International Monetary and Financial Committee

Twelfth Meeting
September 24, 2005

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Statement by IMF Managing Director, Rodrigo de Rato to the International Monetary and Financial Committee on the Global Economy and Financial Markets

The global expansion remains solid, with global growth forecasts for 2005 and 2006 largely unchanged from the last *World Economic Outlook*. However, widening global imbalances and the continuing pressures in crude oil and refined product markets remain central concerns, and risks are still slanted to the downside.

Since we last met, there have been two key developments.

- *Oil prices have continued their ascent*, hitting a new nominal high of some $65 per barrel in late August, before falling back somewhat thereafter. Despite the recent OPEC quota increase, markets remain concerned that the current very low spare production capacity will be insufficient to meet demand growth next winter, while short-term supply uncertainties have persisted. While the impact of Hurricane Katrina on crude oil prices has been contained by releases from strategic reserves, as well as an offer by OPEC to boost crude production if needed, shortages in refining capacity have added to pressures on refined product prices, particularly in the United States.

- *Global imbalances have continued to rise*, with the U.S. current account deficit now projected at over 6 percent of GDP in 2005. On the surplus side, the key counterparts remain Japan, China, the Middle East oil exporters—which as a result of soaring oil prices are now running a larger surplus in U.S. dollar terms than emerging Asia—and Russia. Partly linked, the regional composition of global growth remains unbalanced, with the expansion continuing to be led by the robust momentum in the United States and China.

Global headline inflation has picked up slightly in response to higher oil prices, but remains at moderate levels. Among the major industrial countries, core inflation appears generally contained, inflationary expectations are well-anchored, and wage increases are moderate, although the impact of higher oil prices will need to be carefully watched. In emerging market countries, inflationary pressures have risen somewhat more, with forecasts for 2005 revised upward in most regions. With inflationary expectations in these countries generally less well anchored, the impact of oil price or other shocks on inflation is inevitably more pronounced; in addition, signs of overheating pressures in some countries with large external surpluses are increasingly emerging.

Financial conditions remain favorable, with long run interest rates and credit premia unusually low, and volatility subdued. The prevailing calm reflects, in part, improved fundamentals, including solid growth, low inflation, and strengthened balance sheets of the financial and corporate sectors of most countries. However, it also reflects the influence of abundant liquidity, which continues to foster a search for yield that bids down risk premia

across asset classes, which in turn encourages various forms of leverage to enhance returns. Low interest rates in the United States, and the U.S. dollar, have in part been sustained by foreign investors, who have remained net purchasers of substantial volumes of U.S. securities.

Emerging market economies have benefited from the search for yield and improving economic fundamentals in many countries, which have encouraged increases in strategic allocations from institutional investors such as pension funds. These flows have helped stabilize emerging bond markets in the face of disturbances in corporate debt and credit derivative markets in industrial countries, difficult political environments in several emerging market countries, and sharp rises in oil prices. Most emerging market countries have completed their 2005 external borrowing requirements, and several have begun, or in a few cases even completed, their 2006 requirements. In addition, in a number of countries, improvements in the debt structure and development of local debt markets have also contributed to reducing vulnerabilities to external shocks.

Short-Term Prospects

The short-term outlook remains for a generally solid expansion, with global growth expected to average 4.3 percent in 2005 and 2006. Within this, global growth is expected to slow somewhat through early 2006, picking up modestly thereafter, with the adverse impact of higher oil prices offset by still accommodative macroeconomic policies, benign financial market conditions, especially low long-term interest rates, and increasingly solid corporate balance sheets. The risks, however, remain to the downside. Beyond geopolitical risks, underscored once again by the tragic events in London in July, the key short-term concerns include high and volatile oil prices; rising protectionist sentiment, fuelled by global imbalances and growing fears of emerging market competition; and the possibility of a tightening in financial market conditions, including its potential impact on richly-valued property markets in a number of countries and on emerging markets' external financing.

