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Statement by Rodrigo de Rato
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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 strength of the global expansion has continued to exceed expectations. Growth is now estimated to have reached 4.8 percent in 2005, considerably above expectations when we met last September, and current forecasts suggest this strong pace of expansion will be maintained in 2006 and 2007. Encouragingly, the expansion has become more broadly based. Among industrial countries, while the United States remains the main engine of growth, the Japanese expansion has also become well established, and there are signs of a more sustained recovery in the euro area. Growth in most emerging market and developing countries remains solid, with the buoyancy of activity in China, India, and Russia particularly striking.

The global financial environment remains favorable. While rising in recent months, long-term interest rates have been unusually low during most of this economic cycle, supported by the high net savings of emerging markets and corporations in the G-7 economies. Spreads on emerging market and corporate bonds also remain tight, underpinned in part by improved balance sheets. Low interest rates have helped push up equity valuations in most stock markets, and have elevated property values in a number of countries. Financial markets are pricing in moderate short-term interest rate increases this year. With some of the factors that have supported low long-term interest rates temporary in nature—particularly corporate financial surpluses which are likely to decline as investment picks up—long-term rates are also set to rise further. While the global financial system appears well positioned to manage normal cyclical challenges, tighter financial conditions could pose risks to some emerging market countries and to overextended households in a number of industrial countries.

Oil prices have recently hit record highs and remain volatile. Comfortable inventory levels have been offset by rising geopolitical uncertainties, with prices increasingly driven by concerns about future supply. Elevated oil prices have had less of an impact on the global economy than feared, but with higher prices increasingly driven by supply-side concerns, the impact on growth could be greater in the period ahead. Nonfuel commodity prices—particularly metals—have risen strongly, reflecting both cyclical and supply-side factors.

Despite strong global growth and high oil prices, inflationary pressures remain modest. While headline inflation has picked up in response to higher oil prices, core inflation remains contained, and inflationary expectations well grounded. With diminishing excess capacity, the restraining effect of declining non-oil import prices on inflation has, however, faded, suggesting that a cyclical upturn in import prices could contribute to stronger inflationary pressures going forward. Monetary policymakers need to remain vigilant.

Little progress has been made in reducing global current account imbalances. The U.S. deficit has reached a historical high, matched by large surpluses in oil exporters, China and

Japan, a number of small industrial countries, and other parts of Asia. The financing of the U.S. deficit has so far not been a problem, but this should not give grounds for complacency.

Short-Term Prospects

Global growth is expected to average 4.9 percent in 2006, 0.6 percentage points higher than expected when we last met, before easing slightly to 4.7 percent in 2007. The continued headwinds from high oil prices are expected to be offset by a gradual pickup in investment and continued accommodative—albeit to a lessening degree—monetary policies in some countries. While there are upside risks to the outlook—corporates could run down their financial surpluses more rapidly than anticipated, boosting investment and employment, while growth in some emerging markets could continue to exceed expectations—overall the risks remain slanted to the downside. Beyond geopolitical risks, key concerns relate to: high and volatile oil prices; the possibility of a disorderly adjustment of large global imbalances; the impact of tightening financial market conditions, particularly on households in countries where housing prices are elevated and some emerging markets; a rise in protectionist sentiment; and the difficult to quantify, but potentially very serious, consequences of an avian flu pandemic.

Turning to individual countries and regions, real GDP growth of 3.4 percent is expected in the *United States* in 2006, still the highest among G-7 economies. Despite some weakness in the fourth quarter of 2005, incoming data suggest a relatively strong start to 2006. Robust corporate profits and comfortable financing conditions imply a positive outlook for business investment, while stronger growth in trading partners suggests that the external sector will be less of a drag on growth. Consumption growth, however, is expected to slow, as a cooling housing market and elevated energy prices more than offset any acceleration in disposable incomes from employment and wage growth. Risks, however, are to the downside. Against the background of low household saving and high energy prices, a weaker housing market could trigger a more abrupt withdrawal of consumer demand than anticipated. Further, although flexible and deep financial markets have allowed for a smooth financing of the large U.S. current account deficit so far, its unprecedented size makes the United States vulnerable to a swing in investor sentiment that could put downward pressure on the dollar and see a sharp rise in interest rates.

