World Economy

Commitment

“We agreed that it was important to take advantage of the strong global economic environment to implement further reforms to accelerate growth in our countries.”

Chair’s Summary

Background

The G8 chose to focus its macroeconomic commitments on structural reform now that positive growth has returned to the Group’s largest economies. The constituent nations chose to not pursue a coordinated plan on macroeconomic reforms, a decision largely reflected in the diversity of plans and reform packages implemented by the eight countries. Many of the sectors or policies targeted were previously identified as areas of concern in Article IV consultations between the International Monetary Fund and the members of the G8.

Assessment

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<tr>
<th>Score</th>
<th>Lack of Compliance</th>
<th>Work in Progress</th>
<th>Full Compliance</th>
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<tr>
<td>Canada</td>
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<td>Overall: 0.33</td>
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Individual Country Compliance Breakdown

1. Canada: 0

Canada has partially complied with its World Economy commitments. Contrary to the trend in many other G8 nations, calls for structural reform in Canada have focused primarily on the financial services sector, while health care, labour market and social security reform have all received less attention than in the United States or European countries. Indeed, the IMF commented in its 2005 Article IV Consultations with Canada that “[t]he public pension system is

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actuarially sound for the next 50 years”\textsuperscript{134} – although accord to the 21 Actuarial Report of the Canada Pension Plan, the system is sound for the next 75 years as of December 2003.\textsuperscript{135} In November, 2004, Finance Minister Ralph Goodale identified the implications of Canada’s ageing population on the sustainability of the federal health care and social securities structures as a primary concern for the Paul Martin government.\textsuperscript{136} As such, he said, the government would “implement policies to build an economic environment that fosters greater innovation, productivity and international competitiveness to generate the wealth the country will need to face those additional pressures,” as well as seek to reduce the federal government’s debt load over the next decade.\textsuperscript{137} The Minister did not, however, provide any specific details on the nature of such reforms. In its Economic Survey Canada 2004, the OECD commented on the need for measures to ensure that productivity growth allows for an increase in Canadian living standards while maintaining the federal government’s “exemplary” fiscal record.\textsuperscript{138} The OECD also noted that reforms must be undertaken in the health care sector, in order to provide for major demographic shifts, and in labour markets and tax codes, in order to remove those policies that create disincentives for an expansion in labour hours supplied and an increase in the nation’s capital stock.\textsuperscript{139}

The most vocal proponent of structural reform in Canada, however, has been the Governor of the Bank of Canada, David Dodge. During a speech to the Empire Club of Canada in Toronto on December 9, 2004, Mr. Dodge rebuked Canada’s intransigence in implementing or even addressing the need for radical change to the Canadian financial services sector.\textsuperscript{140} In particular, he called for substantial reform of regulatory regime in Canada to allow for bank mergers and greater foreign competition, as well as to strengthen the reporting and transparency requirements of the major actors in Canadian financial markets.\textsuperscript{141} He also called for greater uniformity in securities regulation across the country (which is under provincial jurisdiction). These reforms, he noted, are crucial to “the future health of [Canada’s] economy and the prosperity of Canadians.”\textsuperscript{142} The International Monetary Fund also voiced these concerns in its aforementioned consultations, especially the need to clarify the rules concerning bank mergers and pension fund regulations.\textsuperscript{143}

\begin{thebibliography}{99}
\item Ibid.
\item Ibid.
\item Ibid.
\item Ibid.
\item IMF, ‘2005 Article IV Consultation with Canada: Preliminary Conclusions of the IMF Mission’.
\end{thebibliography}
Therefore, given the recognition of the need for targeted structural reform by both the government and autonomous regulatory bodies, but the relative inaction on such issues, Canada has received an interim score of 0.

