ANNEX

IMF EXECUTIVE BOARD DISCUSSION OF THE OUTLOOK, AUGUST 2006

The following remarks by the Acting Chair were made at the conclusion of the Executive Board's discussion of the World Economic Outlook *on August 23, 2006.*

Executive Directors welcomed the continued strong, broad-based global expansion. They noted that during the first half of 2006, activity in most regions met or exceeded expectations. Among the advanced economies, growth was particularly strong in the United States in the first quarter, activity in the euro area gathered momentum, and the expansion in Japan remained on track. Directors were pleased that growth performance in emerging market and other developing countries remained robust despite more testing conditions in global financial markets.

Looking forward, Directors considered that the strong global expansion is likely to continue in 2007, with a better balanced composition of demand across the major advanced economies. Directors saw some upside potential to the outlook from even more rapid growth in emerging market economies, notably China, and the possibility of stronger-than-expected investment in a number of advanced economies. Overall, however, Directors felt that the risks to the forecast are clearly tilted to the downside, with the weight of such risks having risen compared to the *World Economic Outlook* in April 2006.

Directors identified a number of downside risks facing the global economy going forward. These include the possibility that a continued buildup of inflationary pressures in advanced economies might require a more aggressive monetary policy response; the continued potential for supply-side shocks in the oil and nonfuel commodity markets; the risk of a more abrupt slowdown in housing markets in advanced economies, notably the United States; and the possibility of weaker-than-expected growth in private consumption in Europe and Japan, due to slow productivity growth and labor market rigidities. Directors believed that a smooth, market-led unwinding of the large global imbalances remains the most likely outcome, but that the risk of a more disorderly resolution of these imbalances cannot be ruled out.

Advanced Economies

Directors noted that the pace of expansion in the United States has moderated after exceptionally strong growth in the first quarter of 2006. Risks to the outlook appear to be slanted to the downside, with a more abrupt cooling of the housing market being a particular concern. Directors observed that the Federal Reserve is faced by the difficult situation of rising core inflation and inflation expectations in the context of a slowing economy. In light of this, the policy stance going forward should depend on the evolving balance between the competing risks to growth and inflation; given the importance of keeping inflation expectations in check, further interest rate increases should not be ruled out. The better-than-expected fiscal performance in FY2006 is encouraging, although the permanence of the recent unexpected revenue buoyancy is not yet established. Directors welcomed the authorities' intention to halve the Federal deficit a year ahead of schedule, by FY2008, while observing that a more ambitious deficit reduction path would provide a firmer basis for the United States to face future demographic pressures, put the budget in a stronger position to respond to future economic downturns, and help reduce global imbalances.

Action to ensure fiscal sustainability should include measures to contain growth in entitlement spending, notably Social Security and Medicare/Medicaid.

Directors welcomed the acceleration in real GDP growth in the euro area in the first half of the year, and noted that prospects for a sustained, more robust, expansion have consolidated. They considered the risks to the outlook to be broadly balanced, with the upside potential arising from strong corporate positions offsetting the downside risks related to higher energy prices, elevated house prices in a number of countries, and the possibility of a sharp appreciation of the euro against the background of the large global imbalances. Directors anticipated a need for some further monetary policy tightening in the euro area if the expansion develops as expected but felt that—with inflation pressures broadly contained for now—interest rate increases could be gradual, especially in view of the downside risks. Directors emphasized that, given the importance of ensuring that the current cyclical upswing is translated into a sustained and long-lasting expansion, priority should be given to further reforms to promote greater competition in goods and service markets, more flexible labor markets, and increased cross-border financial sector integration. The need for further reductions in fiscal deficits was also underscored. Directors stressed that the credibility of medium-term budget targets would be strengthened by welfare, pension, and healthcare reforms, as well as reductions in the government wage bill that would provide much needed room to cut taxes on labor.

Directors welcomed the ongoing expansion in Japan, noting that final domestic demand is being supported by buoyant investment underpinned by robust profits and a turnaround in bank credit. They viewed the normalization of monetary policy as the key near-term macroeconomic policy challenge. They considered that—with the risk of accelerating inflation low and the costs of a reemergence of deflation high—further interest rate increases should be gradual. Directors underscored that further substantial fiscal adjustment is needed to ensure sustainable public finances and meet pressures from an aging population. Given this, while current budget plans aim to eliminate the primary deficit by 2011, some additional adjustment would be warranted to stabilize net government debt by the end of this period.

