ANNEX

SUMMING UP BY THE ACTING CHAIR

The following remarks by the Acting Chair were made at the conclusion of the Executive Board's discussion of the World Economic Outlook on September 3, 2004.

Executive Directors noted that the global recovery remains solid, with economic growth in 2004 projected to reach its highest rate in nearly 30 years. The expansion is underpinned by continued accommodative macroeconomic policies, rising corporate profitability, and wealth effects from rising equity and house prices. It has become increasingly broad-based geographically, although some regions continue to grow more vigorously than others. Global growth remains driven by the United States, with strong support from Asia, particularly China and Japan. Activity in Latin America and some other emerging markets has also picked up strongly, while the outlook for Africa has improved. There is growing economic momentum in the euro area, although the strength of the upturn varies across countries and in some cases is heavily dependent on external demand.

While welcoming these developments, Directors noted that risks to the expansion have increased in recent months. First, oil prices rose sharply through mid-August, driven by strong global demand and, increasingly, supply-side concerns. While prices have since fallen back somewhat, they are still significantly higher than in 2003; and with spare capacity near historical lows, the oil market remains highly vulnerable to shocks and speculative pressures. Against this backdrop, Directors urged greater cooperation between consumers and producers toward a more stable global oil market, with some Directors emphasizing the importance of measures to promote more efficient use of oil and other nonrenewable resources. Second, and partly related, second-quarter growth slowed in some major countries—including the United States and Japan. Directors noted the risk that this slowdown could persist, especially if employment growth in the United States remains relatively modest. Overall, while Directors generally expected a continued solid expansion of the world economy, they considered that the balance of risks has shifted to the downside, with further oil price volatility and geopolitical risks becoming the central short-term concerns.

Directors noted that inflationary risks remain generally moderate. Nevertheless, after falling to unusually low levels in mid-2003, inflation has turned up around the world, reflecting a combination of strong growth and higher commodity prices. Directors cautioned that, going forward, inflationary pressures could prove stronger than expected, necessitating a sharper-than-expected rise in interest rates. While acknowledging that monetary policy in many countries remains appropriately accommodative, Directors underscored that the key short-term policy challenge will be to continue to manage the transition toward higher interest rates to ensure that nascent inflationary pressures are contained, while facilitating—through continued good communication of the stance of monetary policy—sustained economic recovery and orderly adjustment in financial markets. In this connection, Directors viewed further sustained increases in oil prices as a complicating factor. While first-round oil price effects should be accommodated, central banks will need to ensure that second-round effects are well contained.

Directors called on policymakers to take advantage of the current cyclical expansion to address three key medium-term vulnerabilities and concerns.

- First, global imbalances—which remain an important medium-term risk to the economic outlook—need to be tackled. Directors reiterated that eliminating these will require medium-term fiscal consolidation in the United States to increase domestic saving, structural reforms to boost growth in Europe, Japan, and elsewhere, and steps toward greater exchange rate flexibility in Asia, as appropriate. In all three areas, much remains to be done; it will be important to make strong progress on each of them.
- Second, the pace of structural reforms needs to be quickened to increase economic flexibility and resilience, so that countries are well positioned to take full advantage of the opportunities from globalization and the information technology revolution, while strengthening their resistance to future shocks. Noting the key role of open markets in promoting competitiveness and efficiency, Directors looked forward to far-reaching trade liberalization under the Doha Round, building on the welcome progress in Geneva in July.
- Third, medium-term fiscal positions need to be strengthened in both industrial and developing countries. This will require a combination of fiscal consolidation, while allowing automatic stabilizers to work; structural measures to improve debt sustainability, including tax reform and stronger public expenditure frameworks; and reforms of pension and health care systems.

Industrial Countries

Directors welcomed the strong expansion in the *United States*, which has provided important support to global growth. Although business investment remains strong, Directors cautioned that the slowdown in consumption in the second quarter may be a source of concern going forward, especially since support from past macroeconomic stimulus and mortgage refinancing will decline in coming quarters. Nevertheless, in the context of the strong expansion expected for 2004, Directors agreed that a measured pace of tightening of monetary policy—calibrated according to the strength of the expansion and the extent of underlying inflationary pressures—is likely to be appropriate. Regarding fiscal policy, most Directors considered the pace of deficit reduction targeted for fiscal years 2005 and 2006 as appropriate, but many encouraged the authorities to capitalize on the better-than-expected budget outcome for fiscal year 2004 by further strengthening the near-term deficit reduction objective. For the medium term, most Directors suggested that the objective of halving the budget deficit over five years is not sufficiently ambitious. Directors generally reiterated the long-standing call for the establishment of a clear long-term fiscal goal embedded within the context of a credible medium-term fiscal framework.

