

**Remarks by Rodrigo de Rato
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As Prepared for Delivery

Mr. de Las Heras, Mr. Lateef, and Mr. Rhodes; members and guests of the Foreign Policy Association—Good evening. I am delighted to be here tonight. It is an honor to address such a significant event in the Foreign Policy Association's annual calendar. Thank you for inviting me.

For my remarks tonight, I have chosen to focus on the issue of global imbalances. In doing this, I shall also deal with a theme that FPA members like yourselves will relate to naturally, and that is the theme of international cooperation. As you will appreciate, it is such cooperation that will help us deal with the imbalances problem.

Global Imbalances

I begin with some positive notes about the global economy. Growth was strong in 2004, with possibly the highest rate of expansion in nearly 30 years. Importantly, this strong performance was supported by improved economic fundamentals in many countries. The economic expansion was recorded not just in growth, but also a significant rise in per capita incomes in all regions. In other words, the world as a whole became better off last year. Sub-Saharan Africa, in particular, posted its highest GDP increase in a decade. This was partly due to strong global demand and prices for commodity exports, but it also points to better policies in a number of countries. An encouraging boost indeed, to the poverty-reduction efforts of low-income countries!

Looking ahead, last year's momentum should ensure that global growth remains robust in 2005. This is all good news so far. However, within these positive signs lie serious threats and challenges. We are all aware of the large US current account and fiscal deficits. These are matched—or financed, if you will—by growing surpluses in Japan, emerging Asia, and certain oil-exporting countries. This constellation of large deficits in one country, with counterpart surpluses being concentrated in a few others, is what we mean when we speak of global imbalances.

Related to these imbalances, and to complicate matters further, global growth has been, and remains, unduly dependent on the United States and China. Non-oil exports to the US in 2004, for example, accounted for 18 percent of global trade. In the euro area and Japan—which together account for nearly one-quarter of global output—under-performance continues to be the order of the day. If this trend persists, it will further widen existing imbalances, and increase the risks for abrupt disruptions to global growth. Yet, things need not be this way.

By most accounts, Europe's potential to sustain higher growth rates is undisputed. Unfortunately, the European story continues to be one of missed potential, chiefly because of structural impediments. For instance, labor markets remain rigid, and competition in product markets continues to be lacking. In Japan, growth has been uneven. Performance was very strong from mid-2003 to early 2004, but a sharp slowdown was recorded in the latter parts of last year. To create the conditions for sustained growth over the medium term, Japan, like Europe, should accelerate its structural reforms.

China and emerging Asia, needless to say, are also important players. Here, rigidity of exchange rate regimes remains the key issue. Several countries in Asia have recently allowed movement in their exchange rates vis-à-vis the dollar, with prime examples being South Korea, Singapore and India. Going forward, greater exchange rate flexibility would give countries more monetary control, facilitate the emergence of more dynamic economies, and contribute to an orderly reduction of global imbalances.

Let me now take a few moments to reflect in slightly more detail, before this largely US audience, on the US balance with the rest of the world—that is, the US's current account deficit. Throughout the 1990s, the US economy incurred persistent current account deficits. In the first half of that decade, these deficits averaged 1 percent of GDP—not large by the standards of industrialized countries. But, since the mid-1990s, the deficits have increased, rising to an estimated 5½ percent of GDP in 2004.

A country's current account balance reflects the difference between what a country exports and what it imports. And, it also measures the difference between what it saves and what it invests. Importantly, the increase in the US current account deficit in the second half of the 1990s reflected an increase in investment, not a fall in saving. In fact, for a while, as budget surpluses emerged, there was an increase in government saving. This increase more than offset lower private saving, and accounted for a rise in total savings. However, by 2000, the trends were reversed. Government saving declined—that is, the federal government deficit widened. Private investment also declined, until a welcome upturn began in 2003.

Current account deficits are not undesirable per se. Indeed, we recognize that the accommodative monetary and fiscal policies of the United States in these years, which contributed to the increased current account deficits, also prevented a more severe downturn in the global economy in 2002-2003. These policies also helped foster the upswing the global economy is now experiencing. What is undesirable, however, is an unsustainable deficit. And experience shows that the current account deficits of the order that the US has been running cannot be sustained indefinitely.

In any discussion of global imbalances, some focus inevitably shifts to the issue of exchange rates. Explaining exchange rate movements is difficult enough. Forecasting them is an even more hazardous exercise. That said, there can be little doubt that the pattern of persistent and growing US current account deficits, and the increase in dollar indebtedness that they entail, have contributed to the recent renewed depreciation of the dollar. Since reaching a peak in February 2002, the dollar has depreciated by about 50 percent vis-à-vis the euro, and about 30 percent against the Canadian dollar and the yen. Fortunately, the dollar's adjustment thus far has not jeopardized the global recovery. However, the greenback's fall should, at the very least, serve as a timely wake-up call for policymakers to take immediate action to tackle the problem of imbalances in the world economy.

At the end of the day, today's accumulation of large deficits in the US, with matching surpluses in only a few countries, cannot go on forever. The current account deficit of the US is already being financed by record levels of debt in the hands of foreign investors. It is highly unlikely that such easy credit will continue to be available to the US on the basis of the existing policy path.