Directors welcomed staff's analysis of how differences across financial systems might affect economic cycles in advanced countries, while emphasizing that the findings should be seen as tentative. Directors broadly agreed that the recent trend away from bank- and relationship-based systems toward more arm's length financial systems, where securities markets play a greater role, is likely to continue given technological innovations and the removal of regulatory barriers. At the same time, they noted that important differences in financial systems across countries remain. They concurred that in more arm's length systems, households may be able to better smooth consumption in response to changes in income, but that their spending may be more sensitive to changes in asset prices. Corporate investment appears to react more smoothly to cyclical downturns in relationship-based systems, but arm's length systems seem better at reallocating resources in response to structural changes. They emphasized that supervisory and regulatory policies will need to keep up with the changes, while macroeconomic policy management will need to adapt to variations in cyclical behavior.

Emerging Market and Other Developing Countries

Directors agreed that the most immediate policy priority for emerging market and developing economies is the continued implementation of policies to reduce vulnerabilities and sustain the current strong growth momentum. They noted that emerging market economies remain susceptible to rising interest rates and reduced liquidity in global financial markets. Countries at risk include those with weak public sector balance sheets, large current account deficits, and less well anchored inflation expectations. In this regard, Directors viewed the increasing reliance by a number of emerging European countries on private debt flows to finance large current account deficits as a source of concern. They also emphasized that emerging market and developing economies should continue to advance market-oriented reforms, particularly by reducing barriers to competition, in order to create the climate for vigorous private sector-led growth.

Directors observed that sharply rising prices of nonfuel commodities, particularly metals, had underpinned strong growth in many emerging market and other developing countries. Most Directors noted staff findings that speculative activity had not been a significant driver leading commodity price movements. Looking forward, Directors advised that current revenue windfalls should be saved or invested to support future growth in noncommodity sectors, rather than be used to increase spending in areas that would be difficult to reverse later.

Directors welcomed the strong growth performance of the economies in emerging Asia, noting that much of the momentum is due to vibrant expansions in China and India. Nevertheless, some Directors expressed concern that the exceptionally rapid growth in fixed investment in China could lead to overheating of the economy and a boom-bust cycle. While most countries have succeeded in restraining core inflation with quite small increases in nominal policy rates, Directors noted the need to stand ready to increase policy rates further, if needed. Directors observed that, while increased exchange rate flexibility in some countries had helped to achieve a better balance between domestically and externally led growth, China's current account surplus continued to rise in 2005 and the first half of 2006. Most Directors called for greater flexibility of the renminbi, which would help to relieve overheating concerns and encourage a more balanced composition of demand. The move toward greater exchange rate flexibility should be supported by a continuation of complementary financial sector reforms, which, together with reforms to the pension, health, and education systems, would also help to foster a shift toward consumption.

Directors broadly agreed that the remarkable growth performance of many countries in Asia holds important lessons for less advanced developing countries. They welcomed staff's analysis of growth in Asia, and concurred with the finding that the favorable policy environment in the region has been the key to strong total factor productivity growth and rapid accumulation of physical and human capital. Directors considered that prospects for sustaining strong growth in Asia in the future will be strengthened by continued progress in trade liberalization, improving access to education, and steps to promote financial development and encourage entrepreneurship. These would facilitate the ongoing shift of resources out of agriculture and into industry and services. Efforts to boost productivity growth and increase competition in industry, and particularly the relatively more sheltered services sector, will also pay important dividends.

The economic expansion in Latin America gathered momentum in the first half of this year, underpinned by high prices for key commodities, declining interest rates, and a pick up in public spending, while inflation largely remained subdued. Directors expressed satisfaction that the region's expansionary momentum was largely unaffected by the increased financial market volatility during the spring of 2006, as higher reserve cushions, more flexible exchange rate management, and improved fiscal indicators reduced vulnerabilities. Nevertheless, they advised countries in the region to continue preparing for the possibility of more testing financial market conditions, with disciplined fiscal policy at the core of such efforts. Directors noted that the region remains the slowest growing among the emerging market and developing countries, and emphasized the importance of unlocking Latin America's growth potential. This will depend on extending market-based reforms, while taking steps to ensure that benefits of growth are broadly shared.

