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"The Global Economic Outlook and Risks from Global Imbalances"

Thank you for that very warm welcome. I am honored by your invitation to attend this event and to speak. I have been asked to speak about the global economic outlook and about global imbalances. Let me begin by telling you a little bit about my perspective on these issues.

One of the great privileges of my job is that I have the opportunity to get a good overview of the global economy. The staff of the International Monetary Fund travel to almost every country in the world and talk to governments, and also to bankers, business leaders and members of civil society, to try to get as complete a picture as possible of that country's economy. There is then an exchange of views at our Executive Board among the membership of the Fund, so that every country has an opportunity to make the case for what it is doing in economic policy, and get the advice of its peers, in a way that is constructive rather than adversarial. In addition to country analysis, the Fund studies cross-cutting issues: for example the effects of the recent increase in oil prices. These studies are also discussed by the membership, and published semi-annually, in the *World Economic Outlook*.

I would sum up the outcome of the discussions we have had over the last year or so as follows. First, there is agreement that the state of the world economy is generally good, indeed so good that it presents a great opportunity to make reforms that would improve prospects further—because it's usually less politically painful to make policy adjustments when economies are strong. Second, there are serious risks that the world economy will not stay in such good shape for much longer unless actions are taken, especially by the large industrial countries. Third, there is general consensus on what should be done. The U.S. needs to reduce its budget and external deficits; other large countries need to make reforms to increase productive investment and demand in their economies; and some countries in emerging Asia need increased flexibility in their exchange rates. But knowing what needs to be done is one thing, and actually doing it is another. While some progress has been made over the last year or so in measures to close the global imbalances that threaten prosperity, much more needs to be done. I will talk about this in more detail in a few minutes, but let me begin by saying a bit more about the current state of the global economy.

The global economy has been strong over the past couple of years. Growth in 2004 was the highest in three decades, with world output increasing by over 5 percent. We also expect growth to continue at a good pace in 2005 and 2006, despite a number of recent shocks, including higher oil prices and two hurricanes in the United States. Even with an expected dip in U.S. growth in the fourth quarter, we expect global real GDP growth to be over 4 percent in 2005 and 2006.

Global headline inflation has picked up slightly, but remains moderate, despite higher oil prices. In the major industrial countries, inflationary expectations are generally well-anchored, and wage increases have been moderate. International financial market conditions have been benign for quite some time. The resilience of the financial system has strengthened a great deal in recent years. However, asset prices—especially housing—bear close watching.

Within this broad picture of the global economy, there are big divergences across countries.

Growth has been remarkably resilient in the United States. Higher employment and disposable incomes and greater housing wealth have helped boost household demand. Moreover, U.S. corporations have benefited from record profits and cash flow, and solid productivity growth. We think that their contribution to growth will continue in the remainder of 2005 and 2006, so that even though growth in personal consumption is likely to diminish in the near term, due to higher oil prices, monetary tightening, and a slowing housing market, U.S. GDP growth will remain the highest in the G-7.

Despite the terrible effects of hurricanes Katrina and Rita on life and property, the overall direct impact on U.S. GDP growth is likely to be relatively short-lived. Given what you see on the news, this may seem surprising, and indeed we do think that growth in the United States will be reduced somewhat in the coming months. However, it will then receive a boost as reconstruction spending accelerates. Certainly, though, the hurricanes have added to the downside risks facing the U.S. economy, including by adding to the budget deficit, something I will come back to in a few minutes.

Growth in the euro area has been low for some time, though there are significant differences between countries. GDP growth averaged only about 1¼ percent in the first half of the year, and we project GDP growth in the euro area at only just over 1 percent in 2005, and still less than 2 percent in 2006. A long-standing and core challenge for the euro area is to raise potential growth. Europe's per capita GDP has been only about 70 percent of that in the United States for the past 30 years. Reforms that boost the low level of labor utilization, which explains most of the income gap relative to the US, and encourage investment-driven increases in GDP growth are needed. Such reforms would also help address risks related to global imbalances.

As you know, growth in the Japanese economy has also been very low for many years, and Japan has been beset by deflation—falling prices. However, the economy is now improving, with a recovery in both consumption and business investment, supported by a strengthening labor market and high corporate profitability. Deflationary pressures are also abating. The considerable progress of recent years in addressing weaknesses in the bank and corporate sectors has put the economy in a better position to sustain an expansion. Consequently, real GDP is now projected to expand by about 2 percent in both 2005 and 2006. Looking ahead, maintaining the Japanese expansion will require—as in Europe—structural reforms to raise productivity, through greater domestic competition and labor market flexibility. Structural reforms would also lessen any negative impact on growth of the fiscal adjustment necessary to put Japan's public finances on a sustainable path.

