A “Continuous Adventure”: The Pursuit Of Stability And Growth In Modern Economies

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Professor Grzegorz W. Kolodko: It is our great pleasure to welcome today at the Kozminski Business School www.kozminski.edu.pl and TIGER – Transformation, Integration and Globalization Economic Research www.tiger.edu.pl – distinguished scholar and influential policymaker, Professor Anne Krueger. I have had a privilege to know Professor Krueger for a number of years and on several occasions to meet her and discuss the issues of our join concern, yet I am very glad that today we can host you here, with us, and that our students and the faculty of the School have a possibility to meet you too.
It seems to many researchers and policymakers involved in both, the debate about the state of the world economy and efforts to shape the course of its development, that most of the time we are living at a very special period and that there is something if not unique, then for sure special about the current state of the world. To certain extent it is true since the world is changing most of the time, sometimes quite dramatically. Just by following the literature – and not only the one about development economics – one can easy conclude that certain problems which the world had been facing earlier have been solved already, while some other issues and challenges have just emerged. And there shouldn’t be any doubt that many new challenges will emerge in the future as well. Hence, there is – and it must be so – a permanent quest for a proper clue to a number of issues regarding the state and prospects of the world economy. In another words, it is never ending story, or – as we will learn in a minute form Professor Krueger Distinguished Lecture – a ‘continues adventure’. Definitely, this will keep us, the economists, busy.

The International Monetary Fund – where Professor Kruger serves at the top position since couple of years – is very much engaged in both, the research about the world economy and its sustained and financially balanced growth, as well as in technical assistance and support for the policies which suppose to facilitate such a growth in a number of countries worldwide. However, the debate what went wrong in the past – and may go wrong in the future – continues. I have taken a part in such debate myself on several occasions as well, including my personal ‘adventure’ with four visits to the IMF as a consultant and visiting scholar: in 1991 and 1992, and again in 1999 and 2000. These were the years quite different from the point of view of understanding ongoing globalization, on the one hand, and the post-socialist transformation, on the other hand[1]. If at the onset of the last decade, at the early 1990s, the concern about the ‘institutional building’ was not as wide spread as recently, contemporary it

[1] See more, Grzegorz W. Kolodko, „From Shock to Therapy. The Political Economy of Postsocialist Transformation”, Oxford University Press, Oxford and New York 2000, and Grzegorz W. Kolodko, “The World Economy and Great Post-Communist Change”, Nova Science Publishers, New York 2006.

seems to be one of the key word in any professional dispute about stabilization, growth and development. It is worth the stress that here, at TIGER and the Kozminski Business School, we have given a lot of attention to the role of institutions in economic change and growth. Some of the previous *Distinguished Lectures* were very much focused on these issues.[2]

The same has occurred, I think, to the IMF, which earlier had an inclination to neglect somehow the significance of institutional aspects of stabilization and growth, yet recently is strongly emphasizing the importance of it. It is enough to mention that the recent, that is of September 2005, issue of the IMF *World Economic Outlook* carries the subtitle *Building the Institutions*[3]. Thus we know that the institutions do matter, but so does the policies. I can assure you about this having my own experience form the policymaking, while being twice, in 1994-97 and again in 2002-03, the Poland's Deputy Premier and Minister of Finance. Hence, such conclusion is obvious for both, the countries' economies and the coordination of the policies on the international, and even the world scale as well. In the latter case the International Monetary Fund still plays a major role, however not as important as it used to be in the decade of the 1990s, since much more depends on the private sector.

We do know that each answer given by an economist is not at the same time a question for the policymaker, but instantly it brings also a new set of questions for the economists' circle. Hence, we have to keep not just answering the questions but all the time to ask new questions too. And today we have a special opportunity not to listen to Professor Krueger answers for certain interesting questions, but, I believe, we will be able to ask her some difficult questions too.