2. France: 0

France has partially complied with its World Economy commitments. The French economy experienced a particularly disappointing performance in third-quarter growth due to lessening of private consumption and a dramatic reduction in business investment. Although France underwent pension reform (2003), healthcare reform (2004) and is currently undergoing product market reform, the 2005 budget relied too heavily on one time measures instead of real reform. The government also missed the opportunity to reduce its considerably large civil service through retirement attenuation, and continued to replace civil servants at a rate of 7 out of 8. Furthermore France has repeatedly breached the European Union’s Stability and Growth Pact, which sets a limit of 3 percent GDP on the budget deficit. In the opinion of the IMF, France has proposed expenditure exemptions that would weaken the pact as well as make the accounting less transparent.  

France received generally good marks for its financial sector reforms from the Financial System Stability Assessment prepared by the IMF and the World Bank. Although there is banking concentration and progressive integration, which must be firmly supervised, the French financial sector is characterized by a high degree of transparency and compliance with international standards for financial regulation. France does have some regulation gaps but authorities are working to close them soon.

The French economy continues to be hampered by France’s complex regulatory governance system. The OECD Reviews of Regulatory Reform considered France to be suffering from “severe institutional inflexibility”. Although the privatization of post and telecommunications administrations has occurred, difficulties in the reformation of the EDF (French electricity board) and GDF (French gas board) underline continuing problems in the regulatory framework. Nevertheless the OECD feels that “the public service framework and administrative practice are, undoubtedly, capable of being adapted and modernized, provided that the definition of the general interest can take on a slightly different meaning, reflecting an increased global view of economic and social stakes.” In summation, France has failed to take full advantage of opportunities to implement real reform in order to accelerate growth, but shows positive signs of preparing for structural reform. For these reasons, France receives a score of 0.

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147 Ibid.
3. Germany: +1

Germany has successfully complied with its World Economy Commitments. On November 2, 2004, Germany finished Article IV consultation with the IMF. Article IV is an economic strategy to begin addressing key structural weaknesses, comprised of phased tax cuts, expenditure-based fiscal consolidation, and reforms laid out in “Agenda 2010.”148 The IMF noted the German economy’s increased activity, increasing profitability of banks and low inflation. Germany’s implementation of the structural reforms laid out in Agenda 2010 have been applauded by the IMF’s directors, who also emphasize the need for durable cuts in tax expenditures and subsidies, and the phasing in of a higher retirement age.149

The OECD’s Economic Survey of Germany 2004 was also very supportive of Germany’s structural reforms, saying that “these reforms are welcome, have to be continued and need to be broadened further to reduce government debt, remove fiscal distortions, and improve incentives to supply and demand labour.”150 The report also highlighted the importance of a growth and stability oriented macroeconomic policy in order to raise confidence and restore Germany’s traditional economic expansion.

On October 27, the German cabinet approved a progress report of the government’s sustainability report, which was initially published in April 2002.

The progress report showed positive sustainability patterns in the four main areas — the ageing population, renewable energies, modern fuel and engine technology, improved land usage — “with a view to ensuring the preservation of natural and economic resources for future generations.”151

On October 19 a Report on the Situation of the Global Economy and the German Economy in the Autumn of 2004 was presented to the public by the German government. This report indicated expectancies of future growth in the German economy due to the effect of the foreign markets, with many institutions believing that long-term GDP growth could average at approximately 1.8 percent.152

The Hartz IV labor market reform went into effect on January 1, 2005. “The reform is intended to speed up and improve the process of finding employment for the unemployed as well as to create a single source of assistance for them.”153 Both the IMF154 and the OECD155 have praised

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149 Ibid.
this reform. As part of the Hartz IV reform, the German government unveiled Unemployment Compensation II that it describes as “not an insurance benefit but rather a welfare benefit paid for out of tax revenues. The amount of the benefit is to be based on the recipient's needs and not on the last net salary received.” For these reasons, Germany has been awarded a score of +1.

