ANNEX

IMF EXECUTIVE BOARD DISCUSSION OF THE OUTLOOK, SEPTEMBER 2008

The following remarks by the Acting Chair were made at the conclusion of the Executive Board's discussion of the World Economic Outlook *on September 19, 2008.*[1]

Global Prospects and Policies

Executive Directors noted that, after a four-year expansion, the world economy is slowing rapidly, buffeted by many forces, notably a deep financial crisis, a housing downturn in a number of advanced economies, and a surge in commodity prices until recent months. Many advanced economies are close to recession, and emerging economies are also generally decelerating. Looking ahead, Directors agreed that continuing strained financial conditions will weigh heavily on global growth prospects. With credit defaults still on the rise, pressures on financial institutions' capital positions will remain exceptionally high. The necessary process of deleveraging will therefore be difficult and protracted, and credit availability will be very tight. Directors underscored the unusual uncertainties in the global outlook and the difficulty of predicting the severity of the slowdown. Nevertheless, assuming that the many public initiatives under way are successful in lowering financial market strains and rebuilding confidence, it is the IMF staff view that the still relatively sound nonfinancial corporate balance sheets in advanced economies and resilient domestic demand in emerging economies should support the beginning of a global economic recovery later in 2009, as the effects of the commodity price shocks unwind and housing activity in the United States stabilizes.

[1]The IMF staff provided an informal briefing to the Executive Board on October 3, 2008, on the revisions to the *World Economic Outlook* made in light of the developments in global financial markets and commodity markets since the Executive Board discussion of September 19, and this summing up reflects the updates provided and the ensuing discussion at that time.

Directors noted that the uncertainty surrounding the economic outlook is exceptionally large, with risks clearly to the downside. The principal risk relates to the potential for a further deterioration in financial conditions and more protracted balance-sheet adjustments. Directors acknowledged that, as the events of recent weeks demonstrate, the financial crisis has not yet run its full course, and other major disturbances may still lie ahead. Risks of an intensified negative feedback loop between the financial system and the real sectors of advanced economies have risen, as have the risks of stronger spillovers to emerging markets. A further marked weakening of commodity prices could pose a downside risk to already slowing growth in several commodity-exporting emerging economies.

Directors underscored the complex challenges facing policymakers at this juncture in light of the uncertain outlook and the financial turmoil. First and foremost, policymakers in the advanced economies will need to address stresses in financial markets in a coherent and consistent manner, while adjusting macroeconomic policies with a view to striking the right balance between supporting growth and combating inflation. The financial authorities should continue to give priority to stabilizing financial conditions, including guarding against systemic failures through liquidity provision and prompt intervention when needed, while also being mindful of the need to avoid moral hazard. This likely will require broad and well-coordinated policy actions. On monetary policy, given tight credit conditions, growing unemployment fears, subdued wage growth, and still-well-anchored inflation expectations, the IMF staff sees scope for easing in advanced economies with relatively higher real rates of interest. A number of other Directors, however, favored a cautious approach to easing, pointing to the risks of second-round effects from the recent increases in inflation and the challenge of ensuring that expectations remain well anchored. On fiscal policy, Directors welcomed the timely support being provided to a number of economies. However, they recalled the importance of medium-term consolidation and thus suggested that further fiscal initiatives should be limited to dealing with financial problems as needed.

In the wake of recent commodity price declines and the projected slowdown in global activity, Directors expected headline inflation to moderate in emerging and developing economies. This means that macroeconomic policies could stay on hold in an increasing number of these economies, or even ease if the outlook threatened to deteriorate further. In other economies, many Directors observed that underlying inflation pressures remain an issue. They observed that these economies face greater risks of second-round effects than advanced economies, owing to the higher share of food and fuel in consumption baskets and low spare capacity. Many Directors therefore considered that policymakers in these countries should lean toward tightening the overall stance of macroeconomic policies. Additionally, these Directors underscored that monetary policy should take the lead role in short-term stabilization in economies with inflation targeting and flexible exchange rate management, while recognizing that country circumstances differ and that open capital markets can pose special challenges in these cases. They recognized the challenges facing countries with heavily managed exchange rate regimes that are now in effect importing an accommodative monetary policy stance from the United States, while still experiencing strong growth and current account surpluses. A number of Directors observed that more flexible exchange rates would help in some cases by providing scope for adjusting monetary conditions and fostering a rebalancing of demand in their economies. Several other Directors stressed that the choice of the exchange rate regime depends on broader considerations, and that in the countries with fixed exchange rates, fiscal policy would have to take the lead in relieving any excess demand pressures that threaten the viability of the peg. Several Directors argued that more monetary and fiscal tightening may not be needed, as headline inflation is likely to moderate in the near term and a slowing global economy would alleviate overheating concerns.

Advanced Economies

Although the U.S. economy continued to grow at a moderate pace in the first half of 2008, Directors agreed that activity is likely to slow appreciably in the second half. Given the exceptionally unsettled financial market conditions, most Directors expected a prolonged period of very low growth, followed by a gradual recovery that would begin later in 2009. The pickup would be driven by a turnaround in private consumption and residential investment as commodity and housing prices stabilize, although financial conditions are expected to remain tight. Directors expected underlying price pressures to be contained as economic slack rises in the coming months.

