Prospects for the World Economy

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Good morning. It is my pleasure to address you today and take stock of the prospects for the world economy. After three years of strong growth, the global economy is at an important juncture. The expansion is becoming more balanced and broad-based. Growth in the United States-while still strong-is slowing in the face of headwinds from a cooling housing market and rising fuel costs. However, here in Europe, growth has gained momentum, while in Japan the expansion has continued to be supported well by domestic demand. Moreover, emerging Asia has continued to grow strongly, with China and India leading the pack. In Latin America, the pace of activity has picked up, while oil exporters in the Middle East and low-income countries in Africa have also maintained impressive growth rates. But, as we look ahead, there are signs of increasing risks to this favorable outlook and the policy environment has become much more challenging.

Against this background, I would first like to talk about how I see high oil prices affecting with the global economy, and what are the prospects going forward. Then I will focus on what I believe are the main policy challenges, namely, what countries can do, unilaterally and multilaterally, to ensure that the global economy remains healthy. And finally, I will outline the types of policies that we at the Fund believe would enhance the smooth functioning of the oil market while maintaining the healthy global economy.

As for the global prospects, our baseline forecast is for a continued smooth ride for the global economy. However, as I said earlier, there are more clouds on the horizon than there were a year ago. What do we see as the main risks facing the global economy? First, with the housing market in the U.S. cooling faster than anticipated, there is a risk of an abrupt slowdown in the U.S. which could derail the global expansion. At the same time, however, there are also concerns with rising inflation pressures as the expansion matures, with capacity utilization tightening and productivity growth likely to show a cyclical slowdown. Furthermore, sudden or unexpected supply disruptions in the oil market-should they occur-could have more adverse effects than have occurred up to now, especially if they impact consumer and business confidence. As is well known, the impact of higher oil prices thus far and I emphasize thus far has been moderate in large part because they have been accompanied by strong demand for other commodities, and goods and services more generally. Developing countries have also benefited from a pick-up of other capital flows and workers' remittances, including from workers in the oil-producing countries, a relatively strong initial international reserves position, and for many, debt relief. However, these conditions are unlikely to persist into the future.

How can macroeconomic policies in advanced economies adjust to the new environment? Monetary policy decision-making in the advanced economies is becoming more difficult, and needs to remain particularly vigilant to competing risks of slowing activity and rising price pressures. In the United States, the recent pause in interest rate increases was an appropriate response and provides the Fed with more time to gauge the balance of risks and the impact of past rate increases, but further tightening cannot be ruled out. In the Euro area, some further tightening will likely be needed to maintain price stability in the medium run if the expansion develops as expected, but policymaker can afford to move cautiously. In Japan, the transition from zero interest rates has been handled smoothly. Interest rate increases going forward should be gradual since there is little danger of an inflationary surge, while the reemergence of deflation could be

costly. At the same time, it will be important for the advanced economies to sustain progress towards fiscal consolidation in the face of pressures from population aging.

Policymakers in emerging markets must also adjust to the more testing environment, being careful to respond promptly to any emerging strains. A major challenge in China and some other emerging Asian countries is to manage a transition to more flexible exchange rates that would allow necessary appreciation to take place, which would help achieve a more balanced pattern of demand. Russia and some other oil exporters could also benefit from more flexible exchange rates, which would help to contain risks of over-heating. Emerging market countries, in particular those with high public debt (in Latin America and elsewhere) will need to take advantage of opportunities to reduce these vulnerabilities further, while being quick to respond to adverse developments.

Multilateral trade liberalization remains essential for enhancing prospects for sustained global growth. Renewed efforts by *all* policymakers are needed to reinvigorate the process which came to a standstill with the deadlock of the Doha Round.

Large global current account imbalances continue to be a major concern for the outlook, but we still view the mostly likely outcome as a relatively smooth unwinding, led by the private sector. Over time, we anticipate that U.S. national saving will return to more normal levels, and that consumption will rise as a share of GDP in countries with large surpluses such as China and many oil-exporting countries. For such a rebalancing of global growth to occur, policies must support— rather than stifle the private sector-led adjustment. In this regard, the IMF is conducting its first multilateral consultations, involving the U.S., the Euro area, Japan, China and Saudi Arabia to assess how joint efforts by key countries can contribute to reducing global imbalances while maintaining healthy growth.

Let me now turn to the policy challenges that relate to the oil market. As you all know well, reducing imbalances in the oil market requires an orderly, predictable, and transparent market, with adequate data concerning supply and demand conditions to enable investors to better understand future production, consumers respond to price signals in a timely fashion, and prices truly reflect the scarcity of the resource. Such an environment would also help reduce large price swings associated with over- or under-investment. In addition, collective efforts can help to ensure strategies in producer and consumer countries are mutually consistent. Because the oil market is a global market, policy-makers need to consider effects beyond their country's borders.

First, domestic fuel prices in all countries should be set to reflect economic and social costs, and to promote an appropriate demand response. Relatively low gasoline taxes in the U.S. and low prices in China (the largest consumers of oil), as well as highly-subsidized fuel prices in oil-exporting countries and other developing countries relative to international prices discourage conservation with potentially adverse environmental implications. The analysis done at the Fund and at the World Bank, show time and time again that keeping fuel prices below market prices disproportionately benefit wealthier people. Instead, prices need to be raised, and the impact on poor households should be mitigated through well-designed and targeted safety nets. Granted, this is not easy. Raising domestic fuel prices can lead to political resistance in many countries, and the design and implementation of targeted safety nets are difficult in developing countries. But

the recent successful experiences of Indonesia and Jordan, and the United Arab Emirates, among other developing countries, show that it can be done successfully when governments are committed.

Second, ensuring adequate investment in the oil sector will help alleviate concerns about future supply. Regardless of whether production is in the private or public sectors, governments should strive to ensure that regulatory and tax regimes not only encourage investment for expanding the energy supply infrastructure and supply chain (including more refinery construction), but are also flexible enough to ensure that the risks and rewards are appropriately distributed between producers and the home country. Recent moves in various producer countries to change the taxes or terms of contracts of oil companies may raise government revenues in the short term, but this could backfire, as they create significant disincentives to new investment in oil production, thus ultimately affecting the governments' long-run revenues.

Third, oil-exporting countries, particularly in the Middle East, must rise to the challenge of finding the appropriate balance between spending the increased oil revenues on high-return projects that diversify their economies and respond to pressing social needs, and saving revenues for future generations. This balance will ultimately be determined by each country's fiscal position, capacity constraints, and opportunities to invest in high-return social or infrastructure projects. Getting this balance right will mean that these countries seize this historical opportunity to push forward their economic development.

Finally, and very importantly, increased transparency and better oil data can improve decision-making by oil market participants. We fully support the Joint Oil Data Initiative and other initiatives that aim at improving the coverage and quality of energy statistics, and the Fund is participating in many of these initiatives. Nonetheless, further national and international efforts are needed in this area.

I would like to conclude by saying that I am very happy to participate, for the first time, in this very important forum, not long after the Fund and OPEC held the first high-level meeting here in Vienna last May. We have a shared interest in promoting economic stability and sustainable growth. The challenge ahead, therefore, is for OPEC to work closely with other multilateral organizations and the global community to enhance the order and stability of the international oil markets in support of continued sound economic growth. While we cannot expect, nor should we try, to smooth out every fluctuation of oil prices, we can ensure that all countries work to minimize the adverse impact they may have on the global economy.

Thank you very much.