With a continued absence of financial crises, enhancing the effectiveness of its surveillance work continued to be the principal challenge for the IMF. The Fund uses its surveillance role to advocate policies that would benefit individual member countries and the global economy. Chapter 3 provides a detailed overview of the Fund's surveillance work at the global, regional, and national levels. At the global level, the Fund uses channels such as its *World Economic Outlook* report and the *Global Financial Stability Report* to examine and highlight risks to continuing world economic growth and spillovers from the policies of individual countries on the rest of the world. At the regional level, the Fund began in September 2005 to publish *Regional Economic Outlook* reports to help disseminate its analysis of economic developments and policies in the major regions, including the lessons from experience of neighboring countries in dealing with shared challenges. At the national level, the main focus of surveillance work is usually the annual Article IV consultations with member countries.

IMF policy advice is based on the analysis of its staff, the institution's accumulated knowledge, and the lessons of the experience of its membership, all considered by the Executive Board. During FY2006, the focus in some countries was on macroeconomic stability; for others the emphasis was more on the structural reforms needed to strengthen growth and on longer-term issues such as the implications of demographic change. As always with surveillance work, the aim was to identify weaknesses and to use the Fund's unique cross-country expertise to identify and highlight effective reforms.

Although the Fund's mandate has remained essentially unchanged over the years, how it discharges its duties has changed over time, to adapt to changing global economic and financial circumstances. The history of the IMF is, in an important sense, one of adaptation, and the Fund needs regularly to review its work to ensure that it continues to be able to serve its purposes and its member countries as effectively as possible.

Recognizing this, in 2004 the Managing Director launched a major review of the Fund's strategic direction. The aim was to provide a framework for decision making for the IMF's medium-term budgetary framework and work program. The conclusions of the first stage of the review were presented in a report by the Managing Director on the Fund's Medium-Term Strategy (MTS), broadly endorsed by the Executive Board, to the IMFC at the IMF–World Bank Annual Meetings in September 2005. The IMFC endorsed the report, which recognized that the Fund must adapt itself further to the evolving needs of member countries and the international financial system as a whole in an era of rapid globalization.

Following the IMFC endorsement in September 2005, more detailed proposals for implementation of the MTS were developed, and the conclusions were presented in a second report by the Managing Director to the IMFC, at its April 2006 meeting, as endorsed by the Executive Board. The report stated that to achieve its medium-term objectives, the Fund needs to strengthen its surveillance work, adapt its lending instruments to the changing needs of its members, help them build institutional capacity and improve governance, strengthen the governance of the Fund itself, and improve the efficiency of the IMF's internal operations.

In the area of surveillance, building on a broad consensus among the membership about the need for a coordinated, multilateral response to address key global issues (such as current global imbalances), the MTS proposed a system of multilateral consultations to address them. At its Spring Meeting in April 2006, the IMFC not only endorsed this approach but also agreed that the first multilateral consultations should be focused on the issue of global imbalances.[1] The Managing Director was charged with reporting on progress on this issue to the September 2006 Annual Meetings in Singapore.

[1]See Press Release No. 06/118 at *www.imf.org/external/np/sec/pr/2006/pr06118.htm.*

In the area of IMF governance, the IMFC at its April 2006 meeting also agreed that the Managing Director should prepare detailed proposals for the reform of country representation in the IMF, including IMF quotas, in order that these better reflect the changing structure of the world economy, including the increased role in the world economy of a number of emerging market economies, especially in Asia, that have grown rapidly in recent years. On this issue, too, the Managing Director was called on to report back to the IMFC in September 2006.

The MTS envisages a number of other reforms also, including in the way the Fund conducts its internal business. Key to these changes is a switch to a medium-term budgetary framework on a three-year cycle. The Fund is also examining ways of streamlining its internal work procedures, for example by reducing its paper flow. It completed a fundamental review of its staff employment and compensation framework during FY2006, and the conclusions of that review are presented in Chapter 9 of this *Report*. The MTS is covered in detail in Chapter 2.

The prolonged global economic expansion brought other challenges for the Fund. The absence of financial crises in recent years is, of course, an unambiguously positive development—attributable partly to policy improvements in recent years, at the national and international levels, to which the Fund has contributed. This does not mean that crises will not erupt in the future. But the benign global economic environment, as noted, enables member countries and the Fund itself to press ahead with further measures that can mitigate the impact of any future crises and reduce the vulnerability of the international economy as a whole.

At the same time, the IMF now has fewer borrowers and less lending outstanding than it has had for many years. During FY2006 both the Brazilian and the Argentine governments repaid their loan obligations to the Fund ahead of schedule, reflecting the significant progress made in achieving macroeconomic stability and growth. The decline in Fund lending has important implications for the Fund's operating income and points to a need to review the IMF's financing structure, in light of the changed global environment. At the end of FY2006 it was announced that the Fund would undertake such a review, with the help of a committee of eminent persons, to be completed during FY2007 (see Chapter 8).

The *Annual Report 2005* described a year of intense reflection for the Fund on its role and operations. FY2006 was a year of decision on its Medium-Term Strategy, with the Fund beginning to implement the conclusions of its strategic review. As the world economy continues to evolve, the IMF will have to be ready to adapt further, in ways that cannot yet be foreseen. One aim of the MTS is to put the Fund in a position to identify changing priorities and redeploy resources more effectively in the future. In this way, the IMF can continue to play the central role in maintaining international financial stability and the promotion of global growth that has always been its mission.