International Monetary and Financial Committee

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Statement by the Acting Managing Director

Acting Managing Director's Statement to the International Monetary and Financial Committee on the Global Economy and Financial Markets

The global recovery has broadened and strengthened more rapidly than expected, extending to all regions and encompassing more sectors—albeit at varying pace and magnitude. The upturn is most rapid in emerging Asia and the United States while it is still tentative in the euro area, where consumption remains weak and some forward-looking indicators have disappointed in recent months. The strengthening has been underpinned by a pick up in industrial production and a solid revival in investment growth in almost all regions, and was accompanied by a sharp rise in world trade and buoyant financial markets. With continued policy stimulus, improving corporate profitability, favorable financial market conditions, and an expected further pickup in inventories, global GDP growth is projected to accelerate from about 4 percent in 2003 to about 4½ percent in 2004, an increase in both years of about half a percentage point compared to the Annual Meetings in 2003.

Positive economic trends and ample liquidity helped financial markets to impressive gains last year, and the factors that supported those gains remain in place. Corporate balance sheets are strong and profitability has improved sharply. Nominal interest rates in the major financial centers remain near historic lows and volatility in financial asset prices has been subdued. Many emerging market countries have taken the opportunity of the current supportive external conditions to improve the structure of their domestic and external obligations. This year, financial markets have entered a welcome period of consolidation, in which investors appear to be exhibiting greater discrimination. Financial markets are still anticipating a continued strong and broadening recovery and are favoring those credits that are expected to show solid returns in the long term.

The U.S. dollar has depreciated further since last September, driven by concerns about the sustainability of the U.S. current account deficit. While the adjustment has thus far been relatively orderly, the distribution of corresponding appreciations across countries and regions has been unduly concentrated, focused primarily on the euro and a number of other industrial country currencies. Emerging market currencies, while generally appreciating somewhat against the U.S. dollar, have depreciated in trade-weighted terms.

The increasingly rapid global recovery has also fed through to higher commodity prices. The rise in oil prices reflects not only higher-than-expected demand, particularly in the United States and China, but also OPEC announcements of prospective production cuts and speculative activity in the oil futures market. Nonfuel commodity prices have also rallied, with metals (traditionally the most cyclical commodity) and food and agricultural materials experiencing the largest gains. While nonfuel prices are expected to stay firm, they remain moderate by historical standards and their average pace of increase is likely to slow in 2004 as earlier agricultural supply shocks unwind and metals production responds to higher prices.

With the global recovery becoming increasingly well established, the balance of risks has significantly improved. Indeed, a number of factors could generate a more robust upturn in the short term in some regions, including the strong rebounds in both world trade and financial markets, and the continued strength of the U.S. economy, which is often a leading indicator of developments elsewhere. It is also relevant to note that, just as forecasters tend to be overly optimistic during downturns, they tend to be overly pessimistic during recoveries. At the same time, there are important downside risks even in the short term, including geopolitical uncertainties and oil price volatility. Looking forward, the continued large U.S. current account deficit—now matched by a fiscal deficit of similar size—and surpluses elsewhere, notably in Asia, remain a serious concern. Global interest rates are very low and will have to rise eventually, but the timing and speed of future moves remain subject to considerable uncertainty. Medium-term fiscal positions across the globe remain very difficult. Finally, while the Doha Round trade negotiations appear to be regaining some momentum, differences among the negotiating parties remain large, and there are risks of further delay, which may disappoint expectations of healthy and sustained medium-term growth in global trade.

Short-term Prospects

Among *industrial countries*, the recovery is again projected to be strongest in the *United States*, accompanied by continued strong productivity growth. GDP growth is being underpinned by highly stimulative monetary and fiscal policies, rising profitability, and the rebound from the earlier bursting of the equity price bubble. However, employment growth in this recovery has so far been weak by historical standards. With the impact of past fiscal and monetary stimulus waning over the coming year, growth will be supported by an acceleration in investment growth, while private consumption slows only modestly, as improving employment conditions and the rebound in equity prices largely offset the fading impact of tax cuts and home equity withdrawals.

In the *euro area*, the recovery is subdued and has initially relied mainly on external demand. Investment rebounded in the fourth quarter, but household consumption remains weak. Strong external demand, solid household balance sheets, equity market gains, and improving profitability should support a gradual strengthening in domestic demand. However, the robustness of the recovery is uncertain, given subdued consumer sentiment, high unemployment, corporate restructuring apparently having some way to go, and the possibility of a further appreciation of the euro. Much continues to depend on external demand, the traditional driver of European recoveries.