Professor Anne O. Krueger has been the First Deputy Managing Director of the International Monetary Fund since September 1, 2001. According to her bibliographical note, presented at the IMF website, before coming to the Fund, Professor Krueger was the Herald L. and Caroline L. Ritch Professor in Humanities and Sciences in the Department of Economics at Stanford University. She was also the founding Director of Stanford's Center for Research on Economic Development and Policy Reform, and a Senior Fellow of the Hoover Institution. Professor Krueger had previously taught at the University of Minnesota and Duke University and, from 1982 to 1986, was the World Bank's Vice President for Economics and Research. This her current adventure with the International Monetatry Fund is not her first direct and close encourtment with the Bretton Woods organizations. She received her undergraduate degree from Oberlin College and her Ph.D. in economics from the University of Wisconsin.

Anne, welcome again to the Kozminski Business School. Thank you that you have found a time and come here to present a Distinguished Lecture on *A 'Continuous Adventure': The Pursuit Of Stability And Growth In Modern Economies*. The floor is your.

Prof. Anne O. Krueger: Good evening. Thank you, Professor Kolodko, for that kind introduction. For my part, I'm pleased to have the opportunity to visit the Kozminsky Business School during what is a very brief stay in Warsaw. Having seen the list of previous speakers here, I know I am in distinguished company.

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[2] See*, inter alia*, Douglass C. North, "Understanding Economic Change and Economic Growth", WSPiZ & TIGER Distinguished Lectures Series, No. 7, 2002 (May). The series of all Distinguished Lectures is available at the TIGER website and can be downloaded from

http://www.tiger.edu.pl/english/publikacje/dist.htm

[3] „World Economic Outlook September 2005. Building Institutions", International Monetary Fund, Washington, D.C., 2005.

Let me first, though, say a word about the terrible weekend tragedy in Katowice. I want, on behalf of the Fund's Executive Board, Management and staff, to express our sincere condolences. Our hearts go out to all those involved, and especially those injured and the families of those who died.

For the title of my talk this evening, I have borrowed from the Nobel lecture given by the Polish poet Wislawa Szymborska in 1996. She talks of those for whom inspiration is important - not just poets but teachers, doctors and, as she says, a hundred other professions. Their work becomes a continuous adventure, she says, if they are constantly finding new challenges.

Now I have no way of knowing whether economists and economic policymakers figure in Ms Szymborska's [Shymborska's] list - although I would like to think so, of course. But I do know that we are not short of fresh challenges. In that sense, at least, economic policymakers are embarked on a `continuous adventure'. To begin with, the speed at which the world economy is evolving means that policymakers, and economic actors, must be ready to adapt to changing circumstances in order to maintain macroeconomic stability and the sustained rapid growth needed for rising living standards and poverty reduction. We must also be ready to respond to new information about how the world works, and what policies will be most successful. And finally, we must be ready to confront the fresh challenges that accompany success. The more rapidly an economy grows, the more complex it becomes and the more rapidly policy has to be adjusted to ensure that growth can be maintained.

A challenging agenda, but an achievable one. This evening I want to examine some of the key developments in the world economy in the past few decades. I want to identify what economists in general and we in the IMF have learned about the most effective policies for stable macroeconomic management and, in turn, rapid and sustained economic growth. And I will say something about the reform process in the countries that, like Poland, joined the newly-enlarged European Union in 2004.

The changing world economy

The multilateral framework established at the Bretton Woods conference in 1944 has underpinned the remarkable economic growth that the world has experienced since the end of the Second World War. The wisdom and foresight of the Bretton Woods founders enabled dramatic rises in living standards across the globe: and, in the process, enabled many to escape from poverty.

A key element of the multilateral framework that the Bretton Woods founders designed was the principle of an open multilateral trading system. The expansion of world trade since 1945 has been a key driver of economic growth. World trade has consistently grown more rapidly than global GDP, and continues to do so. According to the WTO, the volume of world trade in 2000 was 22 times that of 1950. In volume terms, merchandise exports have grown by 6 per cent a year on average for the past 50 years. In 2004, real global GDP grew by 5.1 percent; global trade grew by 10.3 percent.

The Fund 's role in the postwar framework was, and remains, the maintenance of international financial stability-explicitly in the context of the promotion of global trade as our Articles of Agreement make clear. There have been financial crises from time to time, but the international financial system has been remarkably stable over a long period and this has helped make possible rapid economic growth. Providing a stable international framework that makes possible sustained and rapid growth has thus helped countries realize the benefits that globalization can bring.

