ANNEX

IMF EXECUTIVE BOARD DISCUSSION OF THE OUTLOOK, MARCH 2007

The following remarks by the Acting Chair were made at the conclusion of the Executive Board's discussion of the World Economic Outlook *on March 26, 2007.*

Executive Directors welcomed the continued strong, broad-based expansion of the global economy during 2006, and noted that activity in most regions met or exceeded expectations. Looking forward, Directors believed that the global expansion would slow only modestly in 2007 and 2008 and inflationary pressures would remain contained. Directors noted that the composition of demand is expected to be more balanced among the major advanced economies in 2007, with the United States, the euro area, and Japan all expanding slightly above 2 percent. Directors also saw continued strong, albeit somewhat less rapid, growth among emerging market and developing countries.

Risks around this central scenario appear to be more evenly balanced than at the time of the last *World Economic Outlook* (WEO) discussion in September 2006, but still tilted to the downside. In this context, Directors generally were of the view that the recent market turbulence represented a correction after a period of asset price buoyancy that does not require a fundamental revision in the positive global economic outlook. Some Directors were less sanguine about the risks to the outlook, pointing to heightened concerns about the stability of financial markets, slowing productivity and its implications for growth, and continuing uncertainties regarding oil and other commodity price developments. All Directors underscored the need for continued vigilance.

Directors discussed the downside risks facing the global economy. Most emphasized that the ongoing correction in the U.S. housing market could have a growing impact on the broader economy. Directors underscored that persistently higher financial market volatility could prompt a further retrenchment from riskier assets and markets—with several noting the potential for increased market volatility—and called for careful monitoring of market developments. Directors also recognized the possibility that inflationary pressures could revive as resource utilization constraints start to bind, and stressed the risk of a reversal of the recent decline in oil prices—given continuing geopolitical tensions and limited spare production capacity. They also noted continued risks that the existing large global imbalances could unwind in a disorderly way.

Directors considered that a key question in assessing risks to the outlook relates to the extent to which the world economy will remain on a sound growth trajectory even if the U.S. economy slows more sharply—or whether global prospects may decouple from the United States, especially in light of the limited impact of the recent cooling of U.S. activity. In this context, Directors welcomed the staff's analysis of cross-country growth spillovers, and attributed the limited global impact so far to several factors. In particular, the U.S. slowdown has been focused on the housing sector, which has a relatively low import content. Also, the causes of the slowing have been specific to the U.S. economy, rather than a common event simultaneously affecting many countries. Nevertheless, a number of Directors observed that the greater integration fostered by globalization has increased the potential magnitude of spillovers, and that a sharp further slowing in the U.S. economy would likely have a substantial impact on global growth. Directors recognized, however, that the strength of spillovers experienced by individual countries would vary both with the extent of their trade and financial linkages with the United States and with the degree of domestic vulnerabilities.

Advanced Economies

Directors noted that the U.S. economy has slowed noticeably over the past year, largely owing to the correction in the housing sector, while private consumption has so far remained robust. Nevertheless, activity in the United States is expected to regain momentum in the period ahead with growth rates rising during the course of 2007 and returning to potential in 2008. Directors expressed concern, however, about the recent evidence of intensifying difficulties in the subprime mortgage market, which could start to impose a broader drag on the economy, particularly if the housing downturn deepens and credit standards are tightened more generally. In this vein, some Directors considered that the impact of the weakening housing sector may not yet have played out fully, and that a deeper-than-anticipated downturn in the United States should not be ruled out. Although inflationary pressures have eased somewhat following the decline in oil prices from last year's highs, core inflation remains elevated. Directors supported the Federal Reserve's approach in recent months of holding the policy rate steady, while appreciating that the Fed stands ready to respond to shifts in the balance of risks between growth and inflation. Directors welcomed the indications that the FY2008 budget will seek to balance the federal budget by FY2012, while expressing a preference for the more ambitious target of aiming to achieve balance excluding the social security surplus. Fiscal consolidation will need to be supported by reforms to put the Social Security, Medicare, and Medicaid systems on a sustainable long-term footing.

