EBD/04/107

September 29, 2004

To: Members of the Executive Board

From: The Secretary

Subject: **Managing Director's Statement to the Development Committee**

Attached for the **information** of Executive Directors is the Managing Director's written statement to the Development Committee. This statement will also be issued as a Development Committee document.

It is expected that this statement will be posted on the external websites of the Fund and the Bank.

This document will shortly be posted on the extranet, a secure website for Executive Directors and member country authorities.

Att: (1)

Other Distribution:
Department Heads

DEVELOPMENT COMMITTEE: THE MANAGING DIRECTOR'S WRITTEN STATEMENT

I. INTRODUCTION

1. The recovery in global growth provides a good opportunity for addressing medium-term challenges that will have an impact on future prospects for growth, employment, and poverty reduction. Ambitious actions by Fund member countries will be needed to correct global imbalances among the major economies, remove structural impediments to growth and prepare for changing demographics through forward-looking fiscal consolidation. Also, it is important to help ensure that some countries are not left behind in realizing the benefits of globalization. All development partners must do their utmost to help low-income countries make significant progress in achieving the Millennium Development Goals, including by moving decisively to liberalize trade in the Doha Development Round.

2. The Fund Executive Board will discuss the strategic direction of the Fund in the coming months, and will report on the results at the time of the Spring Meetings in 2005. In this statement, I shall summarize the Fund's assessment of the world economic outlook and explain in more detail the Fund's efforts to review, refine and strengthen its activities, including its efforts to increase the effectiveness of its surveillance, promote global financial stability, prevent crises, reinforce capacity building, and to support its low-income membership and their development partners in the international community's cooperative efforts to promote growth and reduce poverty, and meet the MDGs.

II. GLOBAL ENVIRONMENT AND POLICY RESPONSE

A. Overall Outlook and Policy Response

3. The global recovery remains solid, with global growth reaching its highest rate in nearly 30 years.[1] This has reflected strong growth in industrial countries, and rapid expansion in emerging markets, notably in China. Growth has been underpinned by accommodative macroeconomic policies, rising corporate profitability, and the wealth effects from rising equity markets and housing prices. Consistent with the upside risk identified in the last *World Economic Outlook*, projections for global growth this year have been revised upward from 4.6 percent to 4.9 percent. In 2005, growth is expected to moderate somewhat due to narrowing of output gaps, withdrawal of accommodative macroeconomic policies and higher oil prices. As a result, global growth projections have been revised downward slightly, from 4.4 percent to 4.3 percent.

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[1] *World Economic Outlook: Prospects and Policy Issues* (EBS/04/114, Supplement 1, 8/31/04).

4. After falling to unusually low levels in mid-2003, inflation has picked up somewhat in all regions, reflecting a combination of stronger growth and higher commodity prices. The risk of higher inflation appears moderate in most countries and regions, given substantial excess capacity; moderate wage settlements relative to productivity growth; strong corporate profitability; and reasonably well-anchored inflationary expectations. Financial market developments have been dominated by changing expectations about the pace and timing of monetary tightening in the United States. To date, market adjustment to the rise in long-run interest rates has been orderly. The biggest impact has been in emerging markets where new issuance of bonds has slowed. Global growth in the second quarter of this year fell below expectations, indicating a "soft patch" in the recovery, particularly in the United States, and prompting expectations of a slower pace of monetary tightening.

5. The risks to the outlook have shifted to the downside, reflecting uncertainty in the oil market and slower-than-expected growth in some major countries in the second quarter of this year. With spare productive capacity at historical lows, the oil market remains vulnerable to shocks and speculative pressure. Similarly, the second quarter growth figures may be an early indication that the expected slowdown in the pace of global growth may be sooner than anticipated. Another risk is that if inflationary pressures were to prove stronger than expected, it might necessitate a sharper-than-expected increase in interest rates although this would be tempered by the downside risks to the growth outlook. The most significant impact of a sharp rise in interest rates would be its effect on housing markets. In any case, an inevitable transition toward higher interest rates will need to be managed through solid communication to ensure that nascent inflationary pressures are contained—including those stemming from second-round effects of higher oil prices—while facilitating economic recovery and orderly adjustment in financial markets.

6. The current expansion continues to provide an opportunity to address medium-term vulnerabilities by:

- addressing global imbalances, including through medium-term fiscal consolidation in the United States to increase domestic savings, structural reform in the Euro Area and Japan to increase domestic demand and growth potential, and steps toward greater exchange rate flexibility in Asia;

- stepping up the pace of structural reform more generally so that countries can increase their resilience to shocks and have more flexibility to take advantage of the opportunities provided by globalization and the information technology revolution;

- promoting competitiveness through opening markets via trade liberalization under the Doha Round, building on progress in Geneva this summer; and

- strengthening medium-term fiscal positions in both industrialized and developing countries to address, among other things, changing demographics.

