ANNEX

IMF EXECUTIVE BOARD DISCUSSION OF THE OUTLOOK, AUGUST 2011

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 31, 2011*

Executive Directors observed that global economic activity has weakened and become more uneven across countries, financial volatility has risen, and downside risks have increased sharply. These developments are largely symptomatic of limited progress by key advanced economies in eliminating sovereign and financial sector imbalances to facilitate a shift from public to private demand. Meanwhile, rebalancing from external to domestic demand in key emerging market economies still has a long way to go. The global recovery has been further impeded by unexpected shocks, including supply disruptions from the earthquake and tsunami in Japan, the surge in oil prices, and political unrest in the Middle East and North Africa region. While the impact of these shocks will gradually fade, the fundamental real and financial weaknesses will remain in the absence of decisive and increasingly urgent policy responses.

Directors noted that, in most advanced economies with crisis legacies—such as overleveraged household and financial sectors and overstretched public balances—real GDP growth and employment are anemic, and ongoing fiscal withdrawal will continue to weigh on demand. In others, activity is more robust. In emerging market and developing economies, growth remains strong but will likely moderate from last year given lackluster activity in the major advanced economies and greater financial tensions. Overheating pressures have been building until recently, amid strong growth in credit and asset prices, widening current account imbalances, and resilient capital flows. Meanwhile, many developing and low-income countries remain vulnerable to high and volatile levels of food and fuel prices.

Directors stressed that the foremost priority for key advanced economies is to address sovereign and banking sector fragilities, which pose significant downside risks to the global outlook. In the euro area, it is imperative to repair and reform financial markets and institutions, further boost bank capital where needed, and implement the commitments made at the July 2011 EU Summit. Over the medium term, stronger euro area governance and progress toward a more integrated economic union remain important priorities. In the United States and Japan, political commitment to a well-paced, credible fiscal consolidation plan is an urgent priority, and renewed action to revive the U.S. housing market is also crucial. In general, fiscal policies need to strike the right balance between restoring medium-term public debt sustainability and limiting short-term deleterious effects on growth, taking care to maintain the credibility of fiscal policies. The policy response will vary by country but will likely require consolidation through entitlement and tax reforms and accelerated structural reforms to boost jobs, competitiveness, and potential output. Fiscal plans that credibly achieve medium-term fiscal sustainability could provide the needed policy room to support the near-term recovery, reducing reliance on monetary policy and its spillover effects.

Directors generally agreed that, given the tepid recovery in key advanced economies and growing downside risks, monetary policy should continue to be highly accommodative for the foreseeable future. A number of Directors saw limited scope for additional monetary support, including through unconventional measures, noting risks of distorting incentives and resource allocation. Directors stressed the need for continued progress in financial sector supervision and macroprudential policies to contain risks of excessive leverage emanating from a prolonged period of low interest rates.

Directors stressed that emerging market and developing economies should continue to strengthen fiscal positions to address fiscal risks and rebuild policy room, fend off excessive reliance on capital inflows, and alleviate the burden on monetary policy. At the same time, fiscal consolidation should protect infrastructure and social spending, thereby sustaining medium-term growth prospects and protecting the poor. Economies with strong public sector balance sheets could postpone adjustment if external downside risks threaten to materialize.

Directors noted that the monetary policy needs differ across emerging market and developing economies. The monetary tightening phase should continue in countries with increasing signs of overheating risks. In other economies, given the unusual uncertainty in the global environment, policymakers could consider a cautious approach to slowing the pace of monetary tightening while being watchful of financial stability risks, including from a potential reversal in capital flows.

Directors underscored the importance of maintaining vigilance against potential financial risks in light of past or continued capital flows and strong credit growth in some emerging market economies. Further efforts are necessary to enhance financial sector regulation, including by widening the perimeter of supervision to include nonbank intermediation and use of macroprudential measures to limit risk taking. In economies with persistently large current account surpluses, greater exchange rate flexibility—complemented with structural reforms—is key to dampening inflation pressures, fostering a balanced expansion, and facilitating global rebalancing over the medium term.

Directors emphasized that the escalation of global uncertainty even after three years since the onset of the global crisis is a reminder that the fundamental problems that caused the crisis remain largely unaddressed, while new risks have built up. The policy room to respond to potential exigencies has further narrowed. A renewed spirit of international policy cooperation is needed to advance internal and global demand rebalancing in a more meaningful way, as well as to resist trade protectionism. Without this, strong global growth and financial stability will remain elusive for years to come.