Directors were encouraged that the *euro area* expansion has finally gained momentum, although the upturn remains moderate and heavily dependent on external demand, with substantial differences across countries. Looking forward, rising disposable incomes and progress in corporate balance sheet restructuring should help the euro area boost private consumption and investment, and contribute to a more balanced area-wide recovery. With underlying inflationary pressures still relatively moderate, Directors agreed that monetary policy should remain accommodative until a self-sustaining upturn in domestic demand is in place. Although recently enacted structural reforms have strengthened the prospects for medium-term growth, further reforms will be needed to provide critically needed impetus to employment creation and domestic demand. Directors stressed that the recovery provides a renewed opportunity for progress, focused particularly on the key issue of raising labor utilization. In this connection, some Directors recalled that, based on past experience, renewed initiatives at the European Union level for product market deregulation can also play a useful role, as they strengthen incentives for reforms, especially in labor markets.

Directors were encouraged by the finding of the staff's analysis of fiscal behavior under the EMU that fiscal policies in the euro area have become less procyclical over the past decade. However, they also highlighted the persisting tendency toward fiscal expansion in good times, which they saw as an important reason why some member states are currently breaching the Stability and Growth Pact (SGP) deficit limits. Accordingly, Directors urged euro area governments to take full advantage of the current expansion to strengthen fiscal positions. Many Directors underlined that reducing the procyclical bias of fiscal policy should be an important objective of ongoing reflection on the improvements needed in the design and effectiveness of SGP fiscal rules.

Directors welcomed the strong expansion in *Japan* over the last year. They noted that this was accompanied by a gradual easing of deflationary pressures, and continued progress in addressing corporate and financial sector vulnerabilities—although a substantial reform agenda remains to be completed in both areas. Despite the slowdown in GDP growth in the second quarter, most high-frequency indicators remain supportive of a continued solid expansion, with external sector developments—including with respect to oil prices and the exchange rate, as well as labor market conditions—remaining keys to the outlook. Directors underscored that to ensure an end to deflation, the current highly accommodative monetary stance should be maintained until inflation is firmly positive. Most Directors emphasized that, given Japan's difficult fiscal position and the favorable economic environment, it is now opportune to start the process of fiscal consolidation, including by achieving savings in fiscal year 2004 relative to the budget. Some Directors noted that stepped-up structural reforms should also improve Japan's fiscal position by increasing potential output growth—with the priorities being public enterprise reforms, strengthened competition policy, and enhanced labor market flexibility.

Directors welcomed the staff's analysis of the global house price boom and the impact that rising interest rates in industrial countries might have on housing markets. They noted the staff's analysis, which, reflecting linkages in economic activity and interest rates, shows a remarkable degree of synchronization of house prices across industrial countries—although the data limitations need to be recognized. Given the importance of house prices for private consumption, through wealth and credit channels, many Directors suggested that policymakers should monitor developments in the housing market closely, and they noted that a tightening of monetary policy during the transition to a more neutral policy stance could trigger a slowing or reversal of house price growth. Some Directors also underscored the need to further develop the mortgage market infrastructure and improve housing statistics.

Emerging Markets and Developing Countries

Directors welcomed the continued strength of the expansion in *emerging Asia*, reflecting the combined influence of the global upturn, especially in the electronics sector; the generally supportive macroeconomic policies, including highly competitive exchange rates; and the progressively stronger domestic demand growth. Looking forward, regional growth is expected to slow somewhat, but to remain solid, with much depending on developments in China, where—despite signs of slowing growth—a soft landing is not yet guaranteed. Other potential risks include the region's relatively greater exposure to oil price volatility and to higher global real interest rates, especially on countries reliant on external financing.