I mentioned the importance of adaptability. How the Fund seeks to achieve financial stability has, of necessity, changed over time. The world economy is constantly evolving, and the Fund had to evolve with it. Remember, at the time of Bretton Woods, no-one seriously believed that private capital flows would ever again be significant in size; for much of the postwar period that assumption continued to hold. It was only in the 1990s that private capital flows started to assume the dominant role they have today, a development that had significant implications for the way the world economy functions and the way the Fund operates.

In the early years of the postwar system, the fixed exchange regime established under Bretton Woods provided a stable environment that enabled the industrial countries in particular to grow rapidly, at a pace that was at the time without historical precedent. America saw per capita income growth averaging 2.4 percent a year between 1950 and 1973: over the same period in Germany per capita incomes grew on average by 5 percent a year, and in Japan by more than 8 percent.

By the 1960s those rates of growth came to seem rather tame, as several developing countries started to experience even more rapid growth. Korea achieved rapid growth over a remarkably sustained period, averaging real GDP growth of more than 8 per cent a year for more than three decades. Many other countries followed a similar pattern.

The period up to 1973 came to be known as a golden age, and many feared that the collapse of the Bretton Woods system of exchange rates in the early 1970s would bring that period of rapid growth to an end. In fact, the transition to floating exchange rates was relatively smooth and timely: flexible exchange rate regimes helped economies adjust to the oil price shocks of the 1970s, disruptive though those rises undoubtedly were; and floating rates have facilitated smoother adjustment to shocks ever since.

But the 1970s marked an important turning point that perhaps had longer-term significance for the Fund. This marked the end of the period during which the industrial countries had been the Fund's largest borrowers. Britain in 1977 was the last major industrial country to borrow on a large scale from the Fund-indeed, the loan advanced to Britain that year was, at that time, the largest ever made by the Fund.

In the 1970s, the Fund had provided financial assistance to help developing countries adjust to higher oil prices. But the so-called third world debt crisis led to large-scale Fund lending to these countries in the 1980s. This crisis has its origin in the surplus revenues accumulated by the oil producers after the sharp rises in the oil price in the mid and late 1970s. These revenues had been "recycled" by the international banks who lent funds aggressively to developing economies, usually on floating rate terms. With hindsight the result of this large scale lending was predictable. Debt sustainability-regarded as a crucial element of macroeconomic policy today-was at that time an alien concept. As interest rates rose in the early 1980s, reflecting the efforts of industrial countries to reduce inflation, economic policy weaknesses were exposed and many developing country borrowers found themselves unable voluntarily to service their large debts. The Fund played a significant role in helping to resolve the problems developing countries faced, both in helping them make policy adjustments and in the provision of temporary financial support.

The experience of the 1970s and 1980s brought a sharp reminder of the importance of economic policies in helping foster economic growth. This is now so widely accepted that it is hard to remember a time when it was less obvious. Policymakers in Asia implemented policies that created a growth-friendly environment-low inflation, outward oriented policies that enabled Asia to grow even though many countries were heavily dependent on oil imports. By contrast, in the 1980s many Latin American countries experienced soaring inflation, fuelled by inappropriate economic policies. In addition, higher barriers to trade hampered growth in Latin America over a long period. And oil exporting countries, in spite of their high oil revenues, experienced lower growth rates because of weak macroeconomic policies.

For the Fund and for the economics profession as a whole, the 1990s brought perhaps the biggest challenges. For a start, the international policy community, including the Fund, had to help the countries of the former Soviet bloc to become normally-functioning market economies. The abandonment of central planning took place virtually overnight and meant radical change. The economies of Eastern and Central Europe needed help both in the form of financial assistance but, more important in the long term, in managing the transition. As I'm sure everyone here realizes this was an economic transformation of a kind that had never before been attempted, and there was a steep and sometimes painful learning curve for those involved. So it is gratifying to stand here today, in a privately funded and operated business school, in the capital of one of those transition economies and note that Poland is now a member of the European Union, along with 7 other transition countries. This represents remarkable progress.