Turning to individual countries and regions, GDP growth in the *United States* has eased moderately, but remains strong, and is projected to remain the highest in the G-7 countries, underpinned by solid productivity growth. Despite the appalling loss of life and property from Hurricane Katrina, the direct impact on GDP growth is likely to be moderate. However, the indirect effects—particularly as a result of higher gasoline prices—are more of a concern; with household savings at record lows, this increases the risk of a sharp slowing in private consumption growth, especially if the housing market, which is becoming increasingly richly valued, were to weaken.

In the *euro area*, the tentative recovery in domestic demand in the second half of 2004 has slowed considerably, with real GDP growth forecasts for 2005 and 2006 marked down significantly. Nevertheless, favorable fundamentals—including continued wage moderation, accommodative financial conditions, and buoyant external demand—remain in place for the recovery in domestic demand to continue. Indeed, incoming data suggests that activity should gradually regain momentum, although oil price developments remain a

concern. The pace of recovery, however, is expected to remain modest, and a priority must be placed on implementing structural reforms to boost confidence, growth and employment.

Japan's economy is regaining momentum, with strong GDP growth in the first half of 2005. The expansion is now driven by solid private consumption growth, reflecting the strengthening of labor market conditions, and buoyant business investment on the back of high corporate profitability. GDP growth is now expected to average about 2 percent in both 2005 and 2006. Downside risks come primarily from external factors, including high oil prices and the possibility of renewed upward pressures on the yen in an environment of large global current account imbalances.

Growth prospects for *emerging market and developing countries* in aggregate have remained broadly unchanged, but regional and individual forecasts have changed substantially, reflecting the differences in the impact of oil and other commodity price changes, the exposure to global manufacturing and trade, as well as country-specific factors.

In *emerging Asia*, GDP growth in China has continued to exceed expectations; with substantial liquidity remaining in the banking system, risks of a rebound in credit and investment growth remain a concern. Growth in India has also been robust with the continued expansion in services, including information technology, and accelerating industrial production. Elsewhere in the region, after a slow first quarter, GDP growth is projected to pick up in line with global manufacturing, although this will depend on the expected rebound in the information technology sector, as well as oil prices. A key challenge facing the region remains to achieve an appropriate balance between growth in domestic and external demand; in this connection, the scope for greater exchange rate flexibility afforded by recent welcome exchange rate reforms in some countries should be fully utilized. With the exception of China, the low level of private investment in the region is a concern, and underscores the need to complete the unfinished reform agenda in financial and corporate sector restructuring. In contrast, in China, the central challenge is to improve the quality of investment to sustain growth over the medium-term.

After a strong rebound in 2004, GDP growth in *Latin America* has moderated to a more sustainable pace. Strong export growth and improved macroeconomic policy performance should help sustain the regional expansion going forward. The widespread prefinancing of forthcoming debt repayments will help reduce the risk of financial market volatility in response to current political uncertainties and forthcoming elections in many countries, but some downside risks remain, including a prolonged slowing of industrial country growth or a sharper-than-expected rise in interest rates in industrial countries.

In *emerging Europe,* growth remains strong despite the weakening momentum in Western Europe, regional currency appreciation during 2004, and a moderation in domestic demand after a surge in the run-up to EU accession. With rising oil prices and weaker prospects for the euro area, risks are slanted to the downside, although overheating remains a concern in some countries, given the combination of exceptionally strong credit growth, surging property prices, and large external current account deficits. The rapid domestic credit

growth is now largely being financed by bank borrowing from abroad, thereby increasing economies' vulnerability to exchange rate movements, and measures to reduce the risks associated with the pace of credit growth are critical. More generally, fiscal consolidation is needed to manage demand pressures, contribute to a reduction in the large current account deficits, and pave the way for adoption of the euro.

In the *Commonwealth of Independent States* (CIS), real GDP growth slowed noticeably in early 2005, primarily reflecting sluggish investment and lower growth in oil production. However, consumption growth generally remained buoyant, and with production close to capacity in some sectors, regional inflation has picked up after a long period of disinflation. Looking forward, near-term risks to growth are likely to be on the upside, given the outlook for oil and other commodities, and inflationary pressures are rising. Given the opportunities provided by rising budget surpluses in oil-exporting countries, the appropriate policy mix would include a combination of tighter monetary policy and greater exchange rate appreciation to keep inflation in check, which, depending on absorptive capacity and progress with structural reforms, could provide some room to increase high-priority expenditure and implement tax reforms.