Directors welcomed the acceleration in real GDP growth in the euro area in 2006, and saw the risks to the outlook as evenly balanced. They considered that further cautious withdrawal of monetary accommodation by the European Central Bank would be warranted to forestall inflationary pressures, contingent on the recovery progressing as expected. Directors welcomed the progress made toward needed fiscal consolidation, but felt that more ambitious efforts are warranted given the strong cyclical upswing and the looming pressures from the aging of the population. Directors also underscored the importance of further policy reforms under the Lisbon agenda to bolster prospects for a sustained long-term expansion, particularly steps to boost productivity and increase labor utilization. Recent experience has also underlined the importance of complementary product and services market reforms to foster job creation and expenditure-based fiscal consolidation.

Directors welcomed the emergence of the Japanese economy from its mid-2006 soft patch. With inflation still close to zero, Directors generally supported the Bank of Japan's cautious approach to raising interest rates since exiting its zero interest rate policy last year, and suggested that monetary accommodation should be removed only if the expansion remains strong, and then only gradually. Directors suggested that greater clarity regarding the Bank of Japan's medium-term inflation goals would also help to anchor private sector expectations, while reducing risks of an abrupt unwinding of yen carry trades with sharp movements in exchange rates or the volume of capital flows. Fiscal consolidation appears to be running ahead of the government's plans to achieve a primary surplus by FY2011, but additional fiscal efforts beyond those contained in the current medium-term plan will be needed to put net debt on a declining trajectory. Further progress on structural reforms will also be important to enhance growth with spillover benefits to the world economy.

Emerging Market and Other Developing Countries

Directors welcomed the strong performance of the economies in emerging Asia, with the vibrant expansions in China and India leading the way. Most Directors were confident that the region is well positioned to withstand a U.S. slowdown, although some others cautioned that spillovers could still be sizable, as growing intraregional trade in part represents shipments of intermediate goods ultimately destined for the United States. Against the background of widening current account surpluses in some countries in the region, Directors took note of the differing degrees of exchange rate flexibility observed within the region. Many Directors considered that greater flexibility of the renminbi would help provide a more secure base for monetary policy management in China, while also helping to contain China's widening current account surplus.

Directors observed that growth in Latin America exceeded 5 percent in 2006, supported by a strong external environment and generally sound economic policies. Although the pace of growth is likely to ease somewhat in the next two years, Directors commented that strengthened fundamentals and improved macroeconomic policy frameworks should enable countries in Latin America to maintain growth rates even in the face of a sharper-than-expected U.S. slowdown. Nevertheless, the region remains vulnerable to a softening of commodity prices, which would pose policy challenges in several countries by putting pressure on current account and fiscal balances. Directors also noted that fiscal reforms will be important to create more room for increased spending on well-targeted social programs. Reforms to improve the region's disappointing productivity performance are also a priority.

Directors welcomed the strong growth in emerging Europe, noting that the expansion is likely to moderate in 2007 in response to slower growth in western Europe. While the widening current account deficits should be comfortably financed in most countries, Directors cautioned that a deterioration in global financial conditions could reduce capital inflows in the future. Directors also drew attention to the slowing pace of reform among the new European Union members, which again underscores the importance of structural reforms to facilitate continuing smooth convergence within the European Union.

Directors observed that economic activity in the Commonwealth of Independent States has continued to be boosted by high commodity prices, and growth prospects appear generally positive. They expressed concern that strong capital inflows and robust domestic demand growth, driven in part by large public spending increases that have outpaced revenue growth, have kept inflation high in many countries. Consequently, Directors saw a need for greater spending restraint as well as for tighter monetary policy and, in some cases, greater exchange rate flexibility, to contain inflationary pressures. Sustaining the recent strong growth momentum will also require reforms aimed at attracting greater private investment to diversify the sources of growth away from the export of primary commodities.

While recognizing the variety of challenges facing countries in sub-Saharan Africa, Directors welcomed the continued strong expansion seen in the region as a whole, as well as the prospects for a further acceleration in growth in 2007. At the same time, Directors highlighted the vulnerabilities of the non-oil-exporting economies in the region to commodity price shocks or further increases in oil prices. Sustained macroeconomic stability and structural reforms will be necessary to foster vibrant market-based economies and sustain the recent improvement in the region's growth performance. Directors underscored that most countries in the region would benefit from further trade liberalization, improved market access for their exports, and delivery on aid commitments by advanced economies to support progress toward achieving the Millennium Development Goals. Measures to strengthen institutions and the business environment will also help spur private sector activity, and reduce the region's still-high reliance on commodity exports.

