

3/15/02

RESTORING SUSTAINED GROWTH IN THE GLOBAL ECONOMY

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BANK OF CHINA NINETIETH ANNIVERSARY
BEIJING
MARCH 16, 2002

It is a great honor for me to speak at this conference to celebrate the ninetieth anniversary of the Bank of China. This institution's history is storied indeed. It has served as China's flagship bank in the international community. And today it has a vital role to play in the economic transformation of China, which is the wonder of the economic world.

I first visited China in 1988, and have had the opportunity to return several times since then. The change visible even in that short span of time has been remarkable. I – indeed all observers of China – have been struck most by the phenomenal speed of China's development, which has transformed the lives of over a billion people within a few years. But it is also striking that these changes were implemented following a clear, but flexible, strategy, starting with the reform of agriculture, followed by the development of industry, in which town and village enterprises played such an important role. And now China prepares for the next stage of its transformation, through a strategy of reform associated with the country's accession to the World Trade Organization. The challenges confronting the

¹ As prepared for delivery at the Ninetieth Anniversary celebration of the Bank of China, Beijing, March 16, 2002. Views expressed are the author's, and not necessarily those of Citigroup. I am grateful to Michael Waldman, and to my colleagues Lewis Alexander, Margaret Ren, Kim Schoenholtz, Jeff Shafer, and Earl Yen for their advice and assistance.

economy, among them the closely related problems of the reforms of the enterprise and financial sectors, are great – but based on past performance, the prospects for success are very high.

The next stage of the development of the economy will bind China ever more closely to the world marketplace, and so my presentation today will be about the global economic environment. I will talk about the trajectory of the global economy, looking at the key regions and, briefly, at the system as a whole. As you may know, I moved from the IMF to the private sector just a few months ago. Earlier I taught for over twenty years at MIT. So I speak to you as a former academic economist, as a former policymaker, and as a very new banker – and I hope I can speak with the perspective of all three of those worlds.

Conditions in the world economy are changing very rapidly. At the end of January, I took part in the World Economic Forum, the Davos meetings, which for the first time were held in New York City. That gathering was somewhat nervous – understandably so, given the highly visible security precautions surrounding the event, and concern over the economic shocks from September 11th, Argentina's default, and the collapse of Enron. Yet in the six weeks since then, the evidence that recovery has begun in the United States, and is beginning in Europe, has continued to accumulate. Even the cautious Chairman of the Federal Reserve Board, Alan Greenspan, stated on March 7 that an economic expansion was already “well under way” in the United States. And there are signs of recovery, not only in the United States and in Europe, but also in those Asian countries that had suffered slowdowns or recessions in 2001.

Chairman Greenspan warned that the strength of the recovery would likely be moderate. Europe is probably a bit behind the United States, and its recovery is also likely to

be moderate. In addition there are clear risks to the recovery in the United States and Europe, and the weakness of the Japanese economy is a major concern. Global recovery will improve the external environment for the developing countries, but their own policies will also be critical in determining how rapidly they grow.

Let me now review the global situation in more detail, beginning with the industrialized economies, which account for 70 percent of global output. Most likely, the U.S. recovery will be U-shaped, more accurately, it will be like a Nike swoosh, with a relatively short, mild recession – indeed, some even question whether there was a recession – followed by a prolonged but gradual rebound. Aggressive monetary easing, an expansionary fiscal policy, low energy prices, and a rebound in the inventory cycle all give impetus to the recovery.

Now for the caution, the reasons to believe the recovery will be moderate. The recession was moderate in part because the aggressive monetary policy cut interest rates, which permitted interest-sensitive spending to stay high, particularly spending on automobiles and housing. This implies that demand during the recovery will grow less vigorously than usual during such periods. Good weather and spending induced by or delayed from the immediate aftermath of September 11 may also have improved the data temporarily. And we can easily identify other risks, among them the possibility of another terrorist attack, the effects of political instability in the Middle East, or a loss in investor confidence following the Enron collapse and the questions that has raised about U.S. accounting standards. Further, since the kick from inventories will be temporary, some believe we will see a W-shaped recovery, or equivalently a double-dip recession. I doubt

this, but no recovery is ever totally smooth, and so we have to take that possibility into account.

What does this mean for the U.S. and its policymakers? First, it means it would be premature to tighten monetary policy before it is clear that the recovery has taken firm root – provided that inflation remains low, as is likely for some time. At the same time, the reduction of the proposed extent of the fiscal stimulus, which is reflected in the bill passed ten days ago by the Congress, is appropriate – particularly because it is important to safeguard the healthy medium-term fiscal position that was built up in the United States during the last decade.