GDP growth in *sub-Saharan Africa* is forecast to moderate to 4¾ percent in 2005, partly reflecting a slowdown in Nigeria as oil production nears capacity. Growth in oil-importing countries, while slowing, has so far held up surprisingly well, with the adverse impact of higher oil prices so far offset by stronger non-oil commodity prices, as well as the benefits of improved macroeconomic stability and ongoing structural reforms. Looking forward, GDP growth is projected to rebound to about 6 percent in 2006, led by surging growth in oil producers as new capacity comes on stream. However, with oil prices now increasing more rapidly than nonfuel commodities, downside risks for net oil importers have increased, and strong policies as well as improved political stability will be critical to weather such risks. The recent commitment by the G-8 countries to provide additional resources to the region could increase confidence and investment, although this will also depend on further reforms to strengthen institutions, improve the investment environment, and foster private sector-led growth.

Rising oil production and prices have continued to support GDP growth in the *Middle East*, accompanied by dramatic improvements in external current account and fiscal positions. Despite strong domestic demand, inflation has generally remained subdued, in part reflecting generally high unemployment and, in the context of pegged exchange rates, low global inflation. Higher oil revenues offer a major opportunity to address some long-standing economic problems in the region, notably to finance reforms that would generate employment for the rapidly growing working-age population.

Policy Priorities to Reduce Vulnerabilities and Strengthen Growth Potential

The recent strong performance and the generally solid outlook are a testimony to the global economy's remarkable resilience to the shocks. This has in part reflected improved fundamentals, including strengthened financial sector balance sheets, considerably improved

monetary frameworks, greater economic flexibility, and reduced vulnerabilities in emerging markets. It also owes much to more transitory factors, however, including unusually low interest rates and the continued willingness of investors to finance large global imbalances. Looking forward, while there are clear positive factors—including the ongoing effects of the IT revolution—the longer-run foundations of the expansion seem considerably shakier. The key policy challenge remains to use the present relatively benign conditions to address underlying economic vulnerabilities and boost long-run growth.

On the monetary side, policy requirements have become increasingly divergent, reflecting differing cyclical situations. In the United States, the present measured pace of tightening appears appropriate, although signs of rising labor market pressures will need to be carefully monitored. Further tightening will also likely be needed in China, especially if signs of a rebound in investment growth strengthen, and will be aided by the greater scope for exchange rate flexibility as a result of recent reforms. In contrast, monetary policy has remained on hold in the euro area, and if incoming data confirm that inflationary pressures remain contained and the expected recovery fails to materialize, or if the euro appreciates significantly, an interest rate cut should be considered. In Japan, the current accommodative stance remains appropriate and the quantitative easing policy should remain in place until deflation is unambiguously defeated. In countries where house price inflation remains robust, a combination of moral suasion and, if necessary, prudential measures could help limit potential risks; over the longer term, regulatory features—including those that potentially constrain supply—that may exacerbate price pressures need also to be addressed.

Looking forward, we face four central medium-term challenges:

- *Ensuring an orderly resolution of global current account imbalances.* As we have discussed on many occasions, these imbalances are a shared responsibility. Concerted action to reduce imbalances will be key to forestall the risks of a disorderly adjustment, limit the size of external exposures and the attending risks, and sustain global growth during the adjustment process. We have already agreed on a policy strategy in this regard. We now need to avoid finger pointing and move ahead to implement this strategy. Encouragingly, there has been some progress since our last discussion. The fiscal outlook in the United States has improved, aided by a rebound in revenues (although emergency spending associated with Hurricane Katrina will add to the deficit in the short run); and there have been important further steps toward greater exchange rate flexibility in Asia, notably in China and Malaysia. However, there remains a considerable way to go: the projected medium-term fiscal adjustment in the United States remains unambitious, and fiscal discipline would be supported by the re-establishment of the types of budget rules that had been contained in the Budget Enforcement Act (BEA), including pay-as-you-go provisions that cover revenue measures; the scope for greater exchange rate flexibility in emerging Asia needs to be fully utilized; and financial reforms in Asia, and structural reforms to boost domestic demand and growth in Japan and the euro area, need to be accelerated. Oil-exporting countries with strong macroeconomic and fiscal frameworks will also need to play their part, including by taking advantage of higher government revenues

to boost expenditures in areas where social returns are high (subject to cyclical considerations) and accelerating growth-enhancing structural reforms.

