



A Cooperative Approach to Strengthening Global Growth

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Festvortrag zur 54. Jahresversammlung des ifo Instituts für Wirtschaftsforschung

München, June 24, 2003

1. It is a great pleasure to address you today, and I would like to thank the Ifo Institute and Professor Sinn very much indeed for the invitation. Allow me also to apologize for the absence of Managing Director Horst Köhler, who would very much have liked to be here.
2. **The world economy continues to face significant uncertainty.** The balance of risks has improved somewhat: the headwinds from the bursting of the equity price bubble are diminishing; there is considerable policy stimulus in the pipeline, particularly in the United States and the United Kingdom; and oil prices have fallen from their peaks early this year. Still, the recovery remains gradual and tentative so far, and corporate fixed investment, in particular, is still weak. Overall, I believe that global growth in 2003 will likely remain below trend at about 3 percent [trend is around 4 percent], before picking up to about 4 percent in 2004. But the currently sluggish pace of growth in the advanced economies presents a particular problem for emerging market and developing countries, whose prospects depend critically on growing international trade and a healthy world economy.

3. **At the Evian Summit, the leaders of the G8 voiced the political will to work together with emerging market and developing countries to address the world's problems.** This is encouraging and we should take them by their word. But, of course, we also need to see action following the statements. I trust that the leaders of the advanced economies recognize that it is first and foremost their responsibility to raise medium-term growth potential by accelerating the process of structural change in their economies. Restoring confidence and growth to the world economy requires vigorous efforts by all countries to address their own weaknesses, as well as global economic risks. Chief among these risks is the excessive dependence of the global economy on growth in the United States, which has contributed to the emergence of large current account imbalances.

4. **Global current account imbalances are a source of concern.** Buoyed by strong domestic demand growth, the United States has built up large and persistent current account deficits, reaching close to 5 percent of GDP in 2002. Correspondingly, Japan, several European countries, and emerging Asia have registered large and persistent current account surpluses. And despite the depreciation of the U.S. dollar over the past year and a half, the U.S. current account deficit is expected to widen further this year. Experience suggests that eventually, these current account imbalances must adjust to more sustainable levels. Even if the adjustment occurs smoothly, it is likely that a reduction in the U.S. current account deficit would be associated with lower U.S. growth. And unless this is offset by stronger growth in the euro area or Japan, this would depress global growth.

5. **The continuing weakness in economic activity has brought the discussion of deflationary pressures to the forefront in some countries.** A recent IMF staff study

examined the determinants and risks of deflation, and noted that falling prices could result from both demand and supply shocks. While the study considered that the risk of generalized global deflation is remote at present, it identified risks in specific economies, chiefly in Asia, led by Japan, where prices have already been falling for four years. In Germany, the study pointed to considerable risks of mild deflation over the next year as a result of the persistent weakness in domestic demand. Let me underline, as the study did as well, that we are not forecasting the emergence of a deflationary spiral. What we are saying is that policy makers need to be attentive to the risks posed by falling prices. This reinforces arguments for continued monetary accommodation at the current juncture. It also underscores the importance for central banks to communicate clearly that they will act aggressively and pre-emptively to forestall deflation if the need arises.

6. **Addressing global economic weaknesses and a benign adjustment of the global imbalances requires a broad-based and multilateral effort.** This does not mean the pursuit of a single global economic policy. Rather, it requires a strategy comprising vigorous efforts by individual countries to address economic weaknesses while strengthening the mechanisms of international collaboration that have served so well in the past. In doing so, it needs to be realized that boosting long-term growth potential through structural reforms may have short term costs. Policy makers' dual task is to remain vigilant and aware of the short term, while forcefully implementing the fundamental reforms needed to restore confidence to investors and consumers world-wide.

United States

7. **The United States has been the engine of growth in the global economy over the past several years.** IMF research suggests that the United States generally leads other advanced economies in the business cycle, and that the performance of the U.S. economy has a very significant impact on growth in developing countries. Monetary policy has been vigilant, and has played a valuable role in sustaining domestic demand. Indeed, the Federal Reserve retains room to provide further stimulus should the recovery falter. But over the past two years, much of U.S. growth has been driven by a sharp deterioration in the U.S. fiscal position, which has swung from an overall surplus of 1 ¼ percent of GDP [on a general government definition] in 2000 to a projected deficit of 5 ½ percent for 2003. This huge fiscal stimulus has supported growth. And in the short run, I believe we should avoid overdramatizing it. But the fall in national saving has exacerbated the current account deficit and, if unchecked, represents a severe risk for medium and long-term fiscal stability.