The economic expansion remains robust in emerging Europe, mainly driven by buoyant domestic demand, underpinned by increasing net capital inflows and credit growth. Directors expected continued solid growth in the region but were concerned by the heavy reliance on foreign savings and the substantial fraction of bank lending that is in foreign currency, while recognizing that generally large current account deficits reflect, in part, favorable investment opportunities in the context of EU accession and integration. Against this background, they agreed that growth opportunities provided by foreign savings must be carefully balanced against risks, and that reducing vulnerabilities is a broad priority in the region. With most countries in the region aiming for euro adoption in the medium term, adequate preparation is needed for the loss of monetary policy autonomy and to establish the capacity to achieve external adjustment in the absence of nominal exchange rate flexibility.

Directors observed that activity in the Commonwealth of Independent States has been buoyant, given high commodity prices and support from capital inflows, and that growth prospects are generally positive. Directors noted that care should be taken to avoid undue further increases in consumption and to preserve competitiveness. Inflationary pressures might become entrenched, particularly in countries with limited possibilities for sterilization. Directors suggested that the real effective appreciation would better be achieved by allowing the nominal exchange rate to appreciate. They also stressed the importance of structural reforms to improve the investment climate and avoid the emergence or aggravation of supply bottlenecks.

Directors welcomed sub-Saharan Africa's strongest economic expansion since the early 1970s. While growth is expected to remain high, the persistence of elevated oil prices could have a detrimental impact on growth in oil-importing countries, particularly if combined with a sharp decline in non-oil commodity prices. Against such risks, the challenge is to continue adjusting to high oil prices, including by passing on increases in international oil prices to domestic energy prices. Directors emphasized that sub-Saharan Africa's growth performance, while improved, still falls short of the 7 percent annual growth needed to meet the Millennium Development Goal of halving poverty by 2015. Continued support from the international community, including through debt relief, making good on recent commitments to further boost aid, and bold market opening initiatives, will accordingly be crucial to promoting private sector investment and employment.

Oil revenues in the Middle East rose further in the first half of 2006, and oil-exporting countries continued to enjoy robust growth, combined with rising external current account and fiscal surpluses. Looking forward, Directors expected the outlook for the region to remain favorable, given prospects for high oil prices, although geopolitical risks remain a concern. Directors observed that most oil exporting countries have appropriately begun to use the opportunity provided by higher revenues to increase spending to address long-standing structural problems. They felt that, at the current juncture, there is scope for this buildup of spending, given high unemployment in many countries and still low inflation. Nevertheless, they cautioned that with credit growing rapidly, the risks of overheating need to be carefully monitored, and underscored that higher expenditures should be accompanied by determined efforts at capacity-enhancing reforms to ensure the proper use of funds and lasting supply-side benefits. Directors emphasized that policymakers throughout the region should be mindful of prudential risks in the financial sector, given rapid credit growth, rising financial sector exposure to asset price corrections, and a possible deterioration in credit quality.

Multilateral Issues

Against the background of important downside risks to the global outlook, Directors underscored that policymakers across the world share a responsibility for maintaining the foundations for strong global growth. In this regard, they emphasized that the risks of a disorderly adjustment of the existing large global imbalances will be considerably reduced by sustained policy actions across the major economies, particularly steps to boost national saving in the United States, including through fiscal consolidation; greater progress on structural reforms in Europe and Japan; reforms to boost domestic demand in emerging Asia (consumption in China, investment elsewhere) together with greater exchange rate flexibility; and increased spending in oil-producing countries, particularly in the Middle East where a large buildup is already in train, consistent with absorptive capacity constraints and cyclical considerations. Directors noted that a multilateral approach will enhance the prospect that possible risks associated with individual actions will be alleviated by simultaneous policy initiatives elsewhere. In this respect, Directors considered that the present multilateral consultation by the Fund could contribute to this process.

Directors expressed disappointment about the apparent deadlock in the Doha Round, and emphasized that trade liberalization on a nondiscriminatory basis remains the best way to open up new global growth opportunities. The threat of protectionist pressures will need to be firmly resisted, with all member countries stepping up efforts to reinvigorate the process of multilateral trade liberalization. Directors considered that high and volatile prices in world energy markets remain a major concern that will require sustained efforts from all sides to address. Increased investment is needed to build up adequate production and refining capacity, while appropriate incentives for consumers would encourage improved energy conservation.