International Monetary and Financial Committee

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Statement by the Managing Director

The Managing Director's Statement
To the International Monetary and Financial Committee
On the Global Economy and Financial Markets

Over the last year, the global recovery has become increasingly well established and broad-based geographically, underpinned by continued accommodative macroeconomic policies, improved corporate profitability, rising equity markets and house prices, rising employment, and—particularly in Asian countries—the very strong growth in China. After stronger-than-expected global growth through the first quarter of 2004, the growth momentum has slowed from the second quarter while oil prices have risen sharply. While some slowdown was inevitable, following three quarters of exceptionally rapid global expansion, and—as discussed below—the "soft patch" in some countries appears most likely to be temporary, looking forward the expansion is expected to be somewhat weaker than earlier thought. Correspondingly, while global GDP growth is projected to increase to 5 percent in 2004—almost ½ percentage point higher than expected at the Spring Meetings, largely reflecting the unexpectedly strong first quarter growth this year—it is projected to moderate to 4.3 percent in 2005, slightly weaker than we then thought.

After falling to unusually low levels in mid-2003, inflation across the world has turned up. While headline inflation has inevitably increased with higher oil prices, core inflation has also picked up in a number of countries, including the United States. Inflationary risks vary across countries and regions, but—particularly in most developed economies—appear moderate, given substantial excess capacity; generally moderate wage settlements relative to productivity growth; strong corporate profitability providing scope for firms to absorb price pressures; and reasonably well-anchored inflationary expectations. Even so, central banks will need to be vigilant to contain second-round effects of higher headline inflation, a task that will be easier in those countries where central bank credibility is well established.

Financial market conditions are benign at present, supported by the global recovery, and the financial system is more resilient today than it has been since the bursting of the equity bubble. The earnings and balance sheets of the corporate and financial sectors in industrial countries have generally improved, while the credit quality of emerging market borrowers has been bolstered both by the strengthening global economy, better debt and balance sheet management, and, in some cases, by rising commodity prices. The transition to higher policy interest rates has so far been successfully managed with little discernible impact on wider financial markets. This reflects clear communication strategies by policymakers, generally moderate inflationary pressures, and strengthened risk management. Recently, expectations for further policy interest rate rises have been revised downward in the United States and elsewhere, and longer-term market interest rates have declined in light of softer data on economic activity and little indication of increasing inflationary pressures. In foreign exchange markets, the major currencies have moved rather little in trade-weighted terms since last April, while those in central Europe have strengthened and some other emerging market currencies, notably in Asia, have depreciated.

Emerging market financing conditions have remained supportive, reflecting improved credit fundamentals and the continued global search for high yields. Accordingly, emerging market bond spreads have once again declined to near-record lows after a brief spread widening in the spring. A wide range of countries have taken advantage of the relatively benign financing conditions to complete their external financing needs for 2004 at relatively low costs.

With the oil market remaining highly vulnerable to shocks at current production and capacity levels and with softer-than-expected incoming data in the United States and some other countries, the risks to the outlook have shifted to the downside. In the short run, geopolitical risks remain very much present, and in contrast to the position before the 2000–01 slowdown, the room for policy easing in response to disturbances is relatively limited. There is also a risk that inflationary pressures could prove stronger than expected—a concern tempered by downside risks to global growth—necessitating a sharper rise in interest rates than markets presently price in, with a possible significant adverse impact on housing markets and emerging market financing conditions. Finally, the recent prolonged period of low volatility in a range of financial markets could have led to increased risk-taking, raising the possibility of sudden market shifts that could be disruptive.