B. Regional Outlooks

7. While the recovery has become increasingly broad-based, it is still driven strongly by particular regions. The expansion continues to be led by the *United States.* While business investment remains strong, consumption could slow down further as the impetus from past macroeconomic policy stimulus and mortgage refinancing abate. A measured pace of tightening of monetary policy in the United States is likely to be appropriate. Planned short-term fiscal consolidation is appropriate, but medium-term fiscal objectives should be more ambitious in order to boost domestic savings. The 2004 forecast for the Euro Area has been revised significantly upward, but will remain strongly dependent upon external demand. With underlying inflationary pressure moderate, monetary policy in the Euro Area should remain accommodative until a self-sustaining upturn in domestic demand materializes. In *Japan*, the upturn has been strong amid signs that deflation and financial and corporate sector weaknesses are easing. The current monetary stance should be maintained until deflationary expectations are clearly dispelled, while the upturn provides a favorable environment for budgetary savings and further reform in the corporate and banking sectors.

8. There has also been a strong rebound in activity in emerging markets.

- *Emerging Asia* has experienced continued robust growth, reflecting the combined influence of the global upturn, accommodative macroeconomic policies, and vigorous domestic demand growth. In varying degrees, countries may wish to consider gradual monetary tightening, which should be accompanied by greater exchange rate flexibility. While regional growth should slow somewhat in the coming months, it should remain solid, although much will depend on developments in China.

- In *Latin America*, the recovery has been supported by more robust external demand, sound macroeconomic policies, improved confidence, and higher commodity prices. High external financing requirements remain an important vulnerability that should be neutralized by reducing public debt ratios.

- *Transition countries'* growth has been quite strong, and in some countries there may be a need in the near term to guard against overheating. For the medium term, countries need to continue structural reforms to further improve investment climates and fully develop the institutions that are needed in market-based economies.

- In the *Middle East,* the contribution to growth from higher oil production and prices will abate as production reaches capacity levels. However, the region will still benefit from non-oil global expansion and potential trade liberalization. In particular, given the high unemployment rate in the region, it will be critical to accelerate broad-based reforms to enhance the investment climate with a view to putting the countries on a sustainable high-growth path.

9. In *sub-Saharan Africa*, the outlook continues to improve, supported by broader and deeper macroeconomic stability, higher commodity prices, lower external debt burdens,

liberalization of trade, and improved security situations in some countries. The needed reform effort, however, still remains challenging and while most countries continue to make important improvements, including on governance, on current trends they are likely to fall significantly short of meeting the Millennium Development Goals. The promotion of private investment, development of infrastructure, deepening of institutional reform and the reduction of government involvement in the economy remain key policy challenges.

III. The Fund's Efforts to Improve Surveillance and Global Financial Stability

10. In its 2004 biennial review of surveillance, the Fund reaffirmed the strong foundations of the existing framework, while endorsing specific measures to improve the focus and content of surveillance.[2] In addition, more attention will be given to enhancing the quality of policy dialogue with surveillance country authorities, to communicating the Fund's policy messages to a broader range of domestic stakeholders, and to measuring the overall effectiveness of Fund surveillance, including through "monitorable objectives" against which outcomes can be assessed. Specific measures include:

- Better integration of country-level, regional and global surveillance to improve analysis of global and regional spillovers;
- More clarity and candor in the treatment of exchange rate issues, with a clear identification of *de facto* exchange rate regimes, more systematic assessment of external competitiveness, and more discussion of the policy dialogue between Fund staff and country authorities on exchange rate issues;
- More continuous and effective surveillance of financial sectors;
- Further refinement of the analytical framework for vulnerability assessments;
- More focus on growth issues and their links with macroeconomic sustainability, and building resilience to external shocks;
- Continued attention to ensuring that surveillance in member countries with Fund-supported programs gives a fresh and broader perspective;
- Increased use of the "balance sheet approach"—which emphasizes not only the level of debt, but also its maturity and currency structure and the transmission of shocks

[2] *Biennial Review of the Implementation of the Fund's Surveillance and of the 1977 Surveillance Decision* (SM/04/212, 7/2/04), and *The Acting Chairman's Summing Up* (SUR/04/80, 8/2/04).

across sectors—to help identify and reduce vulnerabilities and improve liquidity management.[3]

11. The Fund continues to support timely and effective resolution of crises through encouraging the use of collective action clauses in sovereign debt issuances, and encouraging development of a Code of Conduct, as well as supporting members' efforts to undertake policy reforms to bring debt and debt-service burdens to levels consistent with medium-term sustainability. A recent progress report explains various initiatives related to the orderly resolution of financial crises, and notes some recent cases of implementation of the lending into arrears policy. The Fund has also begun to explore the design of a possible signaling instrument to meet members' demands for higher frequency policy monitoring outside of formal Fund arrangements.