4. Italy: +1

Italy has fully complied with its World Economy commitments. The main issue of structural reform in Italy is the pension system. According to current demographic projections, the majority of Italy’s population will be over the age of 60 by 2050 and will draw on the system. The pension system is undergoing a transition. The old system calculated pay-outs to retirees based on the income earned near the end of their career. The new system is being calculated based on contributions actually paid into the pension fund. Although the value of the pension will be lower, it is hoped that this will prove more sustainable. All people starting work after 1996 will be covered under the new, contribution based system. Government efforts to reform the pension system include an increase in the average age at which workers retire (currently about 59) and supplementary pension arrangements. Employees will have the choice of having some of their funds being put into regional trusts or investing them with their union or bank. In December 2004, a country-wide strike paralyzed Italy for a day. It was a large-scale signal of trade union resistance to the new reforms.

The government has had problems persuading the country’s employers’ association and the trade unions to go along with the reforms. There were strikes across the country during the summer of 2004. So far, the employer’s association has not said anything while the unions appear to remain opposed in principle to the introduction of any sort of supplementary pension system.

In addition to pension reform, the government has sought to make its economy more innovative. In the Financial Economic Planning Document for 2005-2008, the Italian government is seeking to encourage the deployment of broadband Internet access, promote scientific research and increase human capital. It is hoped that these infrastructure reforms will promote growth in the Italian economy. For these reasons, Italy has been awarded a score of +1.

154 IMF. ‘Germany: 2004 Article IV Consultation—Staff Report; Staff Supplement; and Public Information Notice on the Executive Board Discussion’.
158 Ibid.
160 Ibid.
5. Japan: 0

Japan has partially complied with its World Economy commitments. Although many countries view structural reform as a preventative measure to ensure future growth in living standards, the government of Japan has long viewed reforms as an essential component of restarting Japanese growth and ending the decade-long period of economic decline. In fact, one slogan of Prime Minister Junichiro Koizumi’s 2001 electoral campaign was: “no economic recovery without structural reform.”\(^{163}\) The Executive Board of the International Monetary Fund has noted that a combination of improved performance of the Japanese economy over the past two years and effective regulatory reform of the financial services sector have had positive effects on many banks’ balance sheets.\(^{164}\) However, they urged the government to press on with further reforms of the financial services sector as well as policies to strengthen corporate governance in order to eliminate further weaknesses in financial markets.\(^{165}\) The Executive Board of the IMF believes that implementation of “front-end measures” to increase labour market flexibility and strengthen competition would also improve Japan’s long-term economic situation.\(^{166}\)

The Japanese government, which has been running a fairly large fiscal deficit for some time, continues to consider various reforms targeted at the sustainability of social security programs given the increase in public debt.\(^{167}\) In particular, the Japanese government is examining a number of initiatives to reform the budgetary process and its relationship with local governments in order to reduce the fiscal deficit in the near future.\(^{168}\) Such measures will include the abolishment of state subsidies to local governments for child care and education.\(^{169}\) The government is also seeking to address the rising cost of social security through taxation without causing disincentives for an expansion in the labour supply. These measures will include step-up increases in the support ratio, caps on the level of premiums paid by employees and a change in indexation régimes, from inflation and per-capita income indexing to “macroeconomic indexing.”\(^{170}\) In terms of financial system reform, the Japanese government is preparing for the removal of full state guarantees for deposits in private banking institutions in April 2005.\(^{171}\) Finally, the Council on Economic and Fiscal Policy is preparing a bill for the privatization of the Postal Services and hopes to submit this proposed legislation to the Parliament in early 2005.\(^{172}\) The CEFP hopes that this specific reform will lead to greater efficiency in the channeling of

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165 Ibid.
166 Ibid.
168 Ibid.
169 Ibid.
170 Ibid.
171 Ibid.
172 Ibid.
personal savings into the private sector and expects the privatization to be completed by 2007. For these reasons, Japan has received a scored of 0.

6. Russia: +1

The Russian Federation has fulfilled its World Economy commitments made at the Sea Island Summit. It has been more successful in social reforms than in economic structural transformations and approaches.

