

IMF EXECUTIVE BOARD DISCUSSION OF THE OUTLOOK, MARCH 2008

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 21, 2008.

Global Prospects and Policies

Executive Directors discussed global economic developments and prospects against the background of exceptional uncertainties about the likely duration and cost of the financial crisis, which has now spread far beyond the U.S. subprime mortgage market. In recent months, growth has slowed in the advanced economies in the face of tightening financial conditions, while remaining strong thus far in the rapidly globalizing emerging economies. Directors agreed that global growth prospects for 2008 have deteriorated markedly since the January 2008 *World Economic Outlook Update*, although a number of Directors felt that the staff's new baseline forecast has been marked down too sharply, particularly given the flexibility and resilience of the U.S. economy and the still-robust official data from several western European economies. Clear communication as these forecasts evolve remains essential, particularly at this juncture.

Directors emphasized that the greatest risk to the outlook comes from the still-unfolding events in financial markets, and particularly the concern that the deep losses related to the U.S. subprime mortgage sector and other structured credits can seriously impair financial capital and transform a credit squeeze into a full-blown credit crunch. In the view of most Directors, the interaction between negative financial shocks and slowing domestic demand remains a serious downside risk in the United States, and to a lesser degree in western Europe and elsewhere. At the same time, many Directors still saw positive momentum driven by the potential strength of domestic demand in fast-growing

emerging economies, while recognizing their exposure to negative external risks through both the trade and the financial channels. Directors also cautioned that the risks related to inflationary pressures and the oil market have risen, notwithstanding the economic slowdown, as commodity prices have soared in the context of continued tight supply-demand conditions as well as increased investor interest in commodities as an asset class and other financial factors. A number of Directors also saw a continued risk of a disorderly unwinding of global imbalances despite the recent depreciation of the U.S. dollar against other flexible currencies and the narrowing of the U.S. current account deficit.

Against this backdrop, Directors underscored that policymakers around the world face a fast-moving set of challenges. In the advanced economies, the key priorities are to deal effectively with the financial crisis and counter downside risks to growth, while taking due account of the recent elevated inflation readings and the need to preserve longer-term fiscal sustainability. In many emerging and developing economies, the challenge is to control inflationary pressures while ensuring that strong domestic demand does not lead to a buildup in vulnerabilities. At the same time, Directors noted that a number of these countries are already facing fallout from the advanced economy slowdown, and an intensified or prolonged global slowdown will require judicious responses from policymakers in the affected economies. Directors considered that it will be important to ensure consistency of policy approaches across countries in these difficult global conditions.

Advanced Economies

Directors agreed that the U.S. economy has been slowed by the impact of tightening credit, a deterioration in labor market conditions, and a continuing deep correction in the housing market. Some Directors observed that lending could be constrained by losses experienced by core U.S. financial institutions. Directors considered that economic activity is likely to remain weak through 2009, and will recover gradually thereafter. Consumption will be held back by wealth effects and weakening employment, while residential investment will continue to drop. Most Directors noted that the recently approved fiscal stimulus package will help contain the downturn during the course of the year. Most Directors welcomed the aggressive actions by the Federal Reserve to ease interest rates and inject liquidity into the financial system. They considered that further easing of interest rates may be necessary, depending on the incoming evidence on the extent of the downturn and the deterioration in credit conditions. At the same time, a number of Directors underscored that monetary policy decisions will need to pay careful attention to inflation risks, given the somewhat elevated core inflation and prospects for continued high and volatile energy and food prices—although it was recognized that such trends could well be alleviated by the projected widening of output gaps and the softening labor market. While noting the staff's assessment that the dollar is still on the strong side, a few Directors considered that recent market moves are likely to have significantly reduced the degree of overvaluation.

Directors recognized that activity in western Europe had also slowed starting in late 2007, reflecting high oil prices, tighter financial conditions, and weaker export growth. They observed that lending activity may be constrained due to the losses experienced by some major European banks from their exposure to structured credits. Directors also noted that growth will likely continue to decelerate in the period ahead. Noting the relatively heavy reliance of corporations in Europe on banks for financing, Directors con-

sidered that a key downside risk to the regional outlook is the possible effects on the financial sector in Europe of the spreading credit crisis, although some Directors observed that employment has continued to rise, and money and credit growth rates have remained strong despite a tightening of lending standards. Against this background, and with recent structural reforms bearing fruit, several Directors saw the region as generally well equipped to cope with the fallout from further financial market turbulence. With continuing inflation risks, and the considerable uncertainty in financial markets, the European Central Bank (ECB) continues to attach priority to ensuring that inflation expectations remain firmly anchored. Noting that the ECB is appropriately keeping interest rates on hold for now, most Directors considered that the ECB should stand ready to ease policy if inflation concerns moderate and downside risks to growth intensify. Directors generally agreed that, in the euro area, automatic stabilizers should be allowed to play in full, while bearing in mind the need for steady advancement toward these countries' medium-term fiscal objectives. Countries where medium-term objectives are well in hand could also have scope for some additional discretionary stimulus. However, in other euro area countries, most Directors noted, the scope to allow even automatic stabilizers to operate in full may be limited by high levels of public debt and adjustment plans that are insufficient for medium-term sustainability.

