

Statement by Mr. Donald J. Johnston
Secretary-General
Organisation for Economic Co-operation & Development

International Monetary and Financial Committee
Washington D.C., 2nd October 2004

This statement concerns item 2 (The Global Economy and Financial Markets--Outlook, Risks, and Policy Responses) of the provisional agenda of the International Monetary and Financial Committee meeting.

The OECD is at present updating its *Economic Outlook* projections in view of their official release at the end of November 2004. Our assessment, mostly based on recent developments in large member economies, is as follows.

The recovery projected at the time of the spring IMFC remains on track. Available indicators suggest that activity has strengthened again following the slowdown in the second quarter which was caused in large part by higher oil prices. GDP in the six largest economies could expand by around 3½ per cent in 2004 on a year-average basis. The resilience so far shown by OECD economies in an environment of geopolitical uncertainties and turbulence in oil and commodity markets suggests that, looking further ahead, growth should remain solid. Nonetheless, further increases in oil prices or a deeper and more prolonged slowdown in China than currently foreseen could pose a risk to this Outlook.

In most member countries, real GDP growth is expected to approach or slightly exceed potential in 2004. The expansion in the *United States* may be slightly weaker than foreseen but in the *euro area*, growth has surprised on the upside during the first half of the year and is set to retain its momentum during the second half. The euro area is mainly pulled by exports and the strength of the recovery is still overly dependent on the vigour of the world economy. Stark differences persist between euro area countries, with domestic demand vigorous in France, but lacklustre in Germany and Italy. In *Japan*, growth is set to be above potential for the year as a whole, on the back of buoyant exports and business investment spending. Robust expansions are also unfolding in a number of smaller economies (notably the Nordic countries, Hungary, Poland, Turkey and Korea), notwithstanding their sometimes greater exposure to rising energy costs.

While rising oil prices have exerted upward pressure on headline inflation, core inflation in OECD countries has been stable. Thus far, "second-round" effects in the form of higher wage claims have not materialised, not least because inflation expectations remain well-anchored, in a context where central bank commitments to price stability are rightly seen as robust and credible. Against the background of a continuing recovery, several central banks, including the US Federal Reserve, have started gradually to take back the exceptionally strong stimulus they had injected to foster recovery. With the global recovery spreading more widely, monetary tightening should be progressively extended to other parts of the OECD, with the pace of tightening depending on the speed with which spare capacity is expected to shrink and the extent to which core inflation remains under control. Under the present circumstances of weak domestic demand in the euro area and mild deflation in Japan, the current accommodative stance of their monetary policies seems warranted.

By contrast, fiscal policy consolidation is becoming increasingly urgent in the six largest OECD countries as well as a number of smaller ones. Current fiscal positions are unsustainable, and insufficient consolidation is being envisaged at the moment. To re-establish sustainability, governments should reduce structural deficits and resist any pressures to spend cyclical revenue windfalls. They also need to address

the public finance implications of population ageing, most crucially through further reforms of their pension and health systems. Amending fiscal frameworks, where they have lost credibility, and reintroducing them where they have been discontinued may help bring forward the necessary consolidation measures.

Moving to financial markets, the behaviour of prices has been broadly consistent with this positive economic outlook, despite some uncertainties. Markets have adjusted well to the beginning of monetary policy tightening in key markets, which has been accompanied by effective communication by monetary authorities. Banks have become more resilient thanks to a stronger capital base, higher profitability and improved risk management and spreads on corporate borrowing are exceptionally low. Other financial institutions, especially life insurance companies and pension funds, which are major institutional investors, have also benefited from favorable equity prices and interest rate movements.

Still, policy makers continue to face important financial market challenges. The rapid growth of hedge funds activity and the adoption of similar trading strategies by other financial institutions deserve careful monitoring, while some market segments of the insurance and reinsurance industry remain fragile. The household sector is bearing increasing financial risks and part of the recent strengthening of financial institutions has come about by transferring risks to households which may be ill-equipped to carry them. Despite improvements resulting from the recent financial market recovery, major structural problems remain concerning the funding, risk management and governance of corporate pension funds which policy makers must urgently address.