Given the prospects for solid growth and the still generally accommodative policies in emerging Asia, Directors agreed that monetary policies may need to be tightened, albeit by varying degrees, in most countries. Most Directors noted that, given continued current account and balance of payments surpluses, monetary tightening would be facilitated by greater exchange rate flexibility. In this connection, a number of Directors called on the authorities to use the current favorable conditions to initiate the transition to more flexible exchange rates. Directors stressed the importance of sound underlying macroeconomic policies and structural reforms in ensuring a smooth transition to more flexible exchange rate regimes. Directors were encouraged by the staff's finding that voluntary transitions to more flexible exchange rate regimes are generally not associated with an increase in macroeconomic instability. This probably reflects the strengthening of monetary and financial policy frameworks through greater central bank independence, the adoption of inflation targeting, the improvements in bank supervision, and the development of securities markets that frequently accompanied the transitions. Directors stressed the importance of proper timing and sequencing of reforms in these areas, tailored to individual country circumstances, in order to prepare the transition. Several Directors also pointed out that sound policies are essential for the success of any exchange rate regime.

Directors were encouraged by the strong rebound in economic activity in *Latin America*, supported by easier monetary conditions in most countries, improved confidence, rising commodity prices, and the global expansion. They noted that while sovereign borrowers have already largely met their funding requirements for 2004, external financing requirements remain high, and constitute an important vulnerability going forward. Directors emphasized that cutting high public debt ratios will be key to reducing vulnerabilities, and urged countries to press ahead with fiscal reforms. To boost medium-term growth, Directors pointed to the importance of strengthening the rule of law and investor rights, fostering financial sector development, further liberalizing trade, and promoting labor market flexibility. They noted that the success of these reforms will also require actions to address income inequality and reduce poverty.

Directors welcomed the continued strong growth momentum in *emerging Europe* and the *Commonwealth of Independent States (CIS)*, while cautioning that policymakers in some of these countries need to guard against overheating. They underscored the need for fiscal consolidation, especially in light of substantial expenditure pressures and—in much of emerging Europe and the CIS-7—large external deficits. They also called for tighter monetary policies in the CIS, including through upward exchange rate flexibility in countries with large external surpluses; and for strengthening bank supervision in both regions to curb the prudential risks arising from rapid private sector credit growth. In addition, countries will need to persist with key structural reforms to further improve investment climates and fully develop the institutions and structures for market-based economies. In the *Middle East*, Directors noted the fading impetus to growth from higher oil production and prices as production reaches capacity. At the same time, they noted that the region will benefit from an expected substantial pickup in non-oil growth stemming from the global expansion and progress with reforms, especially trade liberalization. Fiscal consolidation will remain a priority in most countries, as will the need to boost employment by improving the environment for sustained private sector–led growth.

Directors were encouraged by the improved outlook for *Africa*. This has been underpinned by greater macroeconomic stability, higher export commodity prices, lower external debt burdens, somewhat better access to industrial country markets, and a variety of country-specific developments. Nevertheless, with most countries likely to fall significantly short of achieving the Millennium Development Goals, key challenges going forward will be to promote private investment and develop infrastructure, deepen institutional reforms, and reduce government involvement in the economy. Directors were encouraged that several countries have achieved more favorable governance levels. They called on the international community to support the region's strengthened reform efforts—through increased and better-coordinated assistance, continued debt relief, and elimination of barriers to exports, particularly in agriculture.

Demographic Change

Directors welcomed the work undertaken by the staff on demographic change, which is becoming an increasingly urgent concern. To meet the demographic challenges from population aging, industrial countries should boost labor supply, saving, and productivity, which, given the size of prospective demographic changes, will require a combination of reforms to be politically acceptable. Particularly important will be the selection of reforms, especially with respect to pension and health care systems: they will need to be resilient to a wide range of possible future demographic changes. For developing countries, Directors agreed that the key policy priorities will be to increase the flexibility of labor and product markets, and to ensure that labor resources and savings are effectively utilized. It will be important in these countries to move early to lay the groundwork for eventual population aging, including by strengthening pension and health care systems. This will be particularly challenging where medium-term fiscal positions are already under strain. Directors agreed that a broad longer-term implication of the staff's work on demographic change is that the effectiveness of actions to facilitate movements of goods, capital, and labor smoothly and efficiently across countries will significantly influence the pace, and pattern, of global adjustment to different rates of population aging. This promises to be a subject in which the international community—including the Fund—has a shared interest.