A Call for Global Action

What then must be done to solve the imbalances problem? Much focus has been directed at the need to narrow the current account and fiscal deficits in the United States. Some on the other hand are looking to Europe and Japan to take action. Yet others have chosen to call for greater exchange rate flexibility in China and emerging Asia.

There is much merit in all of these arguments. But, there is no one silver bullet. Global imbalances are a problem of global disequilibrium, and it is counterproductive to blame any one party, country or region. Given today's inter-connected economy, the concerted effort of all parties, directed through a coherent set of policies, is what is needed. In particular, and as recognized by G7 finance ministers at their London meeting earlier this month, the time has come for deliberate action by all the major players in the world economy. As the main institution tasked with facilitating international monetary cooperation, the IMF provides the forum—and the tools—for our global membership to tackle the problems at hand, and to encourage appropriate action by countries.

Without a doubt, the favorable economic conditions afforded by the continuing economic expansion provide a valuable window for reforms to be implemented. Countries should take full advantage of this environment to put in place measures to lock in sustained medium-term growth. In fact, given the solid performance of the world economy last year, and its rosy outlook for 2005, countries have no excuse not to proceed with reforms forthwith. In this regard, the broad strategy needed to address the imbalance problem is generally agreed. I would just highlight some of the more critical points in emphasis.

I turn first to the United States. We begin with this plain observation: The continued orderly financing of the US current account deficit depends critically on the attitude of foreign investors—in particular, of foreign private investors, for they hold the bulk of US assets. A convincing and sustained set of policies must be in place to narrow the imbalances, and to signal that any depreciation of the US dollar that might occur, on account of the deficit, will not be disruptive.

Measures must therefore be taken towards credible fiscal consolidation in the US, particularly for the medium-term. The US budget proposals for fiscal year 2006 aim to halve the budget deficit in 4 years. If achieved, this effort at fiscal restraint will be a welcome step towards sustainability. However, firm implementation of these proposals is critical and slippage must be avoided.

Next, actions are needed in the euro area. Structural reforms remain at the heart of Europe's efforts to improve medium-term performance. Measures must be adopted to boost domestic demand and growth, so as to generate another center of expansion for the global economy. Important progress has been made, including in pension, healthcare, and labor market reforms. These must be further pursued and enhanced. Going forward, focus should be sharpened on removing distortions in the labor market, particularly overly generous retirement schemes, high tax wedges, and restrictive labor laws. Above all, European policymakers and citizens must unite to remove unrealistic constraints on the freedom to work. Promoting competition in product markets would also be important, for example by easing restrictions on the trade in services between countries. I should note that productivity growth is already relatively strong in Europe. What these additional reforms will do is unlock Europe's inherent potential for greater output.

Turning to Japan, much has been accomplished in recent years. To ensure that the economy emerges from deflation on a sustainable path, many items of the reform agenda still call for attention. The financial sector needs to be strengthened by improving bank profitability and capital bases, so that these institutions are able to extend credit and support investment and growth. Corporate debt levels should be brought down and restructuring intensified. Other areas of priority include greater labor market flexibility, public enterprise reform, and increasing competition in sheltered sectors of the economy, such as the retail sector.

Lastly, in China and emerging Asia, priority should be placed on moving towards greater exchange rate flexibility and strengthening financial sectors. Just as fiscal adjustment is in the US's own interest, moving to a more flexible exchange rate regime is clearly in China's own interest. I need hardly mention that greater exchange rate flexibility also carries the added benefit of allowing greater scope for the use of monetary policy in pursuing national objectives. As China's economy continues to develop and open up, such flexibility will be an indispensable tool for macroeconomic management. China's vibrant growth has benefited not only the region, but also other parts of the world. With the right policy framework in place, China will continue to play an important role in securing stable growth worldwide.

Conclusion

I think we all recognize that we live in an integrated world with a global economy. The global imbalances problem concerns all countries, and all countries should act to confront it together. The IMF, with its mandate to facilitate monetary cooperation in the world, provides a ready forum to analyze problems and collaborate on solutions. With that in mind, I have outlined the main priorities for countries in tackling the global imbalances problem. As you can see, there are concrete measures which individual countries can and must take. Many of these are in fact in countries' own best interests to pursue.

The continued stability and growth of the world economy can only be assured through the determined effort of all actors. Time and again, from the Bretton Woods agreement of 6 decades ago to the recent relief efforts following the Asian tsunami, the international community has shown itself capable of coming together to find global solutions to global problems. At this particular moment in time, a valuable window for action has presented itself. The current upswing, which is taking place in a period of unusually favorable financial conditions, should be seized upon by countries everywhere to advance their reform agendas.

Importantly, this is also a crucial year for the fight against global poverty. The international community has committed itself, in the Millennium Development Goals, to cut poverty in half by 2015. Many actions and decisions are needed to achieve this. But perhaps none is as important, or integral, as maintaining sustained and orderly growth. I am confident that the relevant countries will rise to the challenges, and in the process secure continued growth, stability and prosperity for all in the world.

Thank you.

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