In the context of continued high oil prices, Middle Eastern oil exporters enjoyed another year of solid growth, accompanied by strong current account and fiscal balances. Directors viewed the outlook for the region as a whole as favorable, and welcomed the public investment plans among the GCC countries. Nonetheless, the region remains heavily dependent on the hydrocarbon sector, while rising populations are contributing to high unemployment rates. In this context, Directors underscored the importance of fostering greater private investment in the non-oil sector in order to balance the sources of growth and increase employment opportunities. Also important will be measures to improve the business environment and adapt education systems to align the skills mix of the labor force with the needs of the private sector. In the non-oil-exporting countries of the Mashreq region, growth accelerated in 2006 in the context of an upturn in foreign direct investment and the overall favorable external environment.

Directors noted that many emerging market and developing countries around the world face the challenge of taking advantage of strong capital inflows to support investment, while avoiding large swings in competitiveness and a buildup of balance sheet vulnerabilities. Noting that there is no simple recipe that can be uniformly applied, Directors highlighted the importance of balanced and flexible approaches to macroeconomic management that suit the circumstances of each country, while avoiding steps that could undermine confidence or distort markets. Several Directors also recognized that even countries with credible policy frameworks and strong institutions and financial systems may be vulnerable to large and volatile capital flows, and could benefit from Fund advice on policy options tailored to their circumstances in the context of Article IV consultations.

Multilateral Issues

Underscoring the shared responsibility among policymakers for maintaining the foundations for strong global growth, Directors emphasized the importance of policy actions across key countries to support the smooth unwinding of large global imbalances. Important elements of such an approach include efforts to raise national saving in the United States, including through further fiscal consolidation; advancing growth-enhancing reforms in the euro area; further structural reforms, including fiscal consolidation, in Japan; and initiatives to encourage consumption and greater exchange rate flexibility in some parts of emerging Asia, especially China. Directors were of the view that lower oil prices and increased spending would reduce external surpluses among Middle Eastern oil exporters, but saw scope for continuing to boost spending—subject to absorptive capacity constraints. A few Directors also considered that an increase in energy taxation in the United States could help reduce the country's high levels of oil consumption, thereby contributing to a reduction in global imbalances as well as to reducing environmental consequences. In this context, Directors took note of the U.S. administration's recently announced objective of curbing gasoline consumption.

Directors took note of the staff's analysis—based on historical episodes of reversals of current account imbalances and a closer look at U.S. trade behavior—that real exchange rates can play a potentially important role in the adjustment process in countries with large and persistent current account surpluses and deficits. However, they emphasized that exchange rate changes, while supportive of adjustment, must be accompanied by policy actions to rebalance domestic demand. In this vein, several Directors considered that the analysis usefully complements earlier WEO studies on the importance of domestic policy adjustments and exchange rate movements in the resolution of imbalances. Directors generally acknowledged that a shared willingness of authorities across key regions to allow real exchange rates to adjust—particularly where they are not freely floating—could prove to be a crucial ingredient of policies to promote a smooth resolution of the large global imbalances. While the staff's analysis suggests that the U.S. trade deficit could be more responsive to real exchange rate changes than is commonly found in the macroeconomic literature, many Directors were not convinced by this finding and felt that additional research and analysis in this area, using alternative methodologies, should be undertaken before firm conclusions can be drawn. Some other Directors emphasized, however, that the staff's finding is an important result.

Directors welcomed the staff's analysis on how the rapid growth of international trade and the introduction of new technologies are beginning to forge an increasingly integrated global labor market. This integration is contributing to growth and incomes in both source and host countries, but at the same time it is affecting distributional outcomes and may thus be contributing indirectly to protectionist sentiment. Steps to do more to help those who are adversely affected by developments in technology and trade should include better education systems, more flexible labor markets, and welfare systems that cushion the impact of—but do not obstruct—economic change.

Directors welcomed the revival of the Doha Round of multilateral trade negotiations. A successful outcome would, by further strengthening multilateral rules and reducing the risks of protectionism, boost medium-term global prospects. Prospects for 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.