Several social reforms have been made in order to spur a higher standard of living and to increase the national output or GDP. In its draft 2005 budget, the Russian government is proposing to increase social spending by some of 1 percent of GDP, associated with an ambitious social reform. The reform, which will affect tens of millions of beneficiaries, aims to downsize entitlements to affordable levels, ensure full funding of remaining benefits, delineate the social spending responsibilities of federal and local governments, and replace in-kind benefits with monetary compensation. In addition, the government is proposing to cut the social security tax, a measure that would reduce revenue by nearly 1 percent of GDP in 2005. While this reform will most likely lead to a hole in the budget, the government is expecting to raise additional revenues from oil taxes. An increase in the marginal tax rates on oil prices is expected to boost tax revenue by some of 1 percent of GDP at oil prices over $30 a barrel. The tax cut also brings to light the urgency of a comprehensive pension reform. The pension fund will receive an additional of 1 percent of GDP as a result of a planned diversion of some pension contributions from the fully funded system to the pay-as-you-go system. The tax fees for the Obligatory Pension Insurance have been removed from the Tax code and will be now directly paid to the budget of the Pension Fund of Russian Federation. As of January 1, 2005 the privileged pensioners (who include the World War II veterans, mine workers, Chernobyl atom reactor victims, invalids and other pensioners requiring additional support) will be receiving an increased amount of monthly payments, as well as a ‘package’ of social benefits.

In the sphere of international relations, Russia has signed the Kyoto protocol, which is a positive factor towards Russia becoming a WTO member. The ratification of the Protocol will have profound effects on Russia’s economy, particularly as its standard of living converges with that of the other G8 members.

Russia has approved the ‘vertical power’ administrative reform of President Putin, in which high-level administrative managers (gubernators) are chosen and proposed by the President.

175 Ibid.
176 Ibid.
177 Ibid.
180 Mikhail Vinogradov. ‘Delegate Repair’. Izvestija. 15 November 2004. [in Russian]
As well, in late 2004, the government increased its share in Yukos through Rosneft’s (the state-owned oil company) purchase of Yuganskneftegas, which was the main production unit of Yukos.\textsuperscript{181} On the one hand, this transaction will make the company’s future activities more transparent to regulatory bodies and thus is more likely to function properly. On the other hand, however, both of these facts illustrate the centralization process of administrative and economical resources (main budget forming industries). This is also confirmed by intentions to unite Rosneft with Gazprom in which the Russian State has a controlling interest.

Another social reform was made in the sphere of housing, in which the hypototka (mortgage) plays an important role. New, corrective hypototka legislation has been introduced that now more precisely reflects the mechanisms currently in use.\textsuperscript{182} This legislation is expected to lower the risks to mortgage users. The new law eliminates the contradictions and obstacles that were creating difficulties for the formation of affordable dwelling markets and improvements in living conditions for millions of Russian citizens. As a result, this reform undoubtedly makes a good base for: 1) a better maintenance of government housing policy; 2) the development of hypototka credit and increasing demand for other forms of payment possibilities by the “middle class” income representatives; 3) liquidations of superfluous administrative barriers; 4) an increase in the volume of the construction industry and an increased attraction of investment into the construction sector; 5) ordering of the rental habitation market and development of commercial hiring; 6) modernization of the current fund and the increase of standards of living; 7) increased reliability of the proportion of the population’s money resources involved in construction.\textsuperscript{183}

For these reasons, Russia has been awarded a score of +1.

7. United Kingdom: 0

The United Kingdom has partially complied with its World Economy commitments. The UK is making progress in its commitment to implement reforms that take advantage of an improving economy in order to further accelerate growth. Broad based structural reforms and judicious macroeconomic policy frameworks have proved vital in the strong performance of the UK economy. The UK has shown impressive resilience during the past downturn in the world economy, and has managed to keep inflation close to target and maintain one of the lowest unemployment rates in the OECD.\textsuperscript{184}