For the world economy as a whole, though, the rise in private international capital flows, to which I referred earlier, was of greater long-term significance. A series of financial crises during the 1990s, triggered by sharp changes in the direction of capital flows, underlined the extent to which sound economic policies both foster growth and help prevent crises from occurring. It became clear, as the decade progressed, that these crises were fundamentally different from those to which we had grown accustomed.

There were crises in Mexico in 1994-95; in Asia in 1997-98; in Russia in 1998; and elsewhere. All were capital account crises, large in scale, and involved enormous upheaval for the countries affected.

Take the Asian crises as an example. Only a relatively small number of countries were directly affected: Korea, Thailand and Indonesia were the worst hit. For those countries years of spectacular growth ended in a dramatic series of national financial crises. But they had an impact well beyond the countries involved, in part because it was shocking to see economies that had experienced such rapid growth over such long periods suddenly appear so vulnerable and in part because there were, for a time, fears that the crises would spread further.

The proximate cause of the crises in Asia was the sharp reversal of capital flows to the region. Net inflows to the Asian crisis countries were over 6 percent of their GDP in 1995, and just under 6 percent in 1996. But as the crises erupted, the inflows went into reverse. In 1997, net outflows were 2 percent of GDP, a figure which rose above 5 percent the following year. The economic dislocation caused by reversals of this magnitude was huge, and would have been so for any country. But the crises also brought speculative attacks against currencies whose exchange rates had hitherto been fixed. And as GDP in the crisis countries contracted sharply, their demand for exports from other countries fell, thus creating a knock-on effect.

But underlying the turnaround in investor sentiment were real causes for concern. There had been a huge expansion of credit over a relatively short period of time. Rapid credit growth is almost always indiscriminate and, therefore, dangerous. The result had been a sharp rise in the number of bad loans. The rate of return on capital had fallen and, in consequence, non-performing loans (NPLs) started to rise. As international creditors saw countries whose fundamentals were less sound than had previously appeared to be the case, a rapid reassessment of the creditworthiness of debtors and loan exposure was inevitable.

Several factors conspired to make the consequences of this shift in investor sentiment extremely painful. Fixed exchange rates prevented a more rapid adjustment to the shift in capital flows-and gave speculators the chance to make a one-sided bet. Government assurances that exchange rate pegs would be maintained had left currency mismatches unrecognized until governments were forced to devalue. Banks had built up liabilities in one currency and assets in others. Devaluation then left financial institutions and businesses facing massive losses, or insolvency. The weaknesses of domestic banking systems were revealed-as was the impact on economic performance.

The contraction in GDP that most crisis countries experienced made things even worse, of course, because the number, and size, of non-performing loans grew rapidly. The further weakening of the financial sector inevitably had adverse consequences for the economy as a whole. In short, the crisis economies found themselves in a vicious downward spiral.

The capital account crises in Asia and elsewhere had several common features: they occurred rapidly; they occurred because holders of a country's debt were concerned about its ability and/or willingness to service; and because there were doubts about underlying macroeconomic policies to service that debt.

These capital account crises erupted with astonishing speed and financial support from the Fund for countries affected was urgently needed-often in days rather than the weeks or months which Fund programs for current account crises had usually taken to put together. And support was required on a much larger scale than the Fund usually provided because of the scale of the outflows experienced by crisis countries. No country can sustain the outflows experienced by the Asian and other crisis countries for any length of time.

Reform programs undertaken with Fund financial support were far-reaching and sought to address the underlying causes of the crises. They included the commitment to rapid fiscal rebalancing; addressing underlying weaknesses in banking systems; a switch to floating rates or at least more flexible exchange rate regimes; and longer-term structural reforms aimed at removing structural rigidities and improving growth potential.

Lessons of the 1990s

We -economists, policymakers and the Fund -learned a great deal from the experience of the 1990s crises. Many of the lessons were directly relevant for the transition economies, of course: but they applied in emerging market economies in general, to low income countries and, in some respects, to advanced economies as well.

We came to appreciate just how vital a sound macroeconomic framework is-one that delivers macroeconomic stability and growth over the long run. In a globalized world, all economies must have in place monetary and fiscal policies that deliver falling or low inflation, budgetary prudence and sustainable debt levels. And we learned to look at the sustainability of fiscal policy in the context of debt dynamics.

