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"THE GLOBAL ECONOMY AND CHALLENGES FOR EUROPE"

1. Thank you for inviting me to speak to you today, and for that very warm welcome. I am honored by your invitation. I would like to talk mostly about the economic outlook for Europe and the challenges that Europe faces in economic policy in the years ahead. But I will begin with an overview of developments and prospects for the world economy, to put our continent's situation in a broader perspective.

2. As you may know, the IMF held its Annual Meetings in Washington last month. As usual, these meetings provided a unique opportunity for finance ministers and central bank governors from all parts of the globe to discuss the world economy. There was consensus that the world economy has been doing very well. Indeed, prospects are sufficiently good that there is an opportunity to implement adjustments and reforms that would improve prospects further—after all, it's usually less politically painful to take such policy action when economies are strong. But there was also consensus that if the world economy is to remain strong, some important risks must be addressed, in particular the risks associated with high oil prices and large global payments imbalances. And European countries must play a part in this, and can help themselves at the same time, by promoting growth. I will talk further about this in a few minutes, but let me begin with a discussion of the world economy.

3. The global economy has been 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.

4. 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.

5. Despite the broadly satisfactory prospects for the global economy, there are risks to growth stemming from higher oil prices. On this topic, I understand that the research department of La Caixa has recently produced an interesting study analyzing the negative effect of higher oil prices on the Spanish economy. There are things that can be done about these risks. 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 are clearly unsustainable and pose serious risks to prosperity if they are corrected in a disorderly way, through an abrupt realignment of currencies that affects their value and interest rates. Some progress has been made recently in addressing the underlying issues. Fiscal revenues in the U.S. have rebounded. There has been progress with structural reform in the euro area and Japan, and the prospects for further progress in Japan are bright. And we have begun to see greater exchange rate flexibility in Asia. But these are just the first steps, and much more action is needed.

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 economy has for some time been one of the main engines driving global growth. But as the net external liabilities of the U.S. continue to increase, so the vulnerabilities of the U.S. economy continue to grow. Therefore, it is particularly important, and increasingly urgent, that the U.S. 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 their plan is unprecedented cuts in non-defense discretionary spending. These would have been difficult to achieve even before the devastation wrought by Hurricane Katrina. So 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. I should like to take this opportunity to say that the IMF agrees with the policy of the Federal Reserve that monetary stimulus should continue to be withdrawn at a measured pace. I should also like to use this occasion to pay tribute--both on my own account and on behalf of the IMF--to Alan Greenspan for his contribution to economic policy making both in the U.S. and globally. Under his leadership, the Fed has created low inflation expectations in the U.S. and conducted monetary policy in a highly transparent manner. I welcome the nomination of Bernard Bernanke to succeed Mr. Greenspan.

- 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 the authorities will use the flexibility afforded by their new arrangements, and 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 structural reforms—including to encourage higher investment in some countries and better investment in others—should 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. I have left a discussion of what European countries can do to reduce global imbalances until last, because I want to give a bit more context to what I would recommend. And the context is that Europe can at the same time help itself and help to reduce global imbalances by promoting 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. A long-standing and core challenge for the euro area is to raise actual and potential growth. How can national governments and the European institutions do this? We have a number of ideas.

10. Europe's key economic challenge is to raise its growth and employment performance while preserving social cohesion with an aging population. Social cohesion is already under pressure. Symptoms include growing hostility toward further European integration and globalization. Absent reform, social cohesion is likely to diminish further. A falling working age population and rising aging-related spending will cause major problems. At present there are somewhat less than four people in the age range 15-65 for every one over 65. By 2050 that ratio could be closer to two to one. The fiscal consequences could be profound. If fiscal measures are not taken, deficits and debt could spiral out of control; if taxes are increased economic growth could grind to a halt.

11. Part of the solution must be to achieve higher employment. A number of countries in Europe have already shown ways to tackle structural problems in employment, without undermining social solidarity. Indeed, employment in the EU as a whole has done better over the past cycle. Unemployment has ratcheted up less during the latest slowdown than in previous ones. In many euro area countries, including Spain, unemployment is now

considerably below its previous peaks. This achievement is mostly due to more job-friendly wage setting, the liberalization of part-time and temporary employment, and the phase-out of early retirement schemes.

12. This shows that reform is possible in Europe, and that it can both improve economic prospects and support social solidarity. But more needs to be done if Europe is to enjoy sustained strong growth.

13. Let me talk first about welfare reform and labor utilization. Here, different countries need to do different things, and European countries can learn from each other. Here are a few examples of actions to consider—each relevant for some countries more than others:

- *Reforming Pensions in a sensible way*: 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. It is also effective, as demonstrated by the rising employment rates among older people that have followed the phase-out of early retirement schemes Since 2000, the employment rates of 55-64 year olds have risen by over 4 percentage points in the euro area.

- *Supporting the jobless, but strengthening incentives*: being generous with unemployment benefits but limiting their duration. For example, the recent reforms in Germany go in the right direction. Long-term unemployment benefits can also be linked to active search and the performance of socially useful work.

- *Making it easier for people to work, but limiting distortions*: for example governments could help people maintain adequate living standards through income tax credits (rather than subsidizing employers to create jobs at high minimum wages).

- *Continuing to overhaul Employment Protection Legislation.* For example, 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.

14. 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. It is

necessary to achieve financial markets integration, with the same rules for all operators and maximum transparency.

15. The system of financial supervision will need to evolve with the market. Baron Lamfalussy characterized Europe's institutional set-up to manage financial stability as a "mind-boggling patchwork." There is a clear need for a more systematic approach to collaboration on supervision, including a centralized repository for up-to-date information on Europe's dozen or so major financial groups.

16. I said earlier that most of the necessary reforms were structural, but it will also be important to place Europe's public finances on a sustainable footing. For many countries this will entail a considerable strengthening of the fiscal position. With populations in most countries aging, governments should be reducing rather than raising debt now. We have 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.

17. Governments must also become more transparent about their fiscal policies. The Stability and Growth Pact plays an important role in helping countries to adjust. And, notwithstanding the heavy criticism that Pact has sustained, general government deficits are a good deal lower today than in pre-Maastricht times. The Pact has also added transparency and peer-driven surveillance. That said, the burden of enforcement cannot rest only on Brussels' shoulders. Greater efforts are needed to explain the fiscal challenges to citizens. National, nonpartisan fiscal councils could play a useful role in this.

18. This is a long agenda, but there is high pay off from structural and fiscal reform. From an international perspective, restoring confidence and revitalizing growth in Europe through structural reforms which address supply-side constraints and which raise domestic demand will help resolve global imbalances. While Europe has not been at the center of the problem in terms of widening external imbalances, it should 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. Promoting an orderly global rebalancing will require actions from all partners—on Europe's part, this will require higher employment and growth.

19. With the right policies, Europe can be part of the solution. And in helping the world economy, European countries can help themselves. They can head off looming fiscal problems, improve employment, and promote social stability. These are goals worthy of a great effort. I hope that Europe will make this effort.

20. Thank you very much.