Against this background, Directors acknowledged that the U.S. authorities' accommodative monetary policy thus far has provided support to the economy in the face of financial stress and the continuing housing correction. They thought that further easing should not be ruled out in view of the deteriorating outlook. By the same token, once economic recovery gains traction and financial conditions stabilize, policies should shift toward a less supportive stance. The fiscal stimulus package has also provided a useful and timely boost to activity. However, given long-term fiscal challenges, further policy initiatives should be focused on providing support for the banking and housing sectors as needed to maintain stability. Directors welcomed the recent intervention in government-sponsored enterprises (GSEs) as an important step to ensure the continued availability of housing financing, while stressing the need for fundamental GSE reform over the medium run. More broadly, they welcomed the authorities' recent additional efforts to ensure an orderly resolution of the ongoing crisis, while remaining mindful of the need to contain moral hazard.

Directors observed that western European economies have slowed considerably. Higher oil and food prices have undercut real disposable incomes, while tighter financial conditions have raised the costs of household mortgages and slowed investment. In some countries, particularly the United Kingdom and Spain, weak housing has weighed heavily on economic activity. Although European banks entered the turmoil from a position of strength, they have been exposed in varying degrees to losses on their holdings of U.S. mortgage-related assets, tightening liquidity conditions, and deteriorating credit quality. As in the United States, financial institutions have been shaken by recent events, with some requiring public support. Given the need for further deleveraging to rebuild confidence, Directors thought that overall credit conditions will likely remain tight for some time. Growth is expected to remain weak for a prolonged period of time before starting to recover gradually later in 2009, as credit markets and commodity prices stabilize and confidence is restored.

With the prospect of a further weakening of economic activity and generally well-anchored inflationary expectations, as well as high risk premiums, many Directors considered that inflation pressures would subside over the near term, providing scope to ease monetary policies. Underscoring the benefits of rules-based policies and the medium-term need for consolidation, Directors encouraged firm adherence to national and EU fiscal policy frameworks, which would generally weigh against fiscal stimulus packages, unless downside risks materialize. Furthermore, a decisive commitment to concerted action with respect to addressing growing financial sector strains would go a long way toward restoring more orderly conditions in financial markets.

Directors observed that the near-term outlook for Japan has deteriorated. Although financial conditions have tightened to a lesser extent than in other major economies owing to the lower exposure of Japanese banks to securitized products, Directors expected that high food and fuel prices and weaker external growth would weigh on consumer and business activity. Most Directors considered that, with the economy weakening and underlying price pressures well contained, the monetary stance should remain accommodative. For fiscal policy, the priority remains medium-term consolidation owing to a rapidly aging population and rising public debt—although automatic stabilizers could be allowed to operate in the event of a sharp downturn.

Emerging and Developing Economies

Growth of emerging Asian economies is expected to moderate over the near term, but to remain around trend in many cases. However, Directors emphasized the increasing risk that growth could slow more markedly owing to intensified financial market stress and a sharper-than-anticipated slowdown in trading partner countries. On the other hand, in some countries inflation could remain at elevated levels, despite the recent easing in commodity prices, as spare capacity has largely been eroded. Thus, countries' policies need to be tailored to their particular circumstances, which are diverse. Most Directors were of the view that countries with heavily managed exchange rate regimes would benefit from shifting to more flexible exchange rate management that would provide more scope for monetary adjustment and foster global rebalancing. At the same time, Directors underscored that global rebalancing would require a mix of appropriate and complementary policies and could not be left solely to adjustments in exchange rates. Fiscal restraint could help reduce inflation concerns, while continued efforts at fiscal consolidation remain an important priority for other countries in the region.

Directors observed that Latin American economies face a challenging combination of slowing activity, volatile financial conditions, and still-elevated inflation pressures. While acknowledging growing downside risks to growth, largely reflecting external factors, many Directors stressed that the priority for policies in a number of countries remains to quell the surge of inflation. While tightening has occurred, notably in countries with inflation-targeting regimes, more action will likely be needed in some countries where real interest rates have become significantly negative and policy credibility is being eroded. Shifts in international oil and food prices should be allowed to pass through to the domestic market, using targeted programs to protect the poor.

Directors noted that, after a prolonged economic expansion, activity in emerging Europe has started to moderate, with the Baltic countries undergoing sharp corrections as earlier booms have started to unwind. Some countries with large current account deficits could be vulnerable to a reversal of capital inflows. Containing inflation pressures also remains a concern, particularly in southeastern European economies. This underlines the importance of macroeconomic policies that steer economies toward a "soft landing," as well as of prudential and regulatory policies to contain balance sheet vulnerabilities.