In the *euro area*, the recovery appears to be strengthening, notwithstanding some slowdown in the final quarter of 2005 due to falling household consumption and weaker net exports. Investment has remained resilient, and recent high frequency indicators continue to point to healthy activity. Looking forward, the expansion will continue to depend on strong global demand, but an increasing contribution from business investment is expected, supported by last year's depreciation of the euro and the continuation of supportive financing conditions. Household consumption, however, is expected to remain more subdued until labor market conditions improve and the effect of oil prices on disposable incomes diminishes. The main downside risks to the outlook are a slowdown in growth in trading partners and a further sharp rise in oil prices.

Japan's expansion remains solidly on track, with growth increasingly driven by strong domestic demand, underpinned by rising employment, buoyant corporate profits, and a turnaround in bank credit growth. GDP growth for 2005 is now estimated at 2.7 percent, 0.7 percentage points higher than projected at the time of our last meeting. Looking forward, GDP growth in 2006 is expected to remain around last year's level, again driven by solid domestic demand. The risks to the outlook are on the upside, especially if private consumption gains momentum in response to rising employment and labor income. Most encouragingly, there is an increasing prospect of a decisive end to eight years of declining prices, with core CPI inflation having been positive for four consecutive months.

Growth prospects for *emerging markets and developing countries* in aggregate have strengthened considerably compared to expectations at the time of our meeting last September, reflecting improvements in the outlook across a range of countries, but particularly in China, India, and Russia.

In *emerging Asia*, growth eased slightly to 8.2 percent in 2005, reflecting a slowdown in the early part of the year. Indeed, growth in the region accelerated in the second half of 2005 as exports were boosted by a pickup in corporate investment in industrial countries, although domestic investment remained weak in many countries. With global economic conditions expected to remain favorable, strong growth momentum is expected to be maintained in 2006. Real GDP growth in China remains very strong driven by high levels of investment and an increasing contribution from net exports (recent data revisions also indicate that growth has been even higher than previously thought in recent years). Growth in India remains rapid, based on considerable momentum in the manufacturing and services sectors. Elsewhere in the region, the rebound in the newly industrialized economies is expected to be supported by the favorable outlook for exports. A key challenge for the region is to achieve a better balance between externally and domestically led growth in countries with current account surpluses. This underscores the importance of structural reforms, including in the financial sector, to boost domestic demand. Exchange rate appreciation will also be necessary.

A robust economic expansion is continuing in *Latin America*, with many countries benefiting from strong global demand for commodities. Regional growth in 2006 is expected to be maintained broadly at last year's pace, with domestic demand projected to play a prominent role. Against the background of strong growth and impressive fiscal discipline, public debt has declined notably in the region. To reduce vulnerabilities to adverse changes in the global financial environment, efforts to sustain the reduction in public debt and improve its structure will need to continue. Structural reforms to boost investment also remain a priority in order to maintain high and stable long term growth that is less dependent on the commodity cycle.

In *emerging Europe*, growth is expected to remain above 5 percent in 2006, underpinned by strong domestic demand and solid export growth. The key risks to the outlook stem from the strength of the recovery in euro area domestic demand, the large regional current account deficits, and rapid credit growth in a number of countries. In the Baltics and southeastern Europe, external deficits primarily reflect private sector behavior, while in Hungary it is

closely associated with the fiscal imbalance. These external imbalances pose significant risks for a number of countries in the region, and need the urgent attention of policymakers.

In the *Commonwealth of Independent States*, growth slowed significantly in 2005 with the sharp slowdown in Ukraine accounting for much of this, although activity also moderated in other key countries. The composition of demand has been very unbalanced, with investment remaining weak and consumption expanding strongly, fueled by higher wages and pensions and increased access to credit. Looking ahead, growth is projected to slow somewhat further in 2006. Monetary policy will need to increasingly focus on containing inflation, including by allowing an appreciation of exchange rates where necessary. Policymakers will also need to undertake reforms to improve the business climate to encourage higher investment and achieve more balanced growth going forward.

Economic activity in *sub-Saharan Africa* continues to expand robustly, and is expected to attain its highest growth rate in over three decades this year, supported by strong demand for commodities and the benefits of past reform efforts. It is important for countries to take advantage of opportunities provided by the favorable global economic environment and the reduction in external debt obligations, especially to multilateral creditors, to further their own reform efforts. This will particularly require the strengthening of institutions and the creation of conditions that encourage a vibrant private sector to pave the way for strong and sustained growth that will lower poverty. It will be important that the advanced economies follow through on their commitments to provide greater resource flows to the region and to improve market access for exports.