Most economists also concluded that countries need an exchange rate regime that enables an economy to be sufficiently flexible to respond to shocks. Fixed exchange rates pose significant challenges because they require much greater reliance on fiscal, monetary and structural policies to provide the flexibility needed in the economy.

Another important lesson is the closeness of the link between the financial sector and economic stability and growth. Let me say a little more about this link, since it is an issue that could be important for some of the transition economies. Emerging market economists and policymakers often underestimate the importance of the link, though it has assumed increasing importance in the Fund's work.

The world's economic growth has gone hand in hand with the development of the financial sector. Even the most basic economies, when activity is confined to a few rudimentary activities in a small geographical area, use some medium of exchange. As economic activities expand and become more differentiated, demands on the financial system increase. Small, localized banks develop as mechanisms for more effectively enabling the owners of capital to lend it to those who can use it more productively.

But to be effective in helping to underpin economic growth, banks, even small ones, must develop the ability to assess creditworthiness, risk and returns. Without these skills, even in a relatively underdeveloped economy, the role of banks as financial intermediaries is less than optimal and thus hampers growth. Resources need to be allocated according to productive potential and banks have an important role to play in directing resources to high-return investments-and reducing the resources wasted on low-return or unprofitable investments. But this, in turn, requires adequate means of assessing the likely returns from competing borrowers.

As economies grow, they become more complex and interdependent; and the demands placed on the financial sector grow commensurately. Banks grow bigger: they need to in order to meet the demand for investment capital. Economic complexity also means that banks must grow more sophisticated, and become more diversified in terms of the risks they assume. Continued expansion brings increasing demands for geographical diversity-firms need banks that can serve their needs across national boundaries and they also need banks than provide specialized financing services.

But breadth and depth are important for the financial sector as a whole. Healthy and sustained growth of firms and economies requires the development of new financing modes for investment capital. The financial sector-in which I include banks, equity and bond markets, insurance providers and other financial intermediaries-has to meet the needs of the range of economic activity.

Experience has repeatedly shown that high growth rates are sustainable only as the financial sector develops in parallel with the economy as a whole. A weak financial sector can undermine growth. Resources are misallocated, and average returns fall. We all knew that a healthy financial sector was an important ingredient of macroeconomic stability. But as we saw how weak financial sectors contributed to the crises of the 1990s we gained a better appreciation than before of the crucial importance of a sound and diversified financial sector.

Recent global developments

I noted that the experience of the 1990s taught us much about the macroeconomic policies needed to deliver stability, sustained rapid growth and, in turn, rising living standards and poverty reduction. The experience of the past few years has, in a positive way, reinforced those lessons. Most striking-and sometimes underestimated-is what has happened to inflation rates worldwide-and what that has shown about the role that low inflation can play both in providing a stable economic framework and in making possible more rapid growth.

In the 1970s and 1980s, inflation came to be seen as a fact of life-albeit an undesirable one. Success in lowering inflation rates, and keeping them low, was mixed. More recently, though, policymakers have made considerable progress in achieving significant and lasting reductions in inflation. The global inflation rate has declined from an annual average of close to 15 percent in 1980-84 to 3.7 percent in 2004. The average inflation rate in the industrial economies fell from almost 9.5 percent between 1975 and 1979, and nearly 9 percent in the early 1980s, to 2 percent in 2004 and an estimated 2.3 percent in 2005.

In developing countries, the decline has been even steeper. In the early 1990s, the average inflation rate in developing countries was just over 80 percent; by 2004, that had declined to 5.8 percent, and is estimated to have fallen further, to 5.6 percent, in 2005.

Here in Central and Eastern Europe there has also been remarkable success in reducing inflation. Consumer price inflation in the transition countries averaged 61.3 percent a year between 1987 and 1996. In the following decade the average inflation rate declined to just over 18 percent. And, as the Fund's latest World Economic Outlook, published in September, shows, the average inflation rate in Central and Eastern Europe is projected to be below 5 per cent this year.