Real GDP growth remains strong in the Commonwealth of Independent States, underpinned by terms-of-trade gains and expansionary macroeconomic policies, although external conditions are becoming more noticeably difficult for several countries. Directors agreed that stronger policy action is needed in many countries in the region to rein in rising inflation pressures and address external pressures. A comprehensive policy response would require a combination of monetary tightening and greater exchange rate flexibility, combined with a prudent fiscal stance. Over the longer term, Directors emphasized that the region should continue to reduce its vulnerability to commodity price shifts through diversification of the economy away from primary commodities.

Directors were encouraged that growth in sub-Saharan Africa is expected to show resilience to the global slowdown, but expressed concern about the impact of the recent surge in food and fuel prices on poverty and about risks of a lower pace of financing and investment inflows. The oil-exporting countries in this region face the challenge of managing the windfall gains from high commodity prices. A number of oil-importing countries, where the negative terms-of-trade shock has weakened fiscal and external positions, will need to tighten their macroeconomic policies, while stepped-up donor support will be essential to help low-income countries cope with high commodity prices.

Directors observed that activity in the Middle East continues to grow at a robust pace, supported by higher oil prices, an improving business environment, and a buildup in government spending in oil-exporting countries. Inflation pressures either remain high or have risen considerably. Directors recommended focusing public spending on infrastructure to address supply bottlenecks, while some cautioned that rising inflation pressures may require exercising greater restraint over current spending to counterbalance strong private demand growth. A few Directors suggested that some countries should consider moving away from U.S. currency pegs. At the same time, Directors emphasized the need to continue strengthening macroeconomic policy frameworks and pursuing structural reforms that are key to the region's medium-term prospects. Financial sector reforms would be important to develop financial systems that can support high and sustained growth and more independent monetary policy.

Other Issues

Regarding the strains in financial markets, Directors emphasized that the immediate tasks are to safeguard financial stability, restore healthy financial balance sheets by encouraging the rebuilding of capital bases, and guard against systemic failures through liquidity provision and intervention as needed. They emphasized that this would require broad and well-coordinated policy action. Over a longer horizon, determined efforts will be needed to build firmer underpinnings for financial intermediation, learning lessons from the weaknesses revealed by the present period of turbulence. Central objectives include ensuring more effective and resilient risk management by individual institutions, developing new securitization techniques to improve incentives, and strengthening accounting and credit ratings systems to raise transparency. Another important task will be to strengthen approaches to crisis management and resolution, including clarifying roles of different official agencies, bolstering deposit insurance schemes, and ensuring adequate intervention instruments, while taking care to avoid exacerbating moral hazard. In many of these areas, but particularly for the purpose of preventing, managing, and resolving financial stress, coordination across national boundaries will be crucial, given the ever-larger international integration of financial institutions and markets.

Directors generally saw merit in giving consideration to introducing a macroeconomic element in the financial prudential framework to weigh against the inherent procyclicality of credit creation. Many Directors saw merit in the possibility of extending monetary policy frameworks to provide for "leaning against the wind" of asset price movements. However, a number of other Directors pointed to the complexities that this involves and questioned the potential benefits.

Directors emphasized that joint multilateral efforts will be crucial to relieve strains in commodity and financial markets in a lasting way. Many Directors agreed with the IMF staff's analysis in Chapter 3, which finds little concrete evidence that rising investor interest in commodities as an alternative asset or speculation has had a systematic or lasting impact on prices, although swings in market sentiment may have contributed to short-term price dynamics. Some Directors, however, had further questions and requested additional analysis, based on data refinements. Directors considered that the focus should be on policies to encourage stronger supply and demand responses to improve market balances, while avoiding measures that could exacerbate market tightness in the short term.

Directors stressed that the multilateral strategy endorsed by the IMFC in 2005 and elaborated by the Multilateral Consultation on Global Imbalances in 2006 and 2007 remains relevant but should be applied flexibly. In this context, they acknowledged that the issues related to global imbalances are shifting. U.S. fiscal consolidation remains a key medium-term objective, but countercyclical fiscal stimulus and public support for the housing and financial sectors have been warranted to alleviate the current slowdown and stabilize markets. For their part, the euro area and Japan should press ahead with product and labor market reforms to raise potential growth in their economies. China needs to build on the progress in boosting domestic demand and continue to contribute to addressing global imbalances. The recent increase in surpluses of Middle Eastern oil exporters is an inevitable counterpart of higher oil prices, given absorptive capacity constraints, and it appears that the recycling of surpluses to importing economies has generally worked well so far. Nevertheless, it will be important to ensure a transparent and open environment for capital flows, including through finalizing a set of good practices for sovereign wealth funds. IMF staff analysis shows that there has been further—albeit uneven—progress toward realignment of major world currencies. The real effective exchange rate of the U.S. dollar is now judged to have moved broadly into line with medium-run fundamentals, and this should help lower the U.S. current account deficit. However, the dollar realignment is mostly attributable to the depreciation against the euro rather than against the currencies of major current account surplus countries. Also, the real effective exchange rate of the euro remains on the strong side of fundamentals. Directors noted the IMF staff's assessment that China's exchange rate is still substantially undervalued. At this juncture, it is important to resist protectionist pressures and to make progress toward multilateral trade liberalization by unblocking the Doha Round.