Looking beyond the short term, there are both opportunities and significant risks. The information technology (IT) revolution, along with China's growing role in the global economy, presents an opportunity for sustained higher global productivity growth. However, significant economic vulnerabilities remain in both industrial and emerging market countries, particularly on the fiscal side. Many industrial countries face already difficult fiscal positions and are far from prepared for the impact of aging populations. In emerging markets, high and poorly structured public debt continues to be an important source of risk. Corporate and financial sector vulnerabilities also remain significant, particularly in countries where nonperforming loans remain large or rapid private credit growth occurs in the context of macroeconomic imbalances or regulatory weaknesses. Moreover, the ongoing reallocation of risks from relatively more regulated institutions to relatively less regulated institutions, particularly pension funds and insurance companies, and from relatively more transparent institutions to relatively less transparent institutions, such as hedge funds, needs to be closely monitored. These developments may enhance the resiliency of the financial sector as a whole, but may do so by presenting new risks. And last but not least, the continued global imbalances, notably the large U.S. current account deficit and surpluses elsewhere, and the uncertainty about how these will be resolved, remain important sources of potential instability.

Short-term Prospects

Among *industrial countries*, the expansion continues to be led by the *United States*, where ebbing fiscal and monetary stimulus is balanced by strong labor productivity growth. Second quarter GDP growth—especially private consumption—was weaker than expected, and employment growth has slowed. Given continuing strength in profits and household labor income, it seems most likely that this soft patch is temporary and that growth will pick up in the second half of 2004 and remain above potential through 2005. However, growth forecasts have been marked downward in both 2004 and 2005 compared to those of April 2004, and much continues to depend on a solid rebound in employment.

In the *euro area*, the recovery is taking root, with the 2004 forecast marked up significantly, but it continues to depend heavily on external demand, and final domestic demand—especially in Germany—has remained relatively weak. Looking forward, rising disposable incomes and progress in corporate balance sheet restructuring should boost private consumption and investment, contributing to a more balanced area-wide recovery. However, given a history of slow adjustment to disturbances, and with employment likely to strengthen only gradually, the pace of the expansion is expected to remain moderate. The risks to the outlook appear tilted to the downside, and include a further rise in oil prices; a slower-than-anticipated pick up in employment after unusual resilience during the recession; and renewed euro appreciation. Elevated house prices in some countries are also a concern.

In *Japan*, the upturn has been strong, amid increasing signs that its longstanding problems—deflation and financial and corporate sector weaknesses—are easing. While growth slowed sharply in the second quarter, recent forward looking indicators generally suggest that underlying private domestic demand and external demand remain robust, with profits continuing to grow strongly and household surveys indicating steady consumer demand growth. Against this background, the outlook remains for a sustained, broad-based expansion; however there are some downside risks to the staff forecast, with the key concerns including oil prices and a hard landing in China.

Emerging market and developing countries continue to experience a generally strong recovery, with GDP growth forecasts for 2004 revised upward markedly in all major regions. In *emerging Asia*, GDP growth has been buoyant, led by booming activity in China and in India. Looking forward, growth is expected to slow somewhat but to remain solid, partly depending on developments in China, where, despite some signs of slowing growth, a soft landing is not yet guaranteed. The region remains relatively vulnerable to external developments, notably oil prices or a downturn in the IT sector. While domestic demand growth has progressively strengthened throughout the region, current account surpluses and, in some cases capital inflows, remain very high. With output gaps declining and limited exchange rate flexibility, the resulting large reserve increases will increasingly complicate the conduct of monetary policy.

In *Latin America*, economic activity has rebounded strongly, supported by the global recovery, rising commodity prices, and increasingly by domestic demand. A number of countries have taken advantage of benign external financing conditions to complete their financing targets for 2004 at low cost and improved the structure of their debt. However, underlying vulnerabilities in the region remain large and adverse external shocks remain a key source of risk. Cutting high public debt ratios will thus be essential. In Argentina, it will be critical to press ahead with structural reforms to sustain the recovery, including the renegotiation of utility concessions, and to agree with creditors on the restructuring of sovereign debt. In Brazil, the recovery and expenditure restraint have helped to strengthen public finances while monetary policy has remained appropriately tight, but to maintain the current rebound in growth, structural reforms need to be extended and deepened.