In most emerging markets and developing countries we expect continued strong growth. Activity in emerging Asia is being led by China and India, whose growth is expected to be 9 percent and 7 percent, respectively, in 2005, and only a little less in 2006. The growth rate in Latin America is also expected to remain strong, though a little less than the rate in 2004. In the transition countries in emerging Europe, growth is expected to slow in 2005, reflecting capacity constraints and low growth in Western Europe. Growth in Africa is expected to continue—something that is desperately needed to help lift people there from poverty. Middle Eastern countries and other oil exporters will benefit from the rise in oil prices.

The outlook then is generally good. However, there are risks, and some of the most serious of these come from global imbalances. Put simply, the world needs to move away from a pattern of growth where investment in most of Asia is too low, and high consumption in the U.S. is financed by rapidly increasing debt, and where growth of domestic demand in Europe and Japan is too weak.

Let me talk first, and in most detail about the United States, as most of you are based here. As so often in the recent past, the United States economy has been one of the main engines driving global growth. But the vulnerabilities of the U.S. economy are increasing. The persistent and large U.S. external current account deficit has caused U.S. net external liabilities rise to unprecedented levels—that is, as foreigners own more and more U.S. assets—relative to the size of the economy. In the face of this, we have to ask when the appetite of the private sector for U.S. debt will weaken. If this happens, it could be accompanied by an abrupt increase in interest rates, a cooling of housing and other asset markets, and a sharp slowdown in demand by U.S. households. The best way the U.S, can reduce its external current account deficit is to reduce its budget deficit. Reducing the budget deficit is in any case important given the impending pressure on entitlement programs from the retirement of the baby boom generation. The administration's plan to reduce the fiscal deficit is welcome, but the unprecedented cuts in non-defense discretionary spending that it requires would have been difficult to achieve even before the devastation wrought by Hurricane Katrina. I believe that actions on the revenue side, preferably through reforms to broaden and simplify the tax base, will also be needed. Re-authorization of the Budget Enforcement Act—including pay-as-you-go provisions that cover revenue measures—would also support fiscal discipline.

But it is not only the U.S. which needs to take action to reduce global imbalances. Europe and emerging Asia can help by taking measures that will increase domestic demand in their economies:

- In Europe, governments need to articulate comprehensive, growth-oriented strategies that address both unemployment and aging, mainly through reducing the rigidities prevailing in labor, product, and service markets. They should also extend the Single Market to the provision of services, including financial services.

- In emerging Asia, more exchange rate flexibility is needed. China and Malaysia have made some welcome changes to their exchange rate regimes lately, and I hope that the authorities will use the flexibility afforded by their new arrangements, and that other countries in Asia which have been managing their exchange rates more flexibly will continue to do so. In addition, Asian countries should pursue structural reforms—including to encourage higher investment in some countries and better investment in others.

There are also risks to growth stemming from higher oil prices, which both change the nature and add to the size of global imbalances. But there are things that can be done about these risks. Oil producers can increase production. And those oil producers whose fiscal and macroeconomic frameworks are strong can help reduce global imbalances by increasing spending in priority areas. Oil-consuming countries have a responsibility too. They need to start increasing refining capacity and also take measures to curb demand, such as improving conservation and energy efficiency. Also, those countries that have reacted to higher oil prices by increasing subsidies instead of passing on the effects to consumers should reconsider their policy. The social inequalities and economic distortions arising from high and indiscriminate subsidies at a time of high oil prices are profound. In many countries the effect is to give money to the people who least need it, often at great cost to the budget.

Let me conclude by saying a few words about another issue—trade. There are a set of meetings coming up on trade in December—the meetings of the World Trade Organization in Hong Kong—that are very important for the world economy. Why do these meetings matter? Because free trade is essential to maintain strong and sustained global growth, because these meetings offer the best chance of significant progress on the Doha Round of discussions on trade liberalization, and because there are rising protectionist sentiments in a number of countries, which must be resisted. Leadership is needed from the large countries, which have much to gain from these negotiations in terms of the opening up of markets, and which have an opportunity to help developing countries while making goods less expensive for their own consumers. Developing countries also have a lot to gain from undertaking ambitious trade liberalization, not only because of the opportunity to improve their access to industrial country markets but because greater openness to trade can lead to stronger institutions and better growth prospects. Governments must grasp this opportunity.

This event is a good place to talk about free trade not just because of the importance of the issue but because the Spain-U.S. Chamber of Commerce has a long history of fostering bilateral trade and investment. It embodies a great deal that is good about links between nations and links between peoples. So let me conclude by saying once again how pleased I am to be here, and by thanking you all for your kind attention.

Thank you.