Directors welcomed the strength of activity in Japan through the end of 2007. While noting the limited direct impact of the credit market turbulence on the Japanese financial system, Directors were of the view that weakening business sentiment, sluggish personal income growth, high oil prices, and lower global growth will weigh on activity in 2008 and 2009. Most Directors saw merit in keeping interest rates on hold for now, but saw some scope, albeit limited, to reduce interest rates from already low levels if there is a substantial deterioration in growth prospects. Directors noted that net public debt levels remain high despite consolidation efforts,

with little scope for additional discretionary fiscal action. Although automatic stabilizers could be allowed to operate in the event of a sharp downturn, their impact on domestic demand will likely be limited.

Directors welcomed the liquidity injections by major central banks and recognized that monetary policy actions have provided an important first line of defense in the current troubled financial environment. They noted the particular challenges to monetary policy implementation at the present juncture. One such challenge is the delicate balance between alleviating downside risks to growth and guarding against a buildup in inflation. With rising threats to price stability, several Directors stressed that central banks should not risk their hard-earned inflation-fighting credibility. Another aspect of monetary policy implementation is that the ongoing financial dislocations may have weakened the normal monetary policy transmission mechanism in some countries, thus raising questions about the impact of monetary easing on the economy. Directors acknowledged, however, that liquidity injections do not solve the underlying financial market problems—involving repricing of risky assets, lack of confidence and counterparty trust, and solvency issues—but could buy time to address these issues. Directors looked forward to returning to financial sector issues in the context of the discussion of the April 2008 *Global Financial Stability Report*.

Directors welcomed the analysis of the connections between housing cycles and monetary policy in Chapter 3. They noted that the impact of house price movements on overall economic activity is likely to be affected by a range of factors that vary over time and across countries. Directors agreed with the analysis that one important factor may be the degree of development of the mortgage market. Many Directors emphasized that house prices matter for central banks to the extent that they affect inflation and the output gap. In addition, it was noted that central banks with an inflation target can incorporate concerns about asset price bubbles by extending the monetary policy horizon. A

number of Directors stressed that monetary policy should continue to be focused on the prospects for inflation and activity. Several Directors also cautioned that monetary policy alone should not bear the full weight of responding to possible asset price bubbles, emphasizing the role of regulatory policy.

Emerging and Developing Economies

Directors noted that emerging and developing economies have been relatively resilient in the face of the spreading crisis in global financial markets, owing in large part to the stabilization gains from improved macroeconomic policy frameworks and the strong growth momentum from productivity gains associated with continuing integration into the global economy and the broadening of export bases. As a result, the advanced economy business cycle may play a less-dominant role, even as these economies have become increasingly more open to trade. Nevertheless, Directors recognized that a protracted weakening of growth in the advanced economies will likely have an appreciable negative impact on these countries. Moreover, a broadening of the problems in financial markets could lead to global deleveraging that could increasingly constrain financial flows to emerging economies that are seen as vulnerable.

Directors agreed that, while many emerging and developing economies continue to face the challenge of containing inflation and avoiding a buildup in vulnerabilities, policymakers in these countries should be ready to respond to a more negative external environment. Although in a number of countries there seems to be more room than in the past to use countercyclical monetary and fiscal policies, Directors emphasized that the appropriate mix will need to be judged country by country. In particular, they noted that countries with large current account deficits or other vulnerabilities may need to respond by tightening policies promptly, so as to maintain confidence and avoid external crises familiar from earlier decades.

In emerging Asian economies, growth is expected to decelerate but will remain strong, led by China and India. Most Directors viewed the risks to the outlook as being broadly balanced—with some upside potential from domestic demand, but downside risks from the external environment. Some Directors expressed concern that a number of countries could face sustained inflation and overheating problems, particularly if consumption continues to gather pace and policy measures to slow investment prove ineffective. Countries in this region with heavily managed exchange rate regimes would benefit from shifting to more flexible exchange rate regimes that provide greater scope for monetary tightening.

In Latin America, stronger policy frameworks, improved debt management, and the development of domestic capital markets have reduced vulnerabilities, and the region has shown resilience to the increasing risk aversion and disruptions in international financial markets. However, Directors considered that the risks to the outlook for the region are weighted to the downside, particularly in the event of a reversal of the recent commodity price boom associated with a deeper global downturn. Directors agreed that in countries where inflation targeting has gained credibility, monetary policy is the first line of defense against weaker outcomes, whereas for other countries the scope for easing will be constrained by the need to contain inflationary pressures. Many Directors also agreed that flexible exchange rate management should play a supportive role, and that countries with public debt at sustainable levels should let automatic stabilizers work.

