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 March 23, 2005.

Executive Directors noted that the global expansion remains broadly on track, underpinned by generally supportive macroeconomic policies and notably benign financial market conditions. Following last year's performance—the strongest in three decades—growth is expected to moderate to a more sustainable pace in 2005. At the same time, Directors observed that the expansion has become less balanced. Growth has been strong in the United States, China, and most emerging market and developing countries, and disappointing in Europe and Japan.

Globally, inflationary pressures remain relatively subdued. With monetary tightening cycles under way in most cyclically advanced economies and generally moderate inflationary expectations, inflation should remain well contained. Directors considered that inflation risks will nevertheless need careful monitoring, with due regard to rising unit labor costs in many industrial countries as labor markets tighten, and to monetary policy implementation in a number of emerging markets receiving strong external inflows that, in the absence of greater exchange rate flexibility, may lead to inflationary pressures.

Looking forward, Directors were of the view that the slower but solid global growth in 2005 will be underpinned by still accommodative—albeit to a lesser degree—macroeconomic policies, improving corporate balance sheets, supportive financial market conditions, a gradual rise in employment, and continued strong growth in China. Given improving corporate and household balance sheets, a stronger cyclical rebound cannot be ruled out. Nevertheless, most Directors assessed the balance of risks to be tilted to the downside. The key risks to the short-term outlook include: (1) the increasingly unbalanced nature of the expansion, with global growth significantly dependent on the United States and China; (2) a significant tightening of financial market conditions, which can adversely affect domestic demand in the United States, prompt financial market deleveraging and asset price corrections more broadly, and lead to a deterioration in emerging market financing conditions; and (3) a further sharp increase in oil prices.

Directors welcomed the staff's analysis of the oil market. Noting that currently oil prices are already significantly higher than staff projections, Directors agreed that conditions in the oil market are likely to remain tight for the foreseeable future, as demand continues to rise and non-OPEC oil production peaks. Directors underlined the importance of stability in oil markets, and considered that measures to promote stability should include steps to increase transparency in oil markets; eliminate overly restrictive regulatory frameworks that impede investment in the oil sector; promote energy sustainability and efficiency; and enhance dialogue between oil producers and consumers.

Directors expressed concern that global current account imbalances have widened further over the past year. A number of Directors cautioned that this may increase the risk of abrupt movements in exchange rates. Directors noted that the strategy to support an orderly adjustment in global imbalances has been broadly agreed. Among the key elements of this strategy are fiscal consolidation in the United States;

steps toward greater exchange rate flexibility, supported by continued financial sector reform, in emerging Asia; and continued structural reforms to boost growth and domestic demand in Japan and Europe. Directors recognized that, while these policies will have varying economic impacts in different countries and regions, the pursuit of this agenda will lead to more sustainable external positions and stronger medium-term growth. Several Directors noted that the euro area was in external balance, and that structural reform was needed primarily for exploiting euro area countries' economic growth potential. Directors reiterated the collective responsibility of the membership to ensure that the strategy is implemented in a timely and effective manner. Several Directors underlined the key role of the Fund, through its multilateral and bilateral surveillance, in monitoring and encouraging the implementation of this strategy. Referring to risks of abrupt movements in exchange rates, several Directors drew attention to the currency composition of official reserves of member countries and the importance of adequate statistics in this area for the Fund to assess those risks and possible policy implications.

Directors welcomed the staff's analysis of globalization and external imbalances. They agreed that the evolving trends of financial and real globalization should ultimately facilitate global rebalancing. At the same time, they stressed that the nature of adjustment, and the magnitudes involved, have not fundamentally changed because of globalization—in particular, exchange rates and trade balances still need to adjust. Many Directors noted that, with investors now willing to hold larger shares of foreign assets in their portfolios, globalization may have contributed to the persistence of current account imbalances, and in this sense, provided policymakers with the option of more gradual adjustment. Directors cautioned, however, that the increased flexibility should not be an excuse to delay difficult policy actions, as continued delays can sharply increase the risk of a sudden and disorderly unwinding of global imbalances. In particular, it was suggested that the risk of rapid changes in global investor preferences for U.S. dollar–denominated assets places an even greater premium on the adoption of sound policies in all key industrial and emerging market countries to achieve internal and external balance.

Directors identified a number of key medium-term issues that in their view need to be addressed.