In 2004, only three of the IMF's 184 members had inflation rates in excess of 40 percent: Angola, the Dominican Republic and Zimbabwe. Indeed, only eight countries experienced inflation above 20 percent in 2004 and only 32 countries had double digit rates of inflation. That is a remarkable global transformation, relative to the 1970s and 1980s.

The worldwide decline in inflation rates has been accompanied by more rapid global growth. As I mentioned earlier, In 2004, the world economy grew by 5.1 percent, more rapidly than at any time in the past three decades, with growth in every region. Growth remained strong in 2005, estimated at around 4 and a half percent; and the outlook for this year is similarly bright. It is worth noting that periods of global expansion are longer, and worldwide slowdowns are fewer, shorter, and more modest: the slowdown in 2001-2002 is a good illustration of this. At a time of considerable geopolitical uncertainty and shocks that have included a sharp rise in oil prices, the world economy has exhibited more resilience than we would have anticipated a few years ago. Improved macroeconomic performance of which the fall in inflation rates is part goes at least some of the way towards explaining this.

High inflation has always penalized the poor more than the rich because the poor are less able to protect themselves against the consequences, and less able to hedge against the risks that high inflation poses. Lowering inflation therefore directly benefits the poorest members in society. As low inflation becomes firmly established, uncertainty among economic actors is reduced and resource allocation becomes more efficient and investment decisions are easier.

And we often overlook one specific and important way in which low inflation helps would-be investors and so greatly improves resource allocation in the economy. High inflation, regardless of the real interest rate charged, discourages long-term investment because it front-loads repayment charges. For example, if inflation is zero and the real rate of interest is 3 percent, the borrower will pay finance charges of just 3 percent of the principal in year one. But if inflation is 10 percent, and the real rate of interest is still 3 percent, the repayment charges in year one will amount to 13 percent of the principal. That is a sizeable proportion of the initial investment-sufficient to act as a strong disincentive to long term planning, no matter how attractive an investment might appear to be.

By tilting investment towards the short term and away from longer-term, high inflation thus contributes to inefficient resource allocation. In the long-term, of course, this drives down all rates of return and undermines the potential rate of the growth of the economy as a whole.

Towards price stability

So we should expect those countries that have been most successful at curbing inflation to record higher growth rates-and, by and large, they have. Indeed, there is plenty of evidence that macroeconomic stability and growth are complementary. Witness the economic reform programs in Turkey and Brazil which have both been supported by the Fund in recent years. Turkey has recorded an astonishing decline in inflation rates-from a recent peak of 70 percent in 2002 to below 8 percent at the end of last year. 2005 was the first time in three decades that the Turkish inflation rate was in single digits. This sharp fall was the result of monetary and fiscal policies aimed at delivering macroeconomic stability.

The Turkish government has been running a primary surplus of 6.5 percent of GDP, fiscal consolidation intended to reduce the public debt burden to sustainable levels. Yet the introduction of fiscal discipline has been accompanied by a remarkable surge in GDP growth. In 2004 real GDP grew by close to 8 percent and growth was at or around 5 percent in 2005. This hardly supports the arguments of those who claim that fiscal tightening stifles growth.

It is a similar story with Brazil. By the end of 2005, the inflation rate was barely one third of the level it reached in 2002. The prudent fiscal and monetary policies that paved the way for this reduction have also made possible more rapid growth: 5 percent in 2004, for example, and around 2.6 percent last year. And this at a time when the primary surplus is around 4.75 percent of GDP.

If we look back to earlier periods we can see many more examples of macroeconomic stability making possible more rapid growth: countries as different as Chile and the United Kingdom have experienced an acceleration of growth accompanying declining inflation and fiscal prudence.

And we have, of course, seen the same phenomenon here in Central and Eastern Europe. Sharp declines in inflation have accompanied economic reforms and have thus made possible in many countries rapid growth over a period of several years.

The new members of the European Union

Progress in many of the "transition economies" has been striking: so much so that it is easy to forget how recently the transition from central planning began. The scale of the challenge was formidable: never before had such a sudden shift in economic structures been attempted. Yet in less than fifteen years, eight of those economies were in a position to join the European Union-and five of those have since joined ERM2, in readiness for Euro membership.

