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International Monetary and Financial Committee
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Item 2 (The Global Economy and Financial Markets—Outlook, Risks, and Policy Responses) of the provisional agenda of the International Monetary and Financial Committee meeting.

The OECD is finalising its *Economic Outlook* No. 77, which will be released on 24 May 2005. Our views at this time are summarised below.

As rising oil prices and exchange rate shifts worked through our economies, OECD-wide growth slowed in the course of 2004 but rebounded in early 2005. Performance, however, diverged across countries. Momentum barely slackened in the United States, and also held up well in the United Kingdom and France. In contrast, activity slowed significantly, and even contracted for a time in Japan, Italy and Germany, where domestic demand remained sluggish. In the other OECD countries and beyond, growth was generally quite robust.

From the second half of 2005, the OECD-wide expansion is projected to gather strength and to become more balanced, helped by sustained buoyancy in the rest of the world, even if oil prices remain around $50 per barrel. The OECD countries ahead in the cycle are likely to slow and the others to catch up, albeit gradually and, in some of the less resilient euro-area economies, only partially. Where the cycle has lagged, investment should accelerate, helped by ample profits, stronger balance sheets, easy credit and rising capacity utilisation rates. However, employment creation will be slow to pick up, and unemployment is not expected to decline rapidly from its current high levels in a number of OECD economies.

Many of the risks surrounding this outlook stem from continuing external and internal imbalances in the form of widening current account gaps and persistent large fiscal deficits, while some classes of assets may be richly valued. Some of the imbalances may be starting to unwind, with housing markets slowing in some countries and long-term interest rates and bond spreads beginning to rise. So far, this has not caused major disruptions, but serious turbulence cannot be ruled out in the future. Moreover, in some countries, another risk is that business investment will be disappointing if firms believe that final demand will remain weak. While prices could go either way, uncertainty regarding future oil price developments also requires caution.

Against the background of intensifying competition from low-cost emerging market producers, and despite energy price increases to date, wage growth generally remains moderate in OECD countries and core inflation low or under control. Monetary stimulus is being withdrawn in the OECD’s English-speaking countries, where any slack that exists is shrinking, and where the return towards neutral interest rate levels should continue. In Continental Europe and Japan, however, the outlook remains too fragile to envisage an early change in the current monetary stance.

Fiscal positions remain precarious in most OECD countries, both in headline terms and, more worryingly, when adjusted for the cycle and for various types of one-offs or omissions. Meanwhile, population ageing is starting to reduce tax revenue and increase public spending in some countries – most notably in Japan – and will shortly do so in others. The ongoing reforms to pension and health care systems need to be implemented, but more is also needed to put public finances back on a sustainable course. More immediately, while in some countries cyclical conditions may call for incremental rather than abrupt fiscal

adjustment, an overly gradual approach could put pressure on long-term interest rates, with risks for economic activity.

Against this macro-economic backdrop and the prevailing qualified optimism about growth and inflation, financial markets are in relatively good shape. Major equity markets have continued to hold up reasonably well, credit spreads have remained compressed and volatility is low. Balance sheets of banks continue to be healthy and, despite record losses associated with large-scale disasters in 2004, insurance companies have remained resilient.

Nonetheless, certain risks and imbalances remain. Compared with historical levels, long-term interest rates are low. This may be due to specific factors that could prove unsustainable. However, low rates also reflect non-transitory factors such as stronger demand for long-term fixed-income instruments resulting from actual or announced changes in the regulatory and accounting environment and expected demographic developments. Continuing current funding gaps of many pension funds may signal that governments need to take appropriate measures. More generally, there is growing awareness that financial risks are increasingly being shifted to individuals. This shift may help risk diversification for the system as a whole, but it also suggests the need for further protection and financial education for households who will increasingly need to take responsibility for their retirement income.

Item 4 (IMF Support for Low-Income Members' Efforts Towards Poverty Reduction and Strong Sustainable Growth) of the provisional agenda of the International Monetary and Financial Committee meeting.

The role the IMF should play in low-income countries when its own operations are no longer involved could be to provide a "signalling function". At a moment when there are calls for major increases in aid over the medium term, such a function would provide a valuable service to both donors and their developing partner countries. In line with the Paris Declaration on Aid Effectiveness agreed on 2 March, the assessment would need to include the predictability of the increased aid flows, including through budget support or other programme-based approaches, on the one side, and the expenditure and revenue management of the developing country on the other. This implies monitoring the efforts of development partner countries to manage expenditure and operate effective tax revenue policies. From the perspective of our work for the DAC on aid effectiveness, the provision of such a medium-term monitoring and signalling service by the Fund would be a major contribution. It would mean that the Fund staff would be both present and highly engaged with the donor community at the country level. We therefore hope for agreement on a role for the Fund that embraces this kind of engagement.