8. **To boost national saving in the United States, fiscal policy must be geared toward medium-term consolidation.** While demographic pressures in the United States are less severe than in most other advanced economies, age-related spending is nonetheless projected to increase by nearly 6 percent of GDP by mid-century. Estimates place the unfunded liability of the Social Security and Medicare systems at 180 percent of GDP over a 75-year horizon. The basic objective should be to reestablish a framework that balances the budget, excluding social security, over the cycle. This would allow the US government to pay down public debt in advance of the demographic shock and to avoid having to raise taxes sharply when it hits. At the same time, the rapid growth of age- and health-related spending

needs to be addressed. These measures take time to introduce and delaying the adjustment will only increase the eventual cost.

Japan

9. **Economic performance in Japan has been weak for close to a decade and the moderate recovery that started last year is losing steam.** Deflation persists at about ½ percent a year, with surveys suggesting that deflationary expectations remain entrenched. At the root of Japan's long-drawn crisis lies the collapse in asset prices in the early 1990s and the inability since then to implement the forceful policies needed to tackle the resulting economic problems. Structural reforms have now been on the agenda for many years, but progress remains slow. What is needed is a vigorous implementation of policies, focused on four main areas: financial sector reform, corporate restructuring, putting an end to deflation, and restoring medium-term fiscal sustainability.

10. **Japan's first priority must be a broad restructuring of the banking and corporate sectors, which is essential to boosting growth.** The government's plan to strengthen banks, announced last October, contains a number of welcome measures and has prompted some banks to improve their capital bases by raising private funds. However, more needs to be done to resolve banking problems. More rapid progress in bank restructuring in Japan will also accelerate the process of corporate restructuring, because underprovisioning against bad loans reduces banks' willingness to restructure or liquidate companies.

11. **The benefit from structural reforms in Japan would be substantially larger if they were accompanied by an aggressive loosening of monetary policy.** Despite some quantitative easing by the Bank of Japan, mild deflation continues, in part driven as much by expectations of future monetary policy as by present monetary conditions. To reverse deeply ingrained deflationary expectations, the Bank of Japan needs to be more aggressive in both its actions and its communications. It would be helpful for the Bank of Japan to state loud and clearly to the public that it will do whatever is necessary to restore inflation within a short time frame. This should include setting a medium-term inflation target, understood by the general public and credibly pursued by the Bank of Japan. At the same time, fiscal policy in Japan needs to be geared towards consolidation, to bring down high levels of government debt and prepare for demographic changes in society. But in the short term, as ambitious structural reforms could dampen economic activity and employment, automatic fiscal stabilizers should be allowed full play.

Euro Area

12. **The euro area remains marred by persistent economic weakness.** Restoring sustained long-term growth requires decisive progress on structural reforms to take full advantage of the growing EU internal market and boost international competitiveness. These reforms are by now well-known and were outlined in the EU's Lisbon Agenda in April 2000. Central among them should be steps to promote employment creation, by raising employment rates and improving the flexibility of European labor markets. In addition, raising labor productivity requires vigorous policies to strengthen education, as well as

research and development, to ensure that Europe can continue to compete in the global economy.

13. **More flexible labor markets would yield large benefits.** Recent IMF analysis [in the April *World Economic Outlook*] suggests that reforms of overly-generous unemployment benefits, inefficient wage bargaining, cumbersome job regulations, and tax wedges could reduce the unemployment rate in the euro area by 3 percentage points and raise economic activity by 5 percentage points in the medium term. And if an improvement in labor market flexibility in the euro area is combined with the liberalization of the market for goods and services, the gain in economic activity could roughly double to 10 percentage points.

14. **What is needed now, is decisive implementation of the reform agenda.** There is inevitably some opposition to reforms, particularly of entitlement systems at the core of the welfare state. In Germany, as in France, Austria, and elsewhere, change is not simple, as it means for some the ending of old certainties. But I am encouraged by the resolve that governments are showing to address reforms now. In Germany, I welcome Chancellor Gerhard Schroeder's proposals to improve incentives to work and make labor markets more flexible, which seem to be gaining growing acceptance. They are certainly the right place to start.