If we look a little further back in time, of course, we are reminded that Europe has a history of rapid economic turnaround. The physical destruction and economic chaos that blighted the continent at the end of the Second World War was rapidly overcome by the countries of Western Europe that became, in fairly short order, the founding members of the European Economic Community in 1957. Economic reforms coupled with the rapid growth of world trade facilitated by multilateral trade liberalization enabled these countries to put their past behind them.

The extent of the changes needed in the new member states was, of course, much greater. But by and large the progress they have made has far exceeded the expectations of even the most optimistic among us at the start of the 1990s. The economies of Central and Eastern Europe have reminded us of the power of markets-and the force for good they represent.

Now many of these countries are facing a new challenge-that of economic success. For most of them the first phase of the transition is largely complete. But policymakers-and, indeed, all economic actors-are discovering that sustaining rapid growth and maintaining stability are part of a dynamic process, that "continuous adventure".

In the coming years, governments in the new member states are likely to face two main challenges. The first is to lock in the progress already made, to ensure that the macroeconomic stability policymakers and citizens worked so hard to achieve is sustained. The second is to raise the potential growth rate by making economies more flexible and resilient in the face of shocks.

Of course, the exact nature of the challenges varies from country to country. In Poland, Hungary and the Czech Republic, for example, efforts are focused on strengthening fiscal policies, reducing debt burdens and continuing with the structural reforms that will ensure that macroeconomic stability is sustainable over the long term and raise growth potential and permit rising living standards.

In other countries, such as the Baltics, Slovenia and Slovakia, policymakers are confronting the risk of overheating as current growth rates exceed the potential growth rates of those economies. In the short-term, this means keeping a tight grip on inflationary pressures, of course: but in the longer term, policymakers aim to tackle rigidities in the economy in order to make possible more rapid growth.

In most transition economies there is still plenty of scope to make labor markets more flexible. Experience has taught us that labor market flexibility both helps raise growth rates and, at the same time, helps ensure that employment rises as growth accelerates. The World Bank publication, Doing Business 2006, offers useful comparative data in this area.

Compared with many parts of the world, many of the new members of the EU have made significant progress. But there are still important rigidities, the removal of which would bring considerable benefits. It costs firms in Slovenia, for example, 43 weeks of salary to fire a worker-and it costs 33 weeks salary or more in Hungary, Estonia and Lithuania. In the US and New Zealand, by contrast, firms incur no costs in firing workers. And the evidence shows that the easier it is to fire workers, the more willing employers are to hire them—because they are taking on less risk when they recruit new staff.

Many of the new member states also have strict rules about working hours. The World Bank has an index measuring rigidities in this area, using a scale of 1-100, where 100 is the worst. Slovenia, Hungary and Estonia all score poorly on this, with an index of 80, while Poland, Lithuania and Slovakia score 60: that compares with a score of 20 for the UK, and zero for the US and New Zealand. Yet strict limits on working hours make it difficult for employers to respond to increased demand—especially if the labor market also discourages recruitment of new workers.

A business-friendly environment is an important ingredient for more rapid and sustained growth. Encouraging enterprise and investment means, among other things, reducing red tape and making it easier—and quicker—for companies to enforce contracts. This is something on which the European Union as a whole has placed increasing emphasis in recent years. And it is an area where, once again, the World Bank's Doing Business, provides some revealing data. Many of the new member states have made great strides in cutting the red tape involved in starting a business: only 6 procedures are involved in Estonia and Hungary, for example, while it still needs 10 procedures in Poland and the Czech Republic. That compares with only 3 procedures required in Denmark, and only 2 in New Zealand and Australia.

The time involved in starting new business has also been reduced in many countries: only 18 days in Latvia, and 25 in Slovakia and 26 in Lithuania. But it takes 40 days in the Czech Republic and 60 days in Slovenia to complete a process which takes only 2 days in Australia, 5 days in Denmark and 8 days in France. The length of time involved, and the cumbersomeness of the procedures, can be important factors for entrepreneurs deciding where to locate a new business, especially in a world where falling transport and telecommunications costs, and the development of the internet, have reduced the importance of geographical distance for many types of business.