Growth in the *Middle East* has been driven by substantially higher oil export earnings, but with oil production close to capacity, the pace of activity is expected to moderate slightly in 2006. The main risks to the outlook are closely related to the prospects for oil prices, although geopolitical uncertainty and recent developments in equity markets also pose risks. With a large proportion of oil revenues having been saved, greater consideration should now be given to carefully targeted expenditures to improve growth prospects in the oil and non-oil sectors.

Policy Priorities to Reduce Vulnerabilities and Strengthen Growth Potential

The recent strong performance of the global economy and the generally favorable outlook reflect in part improved fundamentals, including strong monetary policy frameworks, greater economic flexibility, and improved public finances in many emerging market countries. They also reflect some transitory factors, including unusually low interest rates and the willingness of investors to finance large global imbalances, that will not last forever. The present environment provides an ideal opportunity for policymakers to move ahead decisively to address key vulnerabilities and challenges facing the global economy, to pave the way for strong and sustained growth over the medium term. Among the most important areas where policy actions are needed are:

- *Making progress in reducing global imbalances.* Current account imbalances have risen further, raising the risks for the global economy in the years ahead. Achieving the necessary adjustment in these imbalances is a shared responsibility of the international community. Joint action on the part of the major actors in the global economy would benefit all. Adjustment will in all circumstances require both a significant rebalancing of demand across countries and exchange rate adjustment, with the U.S. dollar depreciating and the currencies of countries running large current account surpluses appreciating. As has been discussed on many previous occasions, the resolution of these imbalances will primarily require an adjustment in private sector behavior. Policies, however, will need to play an important role in facilitating an orderly reduction in imbalances. A joint package of measures across major regions—including steps to reduce the budget deficit and spur private savings in the United States; structural and other reforms to boost domestic demand in Japan, the euro area, and oil-exporting countries; and greater exchange rate flexibility in China and some other countries to allow necessary appreciations to take place—could significantly reduce risks of an abrupt adjustment. To date, however, only modest progress has been made in implementing these policies and with the risks relating to these imbalances rising over time, it is now essential to accelerate this process.
- *Ensuring sustainable medium-term budget positions.* Underlying fiscal positions in industrial countries outside Canada and Japan have improved only modestly since 2003 (although in Japan considerably more progress is still needed). With pension and healthcare systems increasingly stretched and pressures on government finances expected to rise as the current generation of baby boomers begins to retire, it will be critical to accelerate progress on fiscal consolidation in industrial countries. In emerging market economies, fiscal positions have improved considerably, but more needs to be done to further reduce public debt in many countries and lessen vulnerabilities to any deterioration in the global financial environment.
- *Pressing ahead with structural reforms to raise potential growth rates.* Reforms to improve the flexibility of product and labor markets, strengthen financial systems, and improve the investment climate in emerging markets are particularly important.
- *Making progress in reducing barriers to trade.* In the face of rising imbalances, protectionist pressures have risen in a number of countries, which need to be decisively resisted. It will be important to ensure an ambitious outcome to the Doha Round, where regrettable inflexibility in country positions has limited the progress made in negotiations thus far. At the national level, pressure to limit cross-border investment is one key area where policymakers need to reaffirm their commitment to greater openness.
- *Addressing high and volatile oil prices.* Excess capacity in the oil sector remains low, making it vulnerable to unexpected events. With oil prices increasingly driven by supply side concerns, the adverse impact of higher prices on growth going forward could be greater than it has been over the past two years, especially if they feed into

core inflation. To reduce risks emanating from the oil market, it is important to improve the medium term supply-demand balance in the market, including by eliminating obstacles to investment, allowing the full pass through of higher international prices into domestic oil prices (accompanied by a suitable safety net for the poorer segments of the population), stronger conservation efforts, and improving oil market data.

- *Implementing financial sector reforms and other policies to reduce vulnerabilities in emerging market countries.* Active debt management policies in emerging market countries have reduced the share of foreign currency debt and lengthened the average maturity of the debt stock. Most emerging market countries have also pre-financed their 2006 borrowing requirements and a few have begun to pre-finance their 2007 needs. Nevertheless, a number of countries remain vulnerable to a deterioration in the external environment, and currency and maturity risks need to be reduced further. Progress in financial sector reforms that support the creation of deep and liquid domestic financial markets would help reduce the vulnerability of borrowers to adverse changes in external financial conditions.

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In sum, the recent strong growth performance of the global economy—and particularly in some of the poorest countries—is very welcome. But, medium-term vulnerabilities are increasing. Policymakers must seize the opportunity presented by the current favorable economic and financial market environment to make decisive progress in implementing the reforms that are essential for ensuring that strong growth continues in the future.