The rate of productivity growth is key to the longer term growth of the United States economy. At the end of the 1990s, some were estimating that the rate of productivity growth was in the range of 3.5 to 4 percent per annum. For an advanced economy, this would be truly remarkable. The more recent evidence suggests somewhat lower – but still very high – medium term rates of productivity growth, around 2.5 percent. Even this would be an outstanding performance, but the estimate is plausible because there are still many unexploited gains from the IT revolution.²

Hovering over the United States economy is the question of the current account deficit. If a rapidly recovering U.S. economy races ahead of the rest of the world, it could push the current account deficit, already above 4 percent of GDP, to 6 percent, \$600 billion a year, over \$2 billion every business day. Some fear that this is not sustainable, and that some

² Productivity grew at an annual rate of more than 5 percent in the fourth quarter of 2001, but this one quarter result is not necessarily indicative of longer term trends.

day, possibly soon, the rest of the world will collectively decide not to invest so much in the United States. They urge the United States to save more, for they regard it as inappropriate that the richest economy in the world should be attracting capital from the rest of the world, where development needs are so much more pressing.³

This is a very important issue, but I am not so sure that in the short run the current account deficit is an immediate threat, for the U.S. external debt at less than 25 percent of GDP is not yet in the danger zone. Nor do I believe the United States should immediately tighten fiscal policy to reduce the current account deficit, since the recovery is not yet firmly assured. In thinking about the current account deficit, we should bear in mind Herbert Stein's reminder that "if something cannot go on forever, it will stop". The question is how it will stop. If foreign investors lose confidence in investing in the United States, the dollar will weaken, and the current account will gradually begin to decline. Unless the loss of confidence is catastrophic, the adjustment could take place without major disruptions. Or, if other countries grow faster than the United States, the current account deficit can begin to shrink without the dollar declining. So the U.S. current account deficit may well increase as the United States leads the global economy out of recession, and then begin to decline as growth in other countries recovers.

That brings us to the prospects for growth in Europe. Growth in the euro area has been sluggish following the slowdown that got under way last spring. Germany has been

³ Nor should we forget that capital flows respond to market incentives, and that capital will go where the returns are attractive and property rights secure – in other words, countries that want to develop need to create a good investment climate, not only to attract foreign capital, but even more to encourage their own citizens to invest domestically.

worst affected, with activity also slowing significantly in France and Italy. But there is now evidence that business and consumer confidence are bottoming out, and that recovery may already be getting under way.

As in the United States, policy should be supportive. In the last decade, growth in Europe has not been vigorous, despite the historic achievements of the introduction of the single market and the Euro. Some European policymakers criticize the European Central Bank for its caution, and some argue that the Stability and Growth Pact is restraining counter-cyclical fiscal policy.

I do not believe the Stability and Growth Pact should receive that blame. The real problem is the failure to strengthen fiscal policy and move closer to budget balance during the good years of growth. If German fiscal policy could have started out from budget balance in 2000, there would have been ample room for a larger counter-cyclical increase in the deficit in 2001 and 2002. As for the central bank, it is likely to keep interest rates at current levels for some time so long as inflation is restrained; in the longer term, it would be well served both by greater transparency and a modified inflation target, one that penalizes inflation below as well as above target.

The most important challenge for Europe is to undertake more far-reaching reforms of labor, capital and product markets, to boost productivity growth and lower unemployment. Without such reforms, Europe seems destined once again to hit a growth ceiling soon after recovery begins.

Whatever macroeconomic and structural policy challenges confront Europe, they pale in comparison to those facing Japan. Last year saw the country in deflation and suffering its third recession in the space of a decade. Despite the very recent rise in the stock market, and

the hopes of an export-led recovery, the economy remains very weak, though it has picked up slightly in the last month. Japan's long period of slow growth and recession reflects its failure to deal decisively with non-performing loans in the banking system and a highly indebted corporate sector, both of which are legacies of the bursting of its asset bubble at the beginning of the 1990s.

Japan's key challenges are to counteract deflation and to accelerate structural reform. The large budget deficit and government debt preclude fiscal expansion. With interest rates already near zero, the room for maneuver on monetary policy is limited. To be sure, monetary policy could become more aggressive, by purchasing more and longer-dated government securities, but such a policy would weaken the yen, and cause grave concern among Japan's trading partners and competitors in Asia and elsewhere.

Japan needs to grasp the nettle of structural reform if growth is to return in the medium term. Non-performing loans need to be tackled with greater vigor, especially with blanket deposit guarantees due to be removed this month. The government will need to help systemically important institutions, under strict conditionality. More also needs to be done to deal with highly indebted corporations, for example by ensuring that the Resolution and Collection Corporation effectively promotes debt workouts and meaningful operational restructuring.