- *Managing the continuing pressures in global oil markets.* With excess capacity remaining very tight, the market remains—as the impact of Hurricane Katrina has illustrated—very vulnerable to shocks. Moreover, while the impact on global growth has been surprisingly moderate—partly reflecting the fact that higher prices have owed much to strong global demand and that inflationary expectations are well-anchored, so a strong monetary response has not been needed to head off inflationary pressures—further price increases could have a more significant effect, especially if they had a larger effect on inflationary expectations or consumer confidence. The impact on countries with already weak domestic demand, as well as many oil importing emerging market and developing countries, especially those where recent price increases have not been fully passed on, could also be serious. As we have discussed before, the continuing risks and pressures in oil markets underscore the need for oil-exporting countries, international oil companies, and oil consumers to work together cooperatively to improve the functioning of the oil market. In particular, steps are needed to reduce obstacles to investment, including in refining, improve transparency in the market, and slow the growth of oil consumption, including through tax policies and the reduction of subsidies, both of which require strong political leadership. Indeed, the social inequalities and economic distortions arising from large and indiscriminate subsidies at a time of high oil prices are profound. In many countries the effect is to give money to the people who least need it, often at great cost to the budget.

- *Maintaining financial market stability.* While conditions remain unusually favorable, there is no room for complacency. Regulatory and supervisory authorities should be alert to risks stemming from ample global liquidity and the risk-taking and leverage it encourages. Policymakers need to take advantage of the present benign environment to implement measures to reduce risk and further enhance financial resiliency. In particular, it will be important to monitor developments in credit derivative markets and ensure robust counterparty risk practices to avoid potential spillovers in the event of a market correction.

- *Addressing fiscal and structural constraints to long run macroeconomic stability and growth.* Among the major industrial countries, fiscal deficits are expected to decline only modestly over the medium term, and—despite past reforms—budgetary pressures from aging populations remain a serious concern, especially for health care. While emerging markets have improved their fiscal positions noticeably in recent years, public debt ratios remain too high in many countries, and governments need to use the still relatively benign environment to strengthen policies aimed at reducing vulnerabilities, particularly in the fiscal and structural areas. Most countries and regions face significant structural challenges, including product and labor market reforms in the euro area and Japan; continued financial and corporate reform in much of Asia; improving the investment climate in Latin America, the Commonwealth of

Independent States, and the Middle East; and strengthening banking supervision in central and eastern Europe.

As experience has shown, free trade is essential to strong growth. The recent signs of rising protectionist sentiment in a number of countries, and the continued lack of progress with the Doha Round negotiations, are serious concerns. An ambitious outcome of the Doha Round remains possible—we should not lower our sights. But there is little time left: the tough decisions cannot be further postponed. Progress will require leadership from the large countries, and a willingness to match their rhetoric with action. As we will discuss at the Development Committee, a development-oriented trade agenda will also help assuage the concerns of poorer countries about the adjustment costs of trade reform or institutional capacity constraints.

With only 10 years remaining to meet the Millennium Development Goals, the renewed commitment of the richest countries to provide additional resources to the poorest nations is an enormously welcome development. It is now critical that the international community follows through expeditiously, including by increasing aid to the UN target of 0.7 percent of GNP and ambitious trade liberalization—especially for agricultural products. For their part, developing countries must move rapidly to put in place the policies needed for sustainable growth and poverty reduction, including through maintaining macroeconomic stability, further trade liberalization, and building sound, accountable and transparent institutions.