As I said earlier, most of the EU's newest members are now in what we might call the second phase. They have achieved a great deal in a relatively short space of time and many of them are having to cope with the problems of success. As these economies become more closely integrated into the European and global economies, their policymakers, and their citizens, are increasingly facing the same problems as policymakers in other parts of the world: how to sustain growth, how to keep inflation under control, how to raise the economy's growth potential and its resilience in the face of shocks. In some cases they are also facing a problem familiar to many in industrial and emerging market economies: how to ensure that credit growth doesn't spiral out of control.

In some parts of Central Europe and the Baltics private credit growth is already strong: in others it is likely to accelerate as personal borrowing and consumption picks up. This is to be expected given the rapid development of these economies. But the authorities will be on their guard lest there are signs that households or businesses are becoming too indebted.

Most countries in the region now have well-functioning banking systems and well-run supervisory systems. But one trend that is of potential concern is the increasing tendency in some countries for households in particular to borrow in foreign currency. In a period of relative stability in international currency markets, borrowers may assume that the risks of such borrowing are lower than they could turn out to be. Any disruption in foreign exchange markets could leave them uncomfortably exposed. It is therefore important that the banks be equipped to monitor these risks and that supervisory authorities remain alert to the risks both for borrowers and the banks.

In other words, the financial sector in the new member states needs to evolve as those economies develop. This is true, of course, of all economies: as they grow and become more sophisticated, it becomes increasingly important that the financial sector is both wide and deep. The financial sector plays an important role in resource allocation in an economy. It cannot perform that function if it is not properly equipped to assess both risks and returns.

The role of the IMF

The transition experience was-is-a learning process for us all-policymakers in the countries in question, Fund staff and economists around the world. We were, as I noted, working towards a transformation that had never before been attempted. We still are.

I noted at the outset that the Fund's principal objective remains the maintenance of international financial stability. That gives the Fund an important role in crisis prevention and resolution-and the past 15 years have provided plenty of opportunities from which we have all, ultimately, profited. But we also have an important advisory role. Reform is, in a very broad sense, the Fund's business. When appropriate we can also offer technical assistance on a wide range of issues in order to help governments adopt and implement reforms and we have done so in many areas when working with those in the transition economies.

The Fund uses the annual Article IV consultations to draw attention to policy weaknesses and recommend appropriate reforms. But both in our surveillance discussions and in discussion with countries embarking on reform programs with financial support from the Fund, we always seek to remind policymakers that it is they who have to adopt reforms and try to ensure their success. It is they who have to secure the support of civil society and the various economic actors involved and whose response will contribute to the success or otherwise of the reforms.

Conclusion

I started this evening by talking about the continuous adventure that I believe economic policymakers face. I think it is clear that there are always going to be fresh challenges for economists and policymakers because we live in a world that is constantly changing.

It is one where we are also steadily making progress-in our understanding of the economic policies that are most effective and in our ability to implement those policies. There is today a remarkably wide consensus on how to achieve macroeconomic stability and, in turn, sustained, rapid growth.

Low inflation is a vital element in any macroeconomic framework. The progress we have seen worldwide in lowering inflation rates has underlined the benefits this brings. Sound fiscal policies are an essential accompaniment to well-run monetary policy. But macroeconomic stability has to be accompanied by wide-ranging structural reforms if more rapid growth is to be achieved and sustained. And policymakers quickly learn, if they didn't already know, that structural reform is an ongoing process. Economies must adapt to those changes if they are to retain the capacity to grow.

I think it is true to say that the policymakers in the transition economies have risen splendidly to the challenges they have faced thus far. The task in the early 1990s was formidable, both absolutely and in relation to any economic policy challenges faced earlier. Restructuring economies after nearly decades of central planning involved a Herculean effort-and was remarkably successful. I am proud that the IMF was able to contribute to that effort.

Those achievements were, of course, only the start. Success brings with it fresh problems and requires fresh efforts: but it also brings the prospect of fresh successes. Life for economic policymakers is, therefore, a continuous adventure: but, I am firmly convinced, it is a rewarding one.

Thank you.