At the meeting of the G7 Finance Ministers and Central Bank Governors in Washington, DC on October 1, 2004, the United Kingdom reaffirmed its commitment to structural reforms and accelerating economic growth, particularly as the UK will be taking on the presidency of the G7 in 2005. Among other initiatives created at the meeting, it joined the new initiative Agenda for Growth, for which it has been agreed that pro-growth structural reforms should be made a

\textsuperscript{183} Ibid.
regular part of the G7 finance ministers work to increase employment opportunities and productivity. Specifically, the Agenda for Growth initiative focuses on reforms such as marginal tax rate reduction, labor market reform and regulatory changes.¹⁸⁵

The UK plans to continue taking advantage of one of the longest growth periods with a GDP that has grown over the past 49 consecutive quarters. In HM Treasury Pre-Budget Report released in December 2004, the government outlined as its main priorities the maintenance of macroeconomic stability, increasing productivity, and expanding employment opportunities. It is focusing in particular on increasing worker productivity by allocating, by 2007-8, a total of _160 million to the National Employer Training Programme, and augmenting employment opportunity by increasing Working Tax Credit thresholds by _140 million in the same period. Together with a _285 million allocation to the extension of paid maternity leave and _155 million by 2007-8 for improving childcare quality, these represent some of the largest expenditures for policy decisions since Budget 2004. The UK government has also made significant gains through reforming its public services, encouraging environmental objectives (especially working on energy efficiency innovation), and reforming and working against the abuse of government revenues.¹⁸⁶ For these reasons, the United Kingdom receives a score of 0.

8. United States: 0

The United States has partially fulfilled its World Economy commitments. The major issue affecting the American economy is an ever-increasing government deficit and long-term concerns about the future of Social Security. In less than a decade, the federal government has gone from surplus situation to the present US$500 billion deficit. Much of this extra spending has been defense related. In November 2004, President Bush voiced strong support for allowing the development of private accounts to supplement the government’s Social Security program.¹⁸⁷ The proposal would likely require extensive borrowing given that, under the existing Social Security system, payments go directly to retirees with only a small proportion being set aside for future payments.¹⁸⁸ Assuming no other changes occur, many argue that this would require borrowing hundreds of billions more. Given that the current US deficit has already been described as a, “significant obstacle to long-term [economic] stability,”¹⁸⁹ by Federal Reserve Chairman Alan Greenspan, this particular reform may exacerbate other US structural problems. President Bush has announced that he plans to reform the American tax code.¹⁹⁰ Thus far, he has only spoken in vague terms and measuring the impact of this rhetoric is difficult. For these reasons, the United States has received a score of 0.

¹⁸⁸ Ibid.
9. European Union: 0

The European Union has partially complied with its World Economy commitments. On July 27, 2004, the OECD published the *Economic Survey of the Euro Area 2004*. The OECD noted the need for speeding up price and real wage adjustment as well as labour mobility in order to ensure a stable economy.\(^\text{191}\) The report also focused on growth potential, which could be found, according to the OECD, by increasing good, service and market integration. A further area of potential improvement was fiscal policy, which needed to reflect long-run sustainability, while also increasing short-run flexibility.

Both the OECD\(^\text{192}\) and the EU Economic and Financial Affairs Department\(^\text{193}\) have forecast the increasing oil prices as barriers to EU’s GDP growth, assuring a drop in the 2005 GDP as a result. The OECD sees a need to reinvest in structural reforms that will take the aging population into account while still maintaining growth and stability.\(^\text{194}\) The EU Economic and Financial Affairs Department has promised to review labour market reforms, while maintaining its commitment to low inflation.\(^\text{195}\)

At a meeting on 4 November, 2004 in Brussels, EU leaders put economic reforms high on their agenda. Growth and employment were the two economic pillars of the meeting’s focus.\(^\text{196}\) For the reasons stated above, and its relative lack of action on structural reform, the European Union has been awarded a score of 0.

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\(^{194}\) OECD. ‘OECD Economic Outlook No.76’.  
\(^{195}\) EU Economic and Financial Affairs. ‘Economic Forecasts 2004’.  