05/26 As Prepared for Delivery

Speech by IMF Managing Director Rodrigo de Rato
At the Barcelona Meeting Point
Barcelona, Spain
October 25, 2005

"How to Keep the Global Economy Growing"

1. Thank you for inviting me to speak to you today. I would like to talk today a little about the outlook for the global economy, and about what is necessary to keep the global economy growing. Coming a little closer to home, I will also talk more specifically about Europe, and what governments and European authorities can do to promote growth here. Finally, I will talk some about a subject that I know many of you are interested in: the global real estate market, and the way in which developments in real estate, and specifically housing markets, both affect and are affected by global economic conditions.

2. Let me begin with the global economy, which has been very strong over the past couple of years. World output growth in 2004 was the highest in three decades, at 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 serious hurricane damage in the United States. Even with a possible dip in U.S. growth in the current quarter caused by the hurricanes, we expect global real GDP growth to be close to its trend rate in 2005 and 2006, at over 4 percent.

3. Global inflation has picked up slightly, but remains moderate, despite the hike in oil prices. In the major industrial countries, inflation expectations are generally well-anchored, and wage increases have been moderate. International financial market conditions have been benign for quite some time, and the resilience of the financial system has strengthened a great deal in recent years. However, asset prices bear close watching—especially housing prices, as you know here in Spain. Here and in a number of other countries, housing seems richly valued, and corrections could have significant repercussions on consumer demand and financial sector balance sheets. I will return to this point in a few minutes.

4. Despite the broadly satisfactory prospects for the global economy, there are risks stemming from global payments imbalances and from higher oil prices, which are both a problem in themselves and change the nature and add to the size of global imbalances. If strong global growth is to continue, these issues need to be addressed. Let me talk in more detail about the risks and what can be done to reduce them.

5. I'll begin with oil. Action is necessary both to increase the supply of oil and oil products, and to reduce the demand for oil products. While excess capacity is very limited, oil producers can begin to increase investment in new facilities. Oil-consuming countries

have work to do as well. They need to start increasing refining capacity and to take measures to curb oil 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 price increases should reconsider their policy. The regressive distributional effects 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 benefit the people least in need, often at great cost to the budget. So I welcome the measures being taken in some countries, including Indonesia, to contain the cost of subsidies while protecting the poorest people from the effects of rises in prices of oil products.

6. A second major risk comes from global imbalances. The symptoms of these are high current account deficits and rapidly increasing debt in the United States, and corresponding surpluses in Japan, many Asian emerging market economies, and increasingly oil-producing countries, including Russia as well as countries of the Middle East. These imbalances pose serious risks to prosperity, because they are clearly unsustainable, and if they are corrected in a disorderly way, through an abrupt decline in the U.S. dollar and rise in U.S. interest rates, growth and prosperity all over the world will be threatened.

7. Many countries need to share the work of reducing global imbalances and sustaining growth, by taking actions that are in their own interests.

- The United States needs to tackle its current account deficit by increasing domestic saving, and this means mainly reducing its fiscal deficit. The U.S. administration recognizes the need for this, but a major element in the administration’s plan to reduce the deficit is unprecedented cuts in non-defense discretionary spending. These would have been difficult to achieve even before the devastation wrought by Hurricane Katrina. Now they will be even harder to achieve. So I believe that actions on the revenue side, preferably through reforms to broaden and simplify the tax base, will also be needed.

- In emerging Asia, there is scope for greater exchange rate flexibility and increased domestic demand. The recent moves by China and Malaysia toward greater exchange rate flexibility are welcome, and I hope that the authorities will use the flexibility afforded by their new arrangements. I also hope that other countries in Asia that have been allowing more flexibility in their exchange rates will continue to do so. In addition, faster domestic demand growth in Asia through a continuation of structural reforms—including to encourage higher investment in some countries and better investment in others—has to be part of an orderly adjustment process.

- Oil producing countries can also do their part. Specifically, those oil producing countries whose macroeconomic frameworks are strong can help reduce global imbalances by increasing productive spending, including in some cases social spending, in priority areas.

8. What about Europe? While Europe has not been at the center of the problem in terms of widening external imbalances, it needs to be part of the solution. The fact that the euro area’s current account has been stable while imbalances have grown elsewhere is no

assurance that it can escape the fallout from a disorderly adjustment—especially given the major international role of the euro. Moreover, in helping to deal with global imbalances, European countries can also help themselves, because the main thing that Europe needs to do is pursue structural reforms that will raise growth.

9. Growth in the euro area has been low for some time, though there are significant differences among countries. The IMF projects GDP growth in the euro area to be only about 1¼ percent in 2005, and to remain less than 2 percent in 2006. These growth rates are too low, and are already affecting social cohesion. Symptoms include growing hostility toward further European integration and globalization. And these problems are likely to worsen over time, unless action is taken, as a falling working age population and rising aging-related spending will cause major social and fiscal problems. Europe's key economic challenge is to raise its growth and employment performance while preserving social cohesion with an aging population. How can national governments and the European institutions do this?