- First, fiscal positions in many countries remain very difficult, particularly against the backdrop of global population aging, and pose a threat to medium-term macroeconomic stability. Directors noted that fiscal deficits remain high in the largest industrial countries—with the exception of Canada. Projected improvements are modest, and in many cases not underpinned by sufficiently ambitious consolidation measures. In emerging markets, fiscal indicators have generally improved, but many countries still have a long way to go to bring public debt ratios down to sustainable levels.
- Second, structural reforms need to be advanced to remove rigidities and enable domestic economies to take full advantage of the opportunities provided by globalization.
- Third, successful and appropriately ambitious trade liberalization on the part of all countries under the Doha Round, including improved market access for developing countries, will be critical to support medium-term global growth. Directors noted that in agriculture, key issues remain to be resolved, and faster progress is needed in the area of services. They stressed that translating the mid-2004 framework agreements into a viable policy package—to be taken up at the December 2005 WTO Ministerial Conference—should be a key priority for the coming months.
- Fourth, Directors noted that 2005 is a critical year for the Millennium Development Goals (MDGs). Despite the improved growth performance of recent years, meeting the MDGs will be an enormous challenge for most developing countries. Directors called on the developing countries to press ahead with policy and governance reforms to strengthen the invest-

ment environment and private sector–led growth, and on the advanced economies to support these efforts with substantially higher assistance. A number of Directors considered that increased official development assistance will be most effective in support of countries with the strongest policies and the most severe poverty.

Industrial Countries

Directors welcomed the continued strong performance of the *U.S.* economy. With most forward-looking indicators remaining solid, the expansion is set to continue in 2005. With household saving close to zero, however, a retrenchment in private consumption remains a risk, particularly if house price increases are to slow. Against the background of relatively benign inflationary pressures, Directors agreed that a measured pace of monetary tightening remains appropriate, although incoming data will need to be monitored carefully in view of possible upside risks to the inflation outlook from pressures in the labor market or further oil price increases. Directors underscored the need for significant fiscal consolidation, with a view to ensuring medium-term sustainability and facilitating an orderly unwinding of global current account imbalances. In this connection, Directors underscored the importance of fully achieving the expenditure restraint envisaged in the current budget proposal. Many Directors were of the view that the Administration's fiscal plans remain insufficiently ambitious, and noted that a number of likely future budgetary costs are not included in current fiscal projections.

Directors expressed disappointment that the *euro area* economy lost momentum during the second half of 2004, although they expected a strengthening of growth in the period ahead. Further appreciation of the euro and high and volatile oil prices remain the key risks to the regional outlook. With inflationary pressures well contained, Directors agreed that monetary policy should remain firmly on hold until a self-sustaining recovery is in place. A few Directors suggested that an easing of monetary policy would need to be considered if downside risks to growth materialize or the euro further appreciates significantly. Regarding fiscal policy, Directors viewed existing policy settings as insufficient to deliver the budgetary adjustments required to cope with the fiscal pressures of population aging. They emphasized that a faster pace of fiscal consolidation is particularly needed in countries with weak budgetary positions. Underscoring that a strong fiscal framework is an integral part of monetary union in Europe, Directors noted that reform of the Stability and Growth Pact should be implemented in a way that does not lead to a weakening of fiscal discipline. Directors also stressed the importance of making further progress in implementing structural reforms to improve the region's growth performance, with a greater focus on addressing distortions in labor markets and promoting competition in product markets. In this connection, they looked forward to the revitalization of the Lisbon agenda, with a focus on reforms to spur efficiency, flexibility, innovation, and productivity. It was recognized that the scope of required actions varies across countries, and that several countries have already made significant headway on structural reforms.

Directors noted that the *Japanese* economy stalled in the last three quarters of 2004—reflecting weak global demand for IT products and a decline in consumption spending—but that recent data have been more encouraging. With bank and corporate balance sheets now in better shape, Directors believed that growth should regain some momentum in 2005, although they acknowledged the downside risks from high oil prices and the possible adverse impact on exports of a sharp appreciation of the yen. While deflationary pressures have eased in recent years, Directors urged the Bank of Japan to maintain a very accommodative monetary policy stance until deflation is decisively beaten. Against the background of high public debt and intensifying demographic pressures, Directors considered that fiscal consolidation remains a priority. They also stressed the need to continue with efforts to strengthen the bank and corporate sectors and to accelerate structural reforms—including measures to increase competition and improve labor market flexibility—to pave the way for sustained medium-term growth.

Emerging Market and Developing Countries

Directors welcomed the strong economic performance in *emerging Asia,* although growth has slowed noticeably in most countries during the course of last year—with the important exception of China. In 2005, growth in the region is expected to be slightly weaker, with upside risks from higher-than-anticipated growth in China, and downside risks from a more protracted correction in the IT sector or sluggish demand from Japan and Europe. Directors expressed their profound sympathy at the devastating loss of life and property from the recent catastrophic tsunami. They noted that reconstruction costs—and the impact on fiscal and external imbalances—will be very substantial; however, in most cases, excepting the Maldives and Sri Lanka, GDP growth will be only modestly affected. Directors noted that policy challenges facing the region vary. Monetary tightening cycles in most countries—with the exception of Korea, where domestic demand growth remains weak—are already under way, and in the view of most Directors further tightening will be facilitated in many countries by greater exchange rate flexibility. While budget positions have generally improved, public debt levels remain high in a number of countries, and further fiscal consolidation will be needed. In addition, structural reforms are required in several countries to reduce vulnerabilities in the bank and corporate sectors and to boost investment, which remains unusually low.