The economics is clear. However the political economy of structural reform is difficult, for in the short term more vigorous structural reforms are likely to reduce growth. Hence the tendency of the government to wait, in the hope that things cannot get worse and may well get better – after all, the Japanese economy has not collapsed in the past decade,

rather it has suffered from chronic and progressive underperformance. But things *have* got worse, and they can get worse yet.

That would of course be bad for Japan, bad also for the global economy, and for Japan's neighbors. For all those reasons, Japan should act on its structural problems now, to prevent a worse crisis. And if it turns out that a recovery is getting under way, that would be all the more reason to pursue a vigorous reform strategy, to ensure that the recovery turns into sustainable growth rather than once again soon losing momentum.

Now let me turn to the emerging market economies, where the news, despite Argentina, is perhaps surprisingly good.

Capital flows to the emerging market countries have recovered much more rapidly than seemed likely in the wake of September 11. Emerging market bond issuance reached near record levels in November 2001, and has remained healthy since. This reflects in large part the abundance of liquidity in the industrialized country markets, but also, as spreads for well-performing countries have declined, and the correlation among spreads has fallen, greater discrimination among countries by investors. Indeed, excluding Argentina, emerging market spreads are now lower than they have been since the Russian crisis in 1998.

Of course, the greatest immediate concern is the fallout from the crisis in Argentina. So far, we have seen little capital market contagion. A greater risk is political contagion – that populists in other countries would be strengthened by the perceived failure of Argentina's free market policies. But Argentina's problems had far more to do with its macroeconomics – the choice of exchange rate system and the failure to maintain fiscal discipline – than with its microeconomic policies.

What happens in Argentina will depend on whether the government can put in place a convincing program of adjustment and reform that wins international support. Originally the Argentine government seemed torn between populism and more market-friendly policies. In recent weeks, the balance has increasingly been moving away from populism, towards the type of more orthodox policies that served Mexico and Brazil so well following their devaluations. But the situation in Argentina is even more difficult than those that confronted those nations, not least because Argentina has defaulted on its debts.

The pace of recovery in Latin America this year depends on the strength of the global recovery, on access to international capital markets, and on domestic policies.⁴ The global economy is probably beginning to recover, international capital market access has been good in the last four months, and the largest Latin American economies, Mexico and Brazil, have been following very strong policies, as has Chile. All this should provide some reassurance to the pessimists who fear that Latin America is about to return to the discredited policies of the past – although, to be sure, we cannot rule out that there could be some problems in one or two countries.

Turning to the transition economies, Russia's performance since the devaluation in 1998 has been very strong. The most recent data pegging growth at 8.3 percent in 2000, and 5 percent in 2001, and the reform policies of the Putin administration, are changing both the

⁴ The outcome of the Brazilian elections later this year being seen as critical in determining whether the country will be able to reap the long-run benefits of the strong policies that have been followed since 1998. Chile's good policies can be relied on, Colombia has made strong policy efforts, and Venezuela's decision last month to float the exchange rate and reduce the budget deficit, was welcome news.

reality of Russia and investor perceptions about the country. Russia's growth in turn has helped growth in neighboring countries, Ukraine most prominently.

As for Africa, the key to growth in south and central Africa is the performance of South Africa. Since taking office in 1994, the government has pursued responsible macroeconomic policies, which have produced steady but modest growth. Provided it is not followed by a significant increase in inflation, the recent depreciation of the currency will provide an important incentive for the expansion of exports, which could become a critical engine of growth, as they have in so many Asian economies.

South Africa has taken the lead in developing the New Partnership for Africa's Development (NEPAD). This is an attempt to find African solutions to the continent's poverty problem. It has identified the key requirements for recovery: good governance, conflict resolution, the rule of law, macroeconomic stability, curbing corruption, and promoting intra-African trade. The challenge now is to move to action.

This brings us to the region no doubt of greatest interest to all of you, emerging Asia. Here, too, prospects in the short to medium term depend to a considerable degree on outside factors, particularly on what happens in Japan and to the yen, and on the recovery of the electronics sector. Any significant weakening of the yen would probably lead to depreciations of the flexible exchange rate currencies in the ASEAN countries and Korea. Fortunately, current accounts are likely to remain in surplus in most countries. With reserves healthy in most cases, this means less vulnerability to external financing.