10. A key priority is to increase employment, both by raising participation in the labor force and reducing structural unemployment. One important element would be reform of pensions. Raising statutory retirement ages by linking them to life expectancy and introducing actuarial fairness would promote intergenerational equity and help the sustainability of pension plans. The latest pension reforms in France are a good example of this. More comprehensive reform of labor market institutions tailored to each country's needs would be beneficial. Improving employment services and strengthening job-search incentives are necessary everywhere. More flexible labor contracts would promote job creation and prevent the existence of dual labor markets, a safer approach to job protection than the hiring and firing restrictions embedded in the current employment protection legislation in many countries. Other promising avenues for reform include using income tax credits (rather than subsidizing employers to create jobs at high minimum wages), and ensuring equitable access to free or subsidized daycare or elderly care, as Sweden has done.

11. Another promising avenue toward higher growth and efficiency is through further integration of Europe's financial markets. More financial integration should enhance competition, improve efficiency, lower the cost of capital, and improve monetary transmission. Some progress has been made, and much has been done at the EU level to advance the integration of national markets since European Monetary Union. But effective implementation is still needed and work has barely begun on differences in taxation and legal systems that have impeded financial integration. Also, financial innovation is still very much proceeding at the national rather than European level. Making progress will require overcoming vested interests at the national level, and establishing a level playing field for financial institutions to compete and innovate, to the benefit of consumers and investors. There is also a clear need for a more systematic approach to collaboration on financial supervision, including a centralized repository for up-to-date information on Europe's major financial groups.

12. Most of the things that European countries need to do are in the area of structural reform, but preserving macroeconomic stability is also an essential condition for continued

growth. For this reason, it will also be important to place Europe's public finances on a sustainable footing. For many countries this will require a considerable strengthening of the fiscal position. With populations in most countries aging, governments should be reducing rather than raising debt now. The IMF has been calling for broadly balanced fiscal positions by 2010. Steady consolidation of about ½ percent of GDP per annum is necessary to achieve this objective. Budgets in some key euro-area countries are falling short of this objective, and slippages should be remedied sooner rather than later. Governments must also become more transparent about their fiscal policies. Greater efforts are needed to explain the fiscal challenges to citizens.

13. I said earlier that I would talk about housing, and specifically how house prices are affected by economic developments, and how developments in the housing market in turn affect the broader economy. Of course, the importance of housing goes beyond economic effects. Housing satisfies people's basic need for shelter, and for a place to raise their families. And the way a society houses its people is an important measure of its development and progress. But housing market conditions also have important implications for other aspects of the economy. Housing activities accounts for a large fraction of GDP and households' expenditure in industrial countries. Moreover, for most people their house is their main asset, and their mortgage their main liability. So large house price movements have important economic implications because of their effects of households' net wealth and their ability to borrow.

14. It is not news to you that house prices have increased unusually rapidly in recent years in many industrial countries, and especially here in Spain. Nevertheless, some figures collected by our Research Department may be of interest to you: between 1980 and 2003, the ratio of house prices to rents more than doubled in Spain. And mortgage debt as a percentage of GDP increased from less than 10 percent of GDP to more than 40 percent. While this is still lower than in many industrial countries—for example, the United States, Germany and the United Kingdom—it constitutes a profound change in circumstances for many people. Moreover, in recent years house prices in most industrial countries have become more volatile, vary more with the economic cycle, and more synchronized across countries.

15. What can governments and businesses do to combat these vulnerabilities? Well, there is not much that can be done to offset the effects of less favorable global economic conditions or a sharp change in market sentiment. But there are some things that can be done to reduce the chances of risks of these and stemming from these. One thing is to put in place strong economic policies, including dealing with global imbalances, as I discussed earlier. Another is to avoid, where possible, abrupt changes in monetary policy. House prices are of course negatively correlated with changes in interest rates, but they tend to be particularly sensitive to rapid changes in interest rates. This suggests that if monetary policy needs to be tightened, "early but gradual" tightening is best.

16. There are also things that can be done to improve information about housing markets. For example, the quality of data and statistics on house prices is often weak, especially for the purposes of international comparisons, which are becoming more important as house

prices become more synchronized internationally. Countries use different coverage and methodologies to calculate house prices, and in most countries house price indices do not correct for changes in housing quality over time. Improvements in the statistics in this area should be a priority for statistical agencies.

17. Policy makers should also devote more effort to developing mortgage market infrastructure. In particular, countries should try to create the conditions for a richer set of mortgage contracts. Research done by the IMF last year suggests that countries with predominantly fixed-rate mortgages have better-behaved housing prices and fewer negative effects on their economies from house price changes. However, adjustable rate mortgages are most prevalent in countries where funding for mortgages is based on short-term deposits, and this is the case in Spain. To the extent that the development of fixed- rate mortgages is inhibited by structural impediments, such as restrictions on financial institutions or accounting regulations, these should be examined.

18. My message then is that there are things that policy makers, including European policy makers, can do to promote global growth and to head off some of the problems that they face. In the case of European countries these policies include measures to prepare national budgets for the reality of an aging population, structural measures to increase flexibility in labor and financial markets, and possibly some reforms in housing markets designed to reduce price volatility and the negative effects on the economy of changes in housing prices.

19. With that, I thank you once again for your invitation and your attention.