In *Japan*, GDP growth has continued to exceed expectations, supported by strong external demand despite yen appreciation, rising business investment, and more recently a pickup in private consumption. Looking forward, the outlook is for continued moderate expansion in economic activity, with some upside potential if the rebound in corporate profitability continues to feed strong business investment, and improved labor market conditions sustain the pickup in private consumption. The main short-term risks are a further sharp appreciation of the yen and a slowdown in key trading partners, such as China.

Emerging market and developing countries have also seen a stronger rebound in activity because of this more favorable global environment, with GDP growth projections for 2004 marked up—to varying extents—in almost every major region.

In *Latin America*, the recovery is expected to consolidate this year after weak GDP growth in 2003, underpinned by the global recovery and rising domestic demand related to increased confidence and lower interest rates. Given large medium-term external financing requirements, the outlook for many countries remains vulnerable to a reversal of the external financing conditions or to domestic policy slippages, though progress in debt restructuring has reduced vulnerability in some countries. In Argentina, further robust expansion in activity will critically depend on progress in restoring fiscal sustainability, including through sovereign debt restructuring; strengthening the banking system; and resolving problems in the energy sector. In Brazil, continued strong macroeconomic policies and progress in structural reforms are key to sustain confidence and support a recovery in activity in 2004.

In *emerging Asia*, the strong growth momentum has been underpinned by accommodative macroeconomic policies, competitive exchange rates, and the recovery in the global IT sector. Rapid growth in China, driven by rapid increases in investment and exports, has provided important support to activity in countries within and outside the region, while GDP growth in India has also exceeded expectations, aided by favorable rainfall and low domestic interest rates. Reflecting increasing capacity utilization rates and rising global commodity prices, inflation has picked up modestly in some countries, although it remains as yet low. Looking forward, there is the risk that further substantial reserve accumulation could exacerbate inflationary pressures in countries with the strongest cyclical upturns. In China, rapid growth of credit and of investment remains a particular concern.

In c*entral and eastern Europe,* a modest upturn in growth in 2004 is projected, constrained by the relatively weak performance of the euro area and the need for fiscal consolidation in many countries. In Turkey, the expansion in economic activity is expected to continue at a robust pace, and the public debt dynamics, while still vulnerable to changes in confidence, are strengthening. Reforms are needed to strengthen the supervisory and regulatory framework governing financial markets.

In the *Commonwealth of Independent States*, growth in 2003 exceeded expectations, underpinned by robust upturns in Russia and Ukraine, including—encouragingly—some pickup in nonenergy sector investment. Growth in 2004 is projected to moderate to more sustainable but, by historical standards, still robust rates. Looking ahead, further measures to strengthen the investment environment are needed to sustain strong growth.

In the *Middle East*, growth this year is expected to fall back from the relatively high levels of 2003, mainly owing to slower growth in oil production, but will remain robust as non-oil activity will benefit from accelerating global growth. Key risks to the outlook include oil price volatility, especially given difficult fiscal situations in a number of countries, geopolitical uncertainties, and the security situation.

The rate of GDP growth in *Africa* rose in 2003 and is expected to strengthen further, reflecting a combination of improving macroeconomic fundamentals; higher commodity prices; better weather conditions; and—last but not least—rising oil and gas production in several countries. While the projected increase in regional growth is encouraging, IMF staff forecasts of growth in Africa have consistently been overly optimistic in the past, in part because they have not anticipated political instability and natural disasters. To make significant inroads into poverty, it is urgent that countries advance institutional and structural reforms, as outlined in the broad strategy under the New Partnership for Africa's Development (NEPAD), and that additional external assistance is provided in support of poverty-reduction programs.

Key Policy Priorities to Reduce Vulnerabilities and Strengthen Growth Potential

Looking forward, while policymakers need to continue to ensure that the recovery is sustained, the focus increasingly needs to shift toward medium-term issues as well as broader developmental challenges. Similarly, in financial markets, improved prospects afford an opportunity to undertake needed structural reforms that can bolster financial stability over the longer term. Beyond addressing the risks mentioned above, in many countries there is a need to rebuild room for policy maneuver—which permitted an aggressive response to the downturn, as well as the events of September 11, 2001, and then SARS—to ensure the ability to respond appropriately to shocks in the future. In addition, a clear medium-term policy framework provides confidence to markets that underlying problems are being addressed, thereby reducing the risk of short-term turbulence. Against this background, there are a number of broad policy challenges:

Managing the monetary policy transition. Interest rates in almost all countries will need to rise as the recovery continues, although the near-term situation varies significantly, depending importantly on the evolving pace and nature of the recovery. A key challenge for central banks will be to communicate their intentions as clearly as possible to the markets, thereby reducing the risk of abrupt changes in expectations later on. During this transition, as emphasized in the *Global Financial Stability Report*, regulators will need to be particularly alert to possible mispricing of risk, excessive buildup of leverage, or concentrated position taking. Emerging market countries continue to perform well, but must take advantage of the current supportive environment to make further reductions in the level and structure of public debt, development of local capital markets and continued efforts to improve the climate for foreign direct investment.

Facilitating an orderly resolution of global imbalances. At present, the constellation of policies across the major countries and regions does not appear consistent with an orderly adjustment over the medium term. This underscores the need for a credible and cooperative strategy that both facilitates the necessary medium-term rebalancing of demand across countries and regions, and simultaneously supports global growth as that adjustment takes place. Key elements of such a strategy should include the implementation of a credible plan by the United States to restore medium-term budgetary balance (excluding Social Security); stepping up the pace of structural reforms in the euro area; further banking and corporate sector reforms in Japan; and a gradual shift toward more exchange rate flexibility in most of emerging Asia—which will also allow monetary policy to be geared more to domestic stabilization—combined with additional structural reforms to support domestic demand.

Using the recovery to address underlying fiscal sustainability issues and strengthen the growth potential and resilience to shocks. With the recovery underway, the critical need in many countries is to make progress toward restoring sustainable medium-term fiscal positions. This is not just an issue of fiscal consolidation, although in most cases that is certainly needed. In most industrial countries, credible and high-quality measures to reform pension and health systems are even more important—and need to be taken into account in judging underlying progress—even if they do not have an immediate impact on the fiscal accounts. In emerging and developing countries, it is also essential to strengthen public debt sustainability through tax reforms to reduce revenue volatility, strengthen fiscal institutions to increase policy credibility, and take advantage of existing benign financing conditions to improve debt structure. The recovery also provides an opportunity to address other potential vulnerabilities, notably in the financial and corporate sectors, including through further improvements in governance.

Improving the structural resiliency of the international financial system. As discussed in the latest edition of the *Global Financial Stability Report*, the transfer of risk from the banking sector to nonbanking sectors seems to have strengthened banks' resilience, but it has also transferred risk to relatively less transparent and relatively less regulated institutions. The increasing exposure of nonbanking sectors, including households, could also lead to a new form of moral hazard if market participants expect the authorities to regard key asset markets as "too important to fall."

Reducing poverty. While most major regions are expected to reach the target of halving poverty between 1990 and 2015 (Goal 1 of the Millennium Development Goals), most African countries are likely to fall significantly short. Despite much progress toward achieving macroeconomic stability, Africa remains highly vulnerable to exogenous shocks and continues to face a daunting range of development problems, many of which cannot be addressed without strengthening weak institutions. It is therefore welcome that the New Economic Partnership for Africa's Development and the African Union are taking steps to facilitate improved governance and lower corruption in the region. In this connection, it will be particularly important that the substantial oil resources coming on stream in the region are effectively and transparently used. Additional assistance from the international community is also critical, in the form of increased aid, continued debt relief, and—most importantly—greater access to industrial country markets.

Completing the Doha Round of multilateral trade negotiations. With global imbalances adding to the potential for protectionist pressures, and geopolitical risks posing an additional threat to globalization, a successful completion of the round is particularly important, not least for developing countries, to which most of the potential gains would accrue. As I have said in the past, a worldwide slide back to protectionism would harm prospects for economic growth in all countries and could undermine what has already been achieved. It would be a setback nobody wants to contemplate. In completing the Doha Round, countries must not lower their sights in striving for an ambitious agreement. A weaker multilateral agenda risks further boosting regional and bilateral initiatives which, over time, can fragment the global trading system and reduce its transparency.

In summary, with the strengthening and broadening recovery, and with financial markets buoyant, attention needs increasingly to shift toward reducing medium-term risks and vulnerabilities. In this context, structural reforms—the theme of the latest edition of the *World Economic Outlook*—are key to addressing many global challenges, including raising productivity growth, improving economies' ability to take advantage of rapid technological change and globalization, and ensuring medium-term fiscal sustainability. In many countries, structural reforms have advanced in recent years, but the pace has been slow. It will therefore be critical to take advantage of the global recovery to make decisive progress.