

**“Challenges Facing the World Economy in the Medium Term:  
Search of Sustained and Broader Based Growth”**

**Working lunch, 11<sup>th</sup> meeting of the APEC Finance Ministers, Santiago.  
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**The Opportunity**

1. Mr. de Rato has provided us with an encouraging view of where the world economy is heading, although with a cautious note related to recent developments in the US and Japanese economies and in the oil market. And we cannot forget the risk of terrorist attacks and geopolitical problems. He also identified some of the main challenges ahead of us. In the short run, the pace of the reduction in the monetary stimulus in place in many countries at a time when growth is strong and oil prices are high. Furthermore, in the medium term, the economies will have to deal with more in-depth problems: fiscal weaknesses in some countries, structural problems in others and, more generally a risk of a more systemic nature, the large imbalances in the world economy.
2. I share the view that the short-term prospects for the world economy appear promising. Going forward, there is also room for some optimism: the innovations in telecommunications and information technologies, and the modernization and economic integration of large regions of the world, including countries such as China and India, offer great potential for progress in the search for sustained and broadly-based growth, as well as for alleviating poverty and hunger.
3. However, I would like to stress three key ingredients that are needed for this opportunity to materialize, as well as to better confront risks: (1) appropriate macro policies, (2) further progress in removing obstacles to economic integration, and (3) safe and sound financial systems. Progress on all three fronts must be simultaneous, since otherwise, integration might increase exposure to shocks and local vulnerabilities, while macroeconomic instability, in turn, could hinder integration.

4. Achieving macroeconomic stability together with trade and financial integration pose policy and institutional challenges, both at the domestic and the international level.

### **Domestic Response Required in Emerging Markets**

5. To take advantage of the opportunities and to shield themselves from some of the risks identified above, countries should emphasize the design of a policy framework characterized by:
  - Macroeconomic policies that make the economy more resilient to shocks. This requires a credible and flexible framework, with prudent and consistent monetary, exchange rate, and fiscal policies.
  - Modern regulation and supervision of the financial sector, that ensures efficient financial intermediation and manageable levels of risk-taking.
  - Openness to foreign trade and to financial flows and services.
  - Transparency. This improves the effectiveness of policies, allowing markets to internalize changes in a more orderly and gradual way, providing, at the same time, accountability and an incentive for designing better policies.

In parallel, social policies have to be aimed at reducing poverty and improving the access of the poorest groups of the population to better opportunities and appropriate education and health services.

Rather than searching for a one-model-fits-all, countries should aim for coherent frameworks, especially during their transition to what are now regarded as adequate models. Sequencing should be carefully designed. In fact, experience shows that incorrect incentives stemming from policy decisions are very difficult to undo, and extremely costly. Here the experience of Chile can be illustrative.

## **Domestic Policies in Advanced Economies**

6. The specific shape and emphasis of the policy framework depends on the characteristics of each country, but good practices should apply not only to developing and emerging economies, but to advanced economies as well. This is important not only to enhance the well being of their own population, but also because any developments in those economies have repercussions on the rest of the world. From this perspective, key challenges in advanced economies are:
- Reducing their large fiscal imbalances, which aging populations combined with pay-as-you-go social security systems can only aggravate in some countries. (Deficits for 2004: US: 4.7%, Japan: 7.1%, Euro Area: 2.7% and Germany: 3.7%). In the particular case of the US, the high fiscal and current account deficits require prompt action, so as to reduce the risk of large swings in interest and exchange rates, with serious negative effects in emerging markets;
  - Reducing barriers to trade and domestic subsidies that discriminate against emerging and developing countries;
  - Implementing appropriate structural reforms to promote employment and investment in Europe, and strengthening the banking and corporate sector in Japan.

## **The International Response**

7. Although bilateral trade agreements and unilateral trade liberalization are positive steps toward expanding international trade, they are no substitute for moving to freer global trade through multilateral agreements. The recent agreement to eliminate subsidies to agricultural exports and production in developed regions deserves praise, but it is crucial that leading countries take active steps to define the timing and shape of its implementation. To accelerate progress at the multilateral level, there is also room to move toward a more encompassing FTA within APEC along the lines of the Bogor accord.

8. The risks that the world economy faces in the medium run, and, in fact, also in the short-run, which were identified above, require that the agenda on international financial architecture focus primarily on **crisis prevention** rather than on crisis resolution. Considering the extremely high costs of financial crises, in particular on the poor, the saying “prevention is better than the cure” applies.
9. Given the current risks and imperfections in international financial markets, International Financial Institutions (IFI’s) must stand ready to provide liquidity to emerging economies that have put in place adequate policies, but face short-run difficulties attributable to factors beyond their control and may need financial assistance to avoid a financial crisis.
10. In this regard, the agenda should place more emphasis on improving the mechanisms for liquidity provision to cope with adverse fluctuations in the international financial markets, especially after the failure of the IMF’s Contingent Credit Line (CCL), which was never used due to design problems. Efforts should include both (i) the revision of existing —or the development of new— Fund facilities for direct liquidity provision, and (ii) new initiatives aimed at improving the provision of liquidity by private international financial markets. In both cases, schemes based on the logic of insurance should be discussed and explored.
11. It is also important that the IMF continues and further improves its valuable efforts regarding the surveillance and assessment of the macroeconomic imbalances in industrial economies. We also welcome the IMF’s renewed attention to a fuller treatment of the global effects of the economic conditions and policies of the Fund’s largest members, considering their overwhelming weight in systemic risks.
12. Broader representation of less developed countries in the governance of IFI’s can also help in crisis prevention, allowing for more efficiency, fairness and legitimacy of the international financial organizations and their policies. There are important international financial organizations in which emerging economies are not appropriately represented.<sup>1</sup>

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<sup>1</sup> Broader representation of emerging economies in the design of adequate standards and codes for what is considered good practice would improve their compliance and legitimacy. Even though the under-representation of emerging economies at the IMF is much less

13. To sum up, emerging, developing, and advanced economies, as well as the international economic organizations, all have to do our part. The Ministers and authorities present at this lunch all have a key role to play in leading the way.

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dramatic, there is still space for improvements, especially with respect to African countries, and economies that have experienced fast economic growth in the past.