International Monetary and Financial Committee

Twelfth Meeting
September 24, 2005

Statement by Mr. Donald J. Johnston
Secretary-General of the Organisation for Economic Co-operation and Development

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This statement concerns 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 currently starting to update its *Economic Outlook* projections in preparation for their release on 29 November 2005. Our views at this time are summarised below.

Since the April meeting of the IMFC, oil prices have risen substantially, scaling new peaks. Their cumulative increase over the past two years matches, in absolute terms, the large shocks observed in earlier decades. Far futures prices have risen apace, consistent with the perception that prices may well remain high for some time. The associated drag on activity may be magnified by the uncertainty surrounding the evolution of energy prices, which was heightened by Hurricane Katrina. The macro-economic repercussions of this catastrophe cannot yet be gauged precisely, although they were certainly mitigated by the release of emergency oil stocks. It is also too early to provide a precise answer to the question of how well the financial system, and especially the insurance industry (which has shown considerable resilience to catastrophes in 2004), is absorbing the shock. All the recent experiences of natural or man-made catastrophes have clearly highlighted the importance of improving both prevention and the financial management of large-scale disasters.

The main OECD economies are facing the headwinds associated with higher oil prices at different stages of the business cycle and when underlying momentum is considerably varied. In the United States, where output and unemployment gaps are essentially closed, the expansion is expected to proceed at a fairly robust pace, albeit possibly with some deceleration in the course of the second half of 2005 before a pick-up around the turn of the year. In Japan, the labour market has been improving and the recovery is taking hold, helped by sustained dynamism in Asia generally and in China in particular. In contrast, in the euro area, considerable slack has built up and, although some signs of recovery are emerging, it is not set to shrink in the near term. In the United Kingdom, household consumption has faltered recently, alongside the cooling housing market.

At the same time, inflation has been diverging among economies. In the United States, core inflation has settled around 2%, with the headline measure somewhat higher, due to energy prices. In Japan, core inflation is stable but still negative. In the euro area, the trend of core inflation has been downwards, to around 1¼ per cent, whilst headline inflation has remained around 2%. In the United Kingdom, core inflation has been rising.

Against this background, central banks face different challenges. The US Federal Reserve still has some way to go before reaching neutrality. The Bank of Japan should maintain its commitment to keep the policy rate at zero as long as underlying inflation is not durably positive. Central banks in the euro area and in the United Kingdom face more of a dilemma. In the euro area, stable headline inflation in the face of the energy price surge is the reward for credible monetary policy, but it

also and more disquietingly results from a prolonged spell of economic weakness coupled with falling underlying inflation. This means that the case for a very accommodative stance is still strong. In the United Kingdom, as long as inflation expectations remain well-anchored, a wait-and-see attitude may be warranted.

On the fiscal side, limited if any progress with consolidation is under way in Europe and Japan. While tax receipts have been surprisingly high in the United States, it remains unclear whether this represents a lasting improvement in the underlying fiscal position. Even if this is the case, greater restraint on the spending side will be in order in the future, (as in most other OECD economies), given the mounting pressures exerted by demographics on fiscal positions.

These demographic developments may also weaken corporate balance sheets, which have otherwise weathered relatively well the move to market-based accounting methods. Corporate sponsors of pension and health plans are increasingly concerned about their exposure to growing liabilities, and are starting to take corrective action. In countries where sponsors are clinging to defined benefit plans, growing appetite for fixed income securities has been observed, especially long-dated and inflation-indexed government bonds. Expected regulatory changes may be further fuelling this demand, bringing to the fore the need for careful analysis of the implications of pension regulations for financial stability.

Corporate pension plans are also experiencing a more dramatic transformation in some OECD countries. The shift from defined benefit to defined contribution plans, through which investment and longevity risks are transferred to plan members, is expected to intensify in the coming years. The individualisation of pension risks is raising concerns, not only about the ability of individuals to manage their financial future but also about the implications for the behaviour of financial markets. Financial education programmes are expected to play an increasingly important role in the coming years, but policymakers may also have to be more active in encouraging the development of mechanisms that provide high levels of benefit security.

More generally, many households face an increasing number of different risks on both sides of their balance sheets, with several of them having previously been borne by financial institutions. For such institutions, despite these risk transfers, a strengthening of their balance sheets and a broadly positive mood in financial markets (as reflected in low risk premia), several imbalances continue to overhang prospects for their stability, and some of these imbalances have continued to grow. These imbalances include excessive levels of indebtedness for some households, as well as unsustainable current account and fiscal positions. While some of the risk transfers may have increased the resilience of specific financial institutions, the effect of these various transfers on the stability of the financial system as a whole is not yet known. There also appears to be a growing concern that many risks are under-priced.

This statement concerns item 4 (Strengthening IMF Support for Low-Income Countries – Instruments; Financing; and Debt Relief) of the provisional agenda of the International Monetary and Financial Committee meeting.

The discussion over the last year on the IMF's role in low-income developing countries is now producing some concrete action and proposals. We welcome the progress in reviewing the

Fund's role in the development cooperation process. We have particularly appreciated the Fund's close involvement in the preparation and follow-up to the Paris Declaration on Development Effectiveness of 2 March 2005, signed by some 100 countries and development agencies.

OECD projects a $50 billion increase in annual aid by 2010 (of which $25bn will be for Africa), based on donor's public announcements. These projections have been cited as a point of reference by both the Gleneagles Summit and last week's UN Summit Outcome Document, which also provides for developing countries to produce by 2006, national plans for reaching the MDGs by 2015. Key areas where the Fund's role can be crucial include assessment of medium term fiscal frameworks in countries where significant scaling up of aid is in immediate prospect. The Fund's contribution to ensuring the medium term predictability and sustainability of the scaling-up process at the country level, including increased budget support, will be vitally important. This implies also that the Fund should be effectively present at the country level where donors and governments will be collaborating closely on the financial planning implied by the scaling up process. The World Bank and the DAC are jointly chairing a meeting here in Washington next Monday to begin to scope out the aid management issues facing donors in this new context.