For most countries in emerging Europe, containment of inflation remains the main policy challenge. Countries that have built up large current account deficits relying on short-term and debt-related financing could be vulnerable to a reversal of capital inflows. For these countries, Directors underscored the importance of prudent macroeconomic policies, aimed at steering these economies toward a “soft landing,” as well as of prudential and

regulatory policies to contain balance sheet vulnerabilities.

In the Commonwealth of Independent States, domestic demand has continued to expand rapidly, fueled by high commodity prices, expansionary macroeconomic policies, rapid credit growth, and rising asset prices. In this context, Directors agreed that the most immediate challenge for policymakers in the region is to rein in rising inflation pressures. Directors agreed that risks to the regional outlook are tilted to the downside, as a sharper-than-expected slowdown in the global economy will likely lead to a decline in oil and commodity prices, and could adversely affect external financing conditions.

In sub-Saharan Africa, Directors were encouraged by the sustained expansion, led by very strong growth in oil-exporting countries and supported by robust expansion elsewhere. In some countries, rising inflationary pressures from food and fuel prices are of concern. Directors welcomed the analysis in Chapter 5 showing that developing economies in Africa and elsewhere are becoming more diversified and are benefiting from improved policies and structural reforms that are under way in many countries. Although these reforms should strengthen the resilience of the region to a slowdown in the advanced economies, Directors saw the balance of risks to the outlook as tilted to the downside, owing to the risks of a significant drop in commodity prices when the present boom ends and of a possible slowdown in capital inflows and investment. The main policy priorities for the region are to maintain progress toward increasing integration with the global economy and to improve the business environment, infrastructure, and institutions.

In the Middle East, high oil prices have supported buoyant growth, strong external balances, and a buildup in government spending in oil-exporting countries, while strong growth in the region’s other economies has been spurred by trade and financial linkages with oil-exporting countries as well as by domestic reforms. However, inflation pressures have risen considerably due to strong domestic demand,

rising food prices, and higher rents. Directors recommended focusing public spending from oil revenues on addressing supply bottlenecks, and some Directors emphasized that rising inflationary pressures may require exercising fiscal restraint in the short term to counterbalance strong private demand growth. At the same time, Directors emphasized the need to continue pursuing long-term development objectives, through reforms that encourage investment in the non-oil sector and develop financial systems that can support high and sustained growth.

Multilateral and Other Issues

Directors emphasized that reducing the risks associated with global current account imbalances remains an important task. Progress is being made toward trimming the U.S. current account deficit and implementing detailed policy plans consistent with the strategy endorsed by the International Monetary and Financial Committee that were laid out by the participants in the IMF-sponsored Multilateral Consultation. However, recent currency market movements underline the potential for disorderly adjustments. Several Directors stressed that the present environment heightens the importance of continued actions in line with the policy plans and of IMF monitoring of their implementation. Although policies aimed at rebalancing domestic demand across countries remain relevant, they should be approached flexibly to take account of individual country circumstances and the changing global context. Directors agreed that temporary fiscal relaxation in the United States will provide useful insurance against a deeper slowdown but should not jeopardize medium-term consoli-

dation goals. A number of Directors stressed that further tightening of monetary policy in China, alongside greater upward flexibility of the exchange rate, would help relieve the burden being borne by other major currencies in response to the depreciating dollar and would also serve China's aim to control inflation. Directors emphasized the importance of tackling supply bottlenecks in oil-exporting countries and of further pursuing growth-enhancing structural reforms of product and labor markets in the euro area and Japan.

More generally, Directors welcomed the ongoing consultations among countries, especially by the monetary authorities of the advanced economies with each other and with international bodies such as the IMF and the Financial Stability Forum, in dealing with the present financial turmoil. Joint efforts could prove more effective in bolstering confidence and demand than individual efforts. Directors agreed that the IMF is uniquely placed for adding a multilateral perspective to policy responses to the current crisis, including through the *World Economic Outlook* and the *Global Financial Stability Report*; for providing a forum for ongoing discussion and exchange of views, especially with regard to possible contingency actions; and for promoting consistency of national policies and assessing their spillovers in an increasingly integrated global economy.

Directors welcomed the staff's analysis in Chapter 4 drawing out the short- and medium-term macroeconomic consequences of measures to mitigate the buildup of greenhouse gases. They considered that the analysis adds value to the debate on climate change and underlines the role of multilateral efforts in addressing this issue in an effective, efficient, and equitable manner.