15. **Reforms of entitlement systems in the euro area would also help to achieve the important goal of medium-term fiscal consolidation.** This goal—enshrined in the Stability and Growth Pact—is essential to address Europe's severely adverse demographics. Without comprehensive pension reforms, fiscal positions in most of the euro area will become

unsustainable – in some countries quite soon. But in pursuing the inevitable fiscal consolidation, there is a need to balance short-term and medium-term considerations. The Stability and Growth Pact provides a valuable long-term anchor for public finances and must be safeguarded. But overly ambitious fiscal consolidation, focused on the short term, during the current period of economic fragility could be risky. I therefore agree with the proposal by the European Commission, endorsed by the Eurogroup, that countries with large budget deficits need to achieve an annual improvement in underlying budget positions of at least ½ percent of GDP until the close-to-balance or surplus requirement of the Stability and Growth Pact is met. Around this consolidation path, the automatic stabilizers should be allowed their full play, even if this results in budget deficits rising temporarily above the 3 percent threshold.

16. **With growth prospects weak, inflation subdued, and the euro increasingly strong, the ECB's recent interest rate cut is welcome [June 5].** And the persistence of corporate and financial sector fragilities in some countries, the presence of some deflationary pressures, and the downside risks to global growth all argue for maintaining an accommodative monetary stance to support confidence until a broad-based recovery is evident. In saying this, I am mindful of the difficult environment in which the ECB has to operate. Its mandate to maintain price stability within an area that displays wide disparities in inflation performance is challenging. And the impact of the euro appreciation differs across euro area members. In this complex setting, it is important that monetary authorities regularly reassess their approach and framework, and I welcome the recent review of the ECB's monetary policy strategy, which will help clarify earlier communication problems.

17. **The benefits of structural reforms and appropriate demand management policies in the three major currency areas are mutually reinforcing.** Raising national saving in the United States would help reduce global current account imbalances and thus the cost of the inevitable adjustment. Similarly, accelerating growth in the euro area and Japan would in turn boost prospects for emerging market and developing countries, as well as alleviate global imbalances and lower the risk of a disorderly adjustment. This is a true cooperative approach: national governments taking into account the global implications of their policies. Recent currency movements do not suggest the need for intervention in the foreign exchange market. But if large and sharp movements in currencies were to occur that threatened to disrupt global growth, and intervention were required, it is more likely to be successful if coordinated across countries and supported by macroeconomic policy changes. This underlines the need for pursuing sound policies: if governments fail to take responsibility for rebalancing global demand in a measured way, then the foreign exchange market may do it for them – with a risk of being much more disruptive.

18. **The second leg of a cooperative strategy to restore confidence and growth must be a renewed commitment to multilateral cooperation that has served the world economy so well in the past.** And the central pillar of this collaboration must be the successful conclusion of the Doha Round within its allotted timeframe by end-2004. IMF economists estimate that successful multilateral trade liberalization could lead to growth in trade of 30 to 50 percent, with the bulk of the boost occurring in the trade of emerging market and developing countries. Liberalization of agricultural trade is key to ensuring that

the Doha Round is truly a development round. It is absurd that total OECD support to the agricultural sector amounts to some US\$300 billion, six times the level of development assistance! I am concerned about recent slippages in the negotiation schedule, and the persistent delays in agreeing on a far-reaching reform of the EU's Common Agricultural Policy. A genuine development round must have broad-based improvements in market access conditions for agricultural products, and a significant reduction in trade-distorting supports, at its core. The primary responsibility here lies with the advanced economies, which need to put in place comprehensive reforms of their agricultural policies. Without such reforms, and the opening of global trade in agricultural products, I fear that achieving the Millennium Development Goals will remain no more than a promise.

19. **Restoring sustained global growth, and successfully concluding the Doha Trade Round, would also benefit emerging market countries significantly.** Latin America, for example, is emerging from its deepest recession in a decade. While those countries with strong policies, such as Mexico and Chile, have weathered the storm relatively well, others are only just poised for recovery. The first priority is clearly to sustain sound domestic policies, and the success so far of Brazil illustrates well how important this is. I am encouraged and impressed by President Lula's courageous program that aims for growth with equity. His vision of a social market economy is receiving the full support of the IMF. But in addition to good domestic policies, a sound and stable global environment, which provides the opportunity for countries to grow, also plays a key role. And trade can play an important part in this process. Following the establishment of the North American Free Trade Association (NAFTA), Mexico's exports increased sharply, [from 12 percent of GDP in 1992

to 25 percent in 2002]. And World Bank estimates in the case of Brazil suggest that the liberalization of market access under free trade agreements with the European Union and the Americas could raise its exports by \$18 billion, or 32 percent, the vast majority of which would be agricultural products.

20. Harnessing the forces of globalization to ensure that its benefits are more widely shared and its risks contained is, in my view, the prime challenge for economic policy in the 21st century. Facing this challenge requires increased recognition in national policy agendas that growing global economic integration implies heightened interdependence. Reinforcing international commitment to cooperation and dialogue is the best way to tackle this interdependence – and the IMF is playing its part.