The expansion in *central and eastern Europe* continues at a robust pace, supported by rising domestic demand and strong external demand. This, combined with higher oil prices, has also led to a pick up in inflation in many countries, which is now running at levels above the Maastricht target in some countries. Looking forward, GDP growth is expected to remain well-sustained, but large fiscal and, linked to that, current account deficits remain central vulnerabilities. GDP growth in *Turkey* is exceeding expectations, although the widening current account deficit—exacerbated by higher oil prices—is a source of concern and underscores the need for continued policy discipline.

In the *Commonwealth of Independent States*, rising global demand for oil and metals has boosted the already strong growth momentum in the region, with growth forecasts for Russia and Ukraine revised upwards sharply, although some CIS-7 oil importers have been adversely affected. Given strong domestic demand, rising oil prices, and resistance to exchange rate appreciation, inflationary pressures in a number of countries are becoming a concern. Prudential risks associated with rapid credit growth and past regulatory forbearance as well as adverse confidence effects of discretionary government interference continue to be key vulnerabilities. Much remains to be done to improve the investment climate and fully develop the institutions and structures for market-based economies.

In *Africa*, the growth performance has improved, 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. Short-term economic prospects for many countries appear more favorable than they have been for many years, although the humanitarian catastrophe unfolding in western Sudan and the economic collapse in Zimbabwe are of deep concern. Nevertheless, with most countries likely to fall significantly short of achieving the Millennium Development Goals, the promotion of private investment and development of the infrastructure, the deepening of institutional reforms, and the reduction of government involvement in the economy remain key policy challenges throughout the continent.

In the *Middle East*, GDP forecasts have been revised upward, primarily in response to higher oil production and prices. Looking forward, non-oil growth is expected to pick up on the back of the global recovery, higher non-oil commodity prices, and reform prospects and, to some extent, offset lower oil sector growth, as oil production is increasingly close to capacity. While most countries in the region have benefited from higher oil prices, they continue to be exposed to medium-term oil price volatility and, some of them, to risks associated with high public debt levels, underscoring the need to save windfall gains from above-average oil revenue and, if needed, to press ahead with fiscal consolidation. The continued fragile security situation remains a concern. In view of the high unemployment in the region, it will be critical to raise medium-term growth by accelerating broad-based structural reforms.

Policy Priorities to Reduce Vulnerabilities and Strengthen Growth Potential

With the global expansion expected to remain solid, the key short-term policy challenge remains to manage the transition toward higher interest rates, ensuring that nascent inflationary pressures are contained while—through effective communication—facilitating a continued orderly adjustment in financial markets. The desirable pace and timing vary significantly, depending on country's relative cyclical positions, ranging from China—where monetary conditions have already been tightened and more may be needed to prevent incipient overheating—to Japan, where despite stronger growth and easing deflationary pressures, monetary policy should remain accommodative until deflation and deflationary expectations turn around decisively. In the United States, the long-anticipated tightening cycle began in June; with considerable economic slack persisting, the Federal Reserve has appropriately indicated that future interest rate increases are likely to be measured, although with uncertainties both about the pace of recovery and the strength of inflationary pressures, much will depend on the nature of incoming data. In the euro area, monetary policy should remain accommodative until a self-sustaining pickup in domestic demand emerges, given moderate underlying inflationary pressures. Emerging market countries should use the currently favorable financing environment to increase their resilience to future external shocks by improving the structure of public debt.

With the solid on-going expansion, however, the policy priority must be to address key medium-term vulnerabilities and challenges.

Strengthening medium-term fiscal positions, both through consolidation and reforms of pension and health systems. While most industrial countries appropriately target a gradual fiscal consolidation, in many cases this depends on relatively optimistic assumptions, and the policies to achieve it are not well defined. Despite some progress on pension reform, notably in the euro area and Japan, much remains to be done to address the pressures from aging, the more so since past population projections have systematically underestimated the size of the problem. In emerging markets, fiscal consolidation is under way in much of Latin America and beginning in some countries in Asia, but is lagging in much of emerging Europe. In many countries, large and sustained primary surpluses will be needed to bring public debt down to manageable levels, which is key to increasing their resilience to future external shocks. Given substantial—and understandable—pressures for additional social and infrastructure spending, this underscores the importance of other measures to improve public debt sustainability, especially broadening tax bases, strengthening frameworks for public expenditure management, and last, but not least, structural measures to boost growth (which, historically, has been key to most successful debt reduction efforts).