Growth in *Latin America* has exceeded expectations. While the favorable external environment has supported activity, Directors observed that domestic demand is now leading growth. While Directors saw a number of downside risks to the outlook—including unexpected increases in global interest rates or a prolonged slowdown in key export markets—they believed that the region will continue to grow robustly this year. Directors were encouraged by the improved fiscal performance in many Latin American economies, although they noted that public debt, while declining, generally remains high. They therefore stressed the need for fiscal consolidation and more general measures to improve public debt sustainability, including structural reforms to boost growth. Directors agreed that the tightening of monetary policy in a number of countries in response to the recent uptick in inflation has been appropriate, and noted that exchange rate flexibility has played a key role in supporting monetary policy frameworks and improving the region's resilience to shocks.

Directors noted that *emerging Europe* is experiencing its strongest growth since the beginning of transition—with the recovery broadening across the region and moving beyond consumption to the export sector—and welcomed the expected moderation in the pace of activity to more sustainable levels. Two key risks facing emerging Europe are a prolonged slowdown in western Europe and a further appreciation of the euro. Many Directors observed that strong domestic demand has led to a general widening of current account deficits, a key regional vulnerability. They noted, however, that the policy requirements to reduce these external deficits vary across countries. In the Baltics and southern and southeastern Europe, containing credit growth and improving private saving will be key, while in central Europe ambitious fiscal consolidation and structural reforms will be needed, particularly in those countries that aim to adopt the euro in the relatively near future. In the view of many Directors, the rapid growth of credit in the region underscores the importance of strengthening banking supervision.

In the *Commonwealth of Independent States*, growth has been buoyant on the back of strong domestic demand and high energy and metals prices. While growth is expected to moderate in

2005, Directors viewed the outlook as generally favorable, but cautioned about the risks to inflation and growth from capacity constraints and inadequate investment in a number of countries. Against the background of strong capital inflows, Directors were concerned that the pace of disinflation in the region may be slowing, and stressed the need for policymakers to manage the revenue gains from oil and commodity exports prudently, while also allowing greater flexibility in exchange rates.

Directors welcomed the strong growth in the oil exporting countries of the *Middle East*, underpinned by increased export earnings from oil, sound financial policies, and progress with structural reforms. Directors urged policymakers to use the window of opportunity provided by high oil prices to press ahead with the reforms that are needed to boost medium-term growth and employment prospects and reduce vulnerabilities, including from high public debt levels in some countries. Directors noted that increased public spending on high-return human capital development and infrastructure outlays, accompanied by an acceleration of structural reforms, could help to place these economies on a higher sustained growth path and, by creating jobs, help improve social outcomes. Non-oil-producing countries in the region have also benefited from the positive impact of domestic reforms, as well as the strong growth in oil-exporting countries in the region.

Directors were encouraged by the highest growth seen in a decade in *sub-Saharan Africa*. This was underpinned by the strength of the global economy, high commodity prices, improved macroeconomic policies, and progress with structural reforms. Directors viewed the prospects for growth as generally favorable, but cautioned that there are a number of downside risks. A less benign global economy and a further sharp depreciation of the U.S. dollar would adversely affect a number of countries. While higher oil prices would be beneficial for some, they would not be so for other countries. Moreover, many countries would need to adjust to the elimination of world textile trade quotas. To sustain the improved growth performance in sub-Saharan Africa, Directors urged governments to further their reform efforts by promoting private sector investment, developing infrastructure, and strengthening institutions (including better transparency, governance, and property rights). They also called on the international community to support these policies with increased aid, debt relief, and improved market access.

Directors welcomed the two staff essays on output volatility and remittances in developing countries. Directors agreed with the staff's analysis that output volatility has negative effects on long-term economic growth, and encouraged policymakers to address the sources of output volatility. In particular, they noted the contribution that more stable fiscal policies and further steps to develop financial sectors and diversify the production base can make to reduce output volatility. Directors noted the positive impact that remittances have on recipient economies, particularly in terms of imparting macroeconomic stability and helping reduce poverty. They encouraged governments to enact policies to increase remittance flows, particularly by reducing transactions costs and implementing policies to promote formal financial sector participation in the remittance market. Several Directors stressed that remittances should not be seen as a substitute for aid flows.