Korea, Singapore and Malaysia all look set to pick up speed this year. Thailand is being held back by weaknesses in its financial and corporate sectors. For all these countries,

recovery in the electronics sector is especially important – and in conversations, I have heard some optimistic signals. Indonesia has been hit by a fall in consumer confidence and foreign direct investment, after robust consumer spending insulated overall growth from the effect of weaker business investment last year. This week's decision to sell BCA may help revive foreign direct investment. India has sustained high growth over the last decade. Still, the fitful pace of reform, a large budget deficit, and the country's uncertain and inconsistent attitude to foreign investment, have kept India from achieving its growth potential.

And now to China. China is on its way to becoming one of the world's main manufacturing hubs and eventually one of the largest markets for goods and services. But the authorities face enormous challenges, including the need to restructure many state-owned enterprises and the associated need to deal with non-performing loans in state-owned banks. How successfully they tackle these and other challenges could have profound implications not only for China but also for the global economy in coming decades.

The next stages of China's economic transformation will take place in association with entry into the WTO. There is every reason to believe that China's entry into the WTO will spur positive reforms. To increase the efficiency of the economy, China will need to ensure that its courts swiftly and fairly apply rules to protect foreign investors rights, including their intellectual property. It also plans to eliminate agricultural subsidies and lower tariffs. There is a time-phased process for opening up the financial system. While these changes could be disruptive in the short run, they promise large benefits in the long run.

The transformation of the financial sector is of critical importance. Already, China has begun to open its financial sector to outsiders. With a stock market culture taking hold

and millions of people opening investment accounts, the authorities need now to work out how to use \$900bn of domestic savings to develop healthy and efficient financial markets.

Among the priorities for financial sector reform are the strengthening of the supervisory and regulatory system, stronger measures to deal with the very high level of non-performing loans, and the strengthening of bank balance sheets and efficiency. As is well understood, this can only be done in conjunction with the reform of the state-owned enterprises, for so long as the SOEs do not reform, the risk of further NPLs emerging from new loans remains high. It is also understood that the modernization of the banking system will require further development of the capital markets. In all these areas, the Bank of China – indeed the entire banking system – has an important role to play, and important challenges to overcome. But overcoming those challenges is critical to the future growth and modernization of the Chinese economy.

Some have expressed the view that China's growth and dynamism are sapping the strength of the economies around it. Economists brought up on the theory of comparative advantage do not find this logic compelling, although they should recognize that the remarkable pace of change in China could create temporary disruptions in both China and its neighbors. But as China grows, and opens up its economy to trade, it will become a market for the products of its neighbors, as well as a competitor on the supply side. And, as Asian countries explore the possibilities of further regional collaboration, there is also the prospect of Asian regional trade arrangements that could create the biggest economic area in the world.

Finally, how should we view the international economic framework? Much has been done to strengthen the architecture of the international financial system in recent years, notably to improve crisis prevention and management for the emerging markets. The IMF has recently proposed the creation of what would in effect be an international bankruptcy procedure for countries that find themselves with unsustainable debts.⁵ I believe we do need better procedures for dealing with the situations of countries whose debts have become unsustainable, and support further work in this area.

World Bank President James Wolfensohn, British Chancellor of the Exchequer Brown, and other international leaders have proposed a doubling of the volume of international aid. A significant increase in aid would be justified, provided it is used productively. This means it should go in support of countries that pursue good policies – and there are countries that would benefit from such assistance. President Bush's announcement that he will seek to increase United States foreign aid by about 20 percent makes it more likely that aggregate aid could increase significantly over the next few years.

But the biggest priority for the international community in restoring sustained growth is to make rapid progress in liberalizing trade, which has been the engine of global economic expansion throughout the post-war period. The Doha Round is critical to this end.⁶

⁵ The G7 finance ministers have backed further work in this area. Many private sector financial market participants are opposed to the proposal, and its political future remains in doubt.

⁶ This would require trade-offs in a number of areas, including the length of transition periods, offers of technical assistance, environmental concerns, intellectual property considerations, and labor standards.

Let me sum up. It is possible to paint a benign picture of the world economy this year, with the U.S. locomotive regaining speed, and Europe not far behind, pulling the rest of the world to recovery, with exports recovering and good policies taking hold in a number of important emerging market countries. But a more-or-less synchronized global upswing cannot be taken for granted. Europe and especially Japan and the emerging market economies all have important policy steps they need to take to help ensure the recovery. There are also real risks to the global outlook. So as we look ahead we can be more optimistic than we were just a few months ago – but we need to temper our optimism with caution and the recognition that it will take consistent and strong policies, macroeconomic and structural, to ensure that the recovery turns into sustained growth.

Let me conclude by again congratulating the Bank of China on your anniversary, by thanking you for the opportunity to be with you today – and by wishing you well for the next ninety years.