Strengthening the foundations for sustained and sustainable growth. In industrial countries, the cost of economic inflexibility has risen with rapid technological change and globalization, and in a number of countries more growth-friendly ways need to be found to achieve social goals. Flexibility in labor and product markets, especially in the euro area, education and training to improve workforce skills, and well-targeted social safety nets will play a critical role. The agenda also includes corporate and banking reform in Asia, improving the investment climate—including through tax reform—in Latin America, strengthening bank supervision in emerging Europe, and, in the Middle East and Africa, putting in place the institutional infrastructure to underpin non-oil private sector development. From a multilateral perspective, the central objective is to achieve substantive trade liberalization under the Doha Round. The end-July package of agreements reached in Geneva is therefore a welcome step forward, putting the Round formally back on track. However, the agreements only provide the minimum needed in terms of ambition and specificity for the next phase of negotiations, and much work combined with continued commitment is required to advance the Round to the December 2005 Ministerial Meeting in Hong Kong SAR. Responding to concerns about the costs of adjusting to more open global trade, the Executive Board recently approved the Trade Integration Mechanism, which provides additional financing assurances to countries where liberalization by trading partners may lead to a temporary deterioration in the balance of payments.

In mature financial markets, authorities should guard against complacency by market participants that the currently low volatility will continue. While most financial institutions seem well protected against the risk of higher interest rates, regulators should remain vigilant in their supervision of systemically important institutions to guard against the build-up of excessive leverage and risk taking in other areas. In addition, the improved market conditions also provide an opportunity to strengthen the supervision and regulation of financial institutions that came under pressure during the most recent market downturn, such as insurers and pension funds. Greater use of risk-based supervisory standards can help to encourage improvements in risk management at these institutions, consistent with such improvements already made at many banks, and thus position these institutions better against future market downturns. Authorities should also better understand hedge funds' activities, their relationships to regulated financial institutions, and their impact on financial stability. Going forward, analysis of financial stability needs to pay increasing attention to nonbank financial institutions, to aging populations and to the risks being taken on by the household sector, which is often the final recipient of risks and the ultimate shock absorber in the financial system.

All countries and regions need to play their part in addressing the global imbalances. The key policy requirements include medium-term fiscal consolidation in the United States to boost national savings; structural reforms to boost growth prospects outside the United States; and exchange rate flexibility in Asia. Some welcome steps have been made with regard to the first two requirements even though much remains to be done, but little progress has been made on the third.

Poverty reduction must remain a priority on the international agenda. The recent strong growth has made a welcome contribution to poverty alleviation where poverty is most concentrated—China, India, and sub-Saharan Africa. Nevertheless, Africa is still likely to fall well short of the Millennium Development Goal target. With macroeconomic stability generally achieved, the key challenge—as recognized in the New Partnership for Africa's Development—is to strengthen institutions and governance. The global community, in turn, needs to support strengthened reform efforts with substantially increased and better coordinated assistance and, perhaps even more importantly, by eliminating barriers to exports, particularly of agricultural goods.

In summary, the overarching policy priority is for countries to take advantage of the current favorable economic conditions and address fundamental medium-term vulnerabilities and challenges. What is needed is durable fiscal consolidation, growth-enhancing structural reforms, strengthened corporate and financial balance sheets, the rebalancing of global current account positions, and poverty reduction. This is all the more important since, to date, progress has been at best mixed, and in some countries signs of reform fatigue have emerged. Without further action, policies will not rise to the challenge, leaving the world significantly more vulnerable to the shocks it will inevitably face in the future. Fortunately, as previous reform successes have shown, obstacles to reform can be overcome with determined efforts and implementation strategies that take political and economic constraints into account.