IV. Supporting Low-Income Member Countries

A. The Role of the Fund in Low-Income Member Countries

12. The Fund has an important long-term role to play in helping its low-income members establish and maintain macroeconomic and financial stability, which is essential to foster durable growth and poverty reduction consistent with progress toward the Millennium Development Goals. The operational framework for the Fund's involvement continues to be the Poverty Reduction Strategy (PRS) approach at the country level, in the context of an overall cooperative approach with other development partners to implement the Monterrey Consensus.

13. These principles guiding Fund involvement have remained fundamentally unchanged in recent years, but the institution is continuing to work to strengthen its engagement. To this end, a Committee on Low-Income Country Work was recently established, chaired by the First Deputy Managing Director. The Committee has prepared a *Statement on the Role of the Fund in Low-Income Countries* which lays out the basic framework for Fund involvement with its low-income membership. The statement reaffirms that low-income countries must take the lead in their own reform efforts, and that the Fund should focus on supporting the macroeconomic policy reforms needed to achieve high growth and poverty reduction over the medium term, through policy advice, capacity building and, as appropriate, financial assistance. The statement will be further refined, as progress is made in clarifying the Fund's modes of engagement.

B. Refining the Poverty Reduction Strategy Approach

14. The Poverty Reduction Strategy approach recognizes the importance of a more country-driven growth and poverty reduction strategy, which is imbedded in a country's domestic processes and can serve as a basis for international support. Forty-two (42) member

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[3] See *Integrating the Balance Sheet Approach into Fund Operations* (SM/04/52, 2/23/04).

countries are now implementing full poverty reduction strategies, and 23 of these have completed at least 1 annual progress report. While experience with the PRS approach has been generally viewed as positive so far, the recent Independent Evaluation Office (IEO) review of the PRS approach and the recent progress report on PRS implementation by Fund and Bank staff identified a number of areas for improvement.[4] These include getting the right balance between ownership and external involvement; broader domestic participation in the development and monitoring of the strategy, especially its macroeconomic framework; strengthening the analysis of the sources of growth and its distributional impacts; linking ambitious objectives for the future with existing resource and capacity constraints; and strategies that give a better guide to the operational decisions needed for implementation.

15. In response to the IEO and staff findings, the Fund Executive Board will discuss proposals for improving the Fund's involvement in the PRS approach later this year. In the meantime, the Fund and Bank Executive Boards have agreed to eliminate the requirement that a Joint Staff Assessment (JSA) explicitly state that a PRSP constitutes a suitable basis for the provision of concessional assistance, and rename it the Joint Staff Advisory Note (JSAN). Subsequent Board discussions' annual progress reports (APR) would be limited to cases where the APR elaborates a major shift in the country's strategy. These changes are intended to reduce the perception of too much influence by the Bretton Woods institutions and encourage more candid and helpful staff assessments. Nonetheless, an explicit link between the PRSP and Fund and Bank financing activities will be maintained, and programs will be required to incorporate measures to address the weaknesses identified in poverty reduction strategies. A more comprehensive review of progress, challenges, and good practice of the PRS approach will be undertaken in advance of the 2005 Annual Meetings.

C. Strengthening the Foundations for Growth

16. The Fund's contribution to strengthening the foundations of growth is through its macroeconomic policy advice, technical assistance, and financial assistance. A wide range of efforts is underway to strengthen the Fund's capacity to meet its low-income members' needs:

- The Fund is working to strengthen the analytical framework for **policy advice** to its low-income member countries by more extensive analysis of the sources of growth and the links between growth and poverty reduction. A review of PRGF program design will focus specifically on the role of institutions and good governance in supporting growth, macroeconomic policies beyond the stabilization phase, and good management of large aid inflows. Also, the Fund is seeking to incorporate more frequently available poverty and social impact analysis (PSIA) in PRGF program

[4] *IEO Evaluation Report on PRSPs and the PRGF* (SM/04/277, 7/7/04) and *The Acting Chair's Summing Up* (BUFF/04/142, 7/27/04); and *Poverty Reduction Strategy Papers—Progress in Implementation* (SM/04/292, 8/19/04) and *The Acting Chair's Summing Up* (BUFF/04/175, 9/10/04).

design, and has formed a group in the Fiscal Affairs Department to assist country teams in this regard.

- The Fund's **technical assistance** targets country-specific capacity-building needs, including better mechanisms for governance, regulatory structures and institutions, and developing in-country capacity to formulate and implement good macroeconomic policies. There is work underway to review the experience with delivery of Fund technical assistance to ensure that it is both effective and efficient.

- Recent Executive Board discussions have considered alternative lending instruments and policies for the Fund's **financial assistance** to its low-income membership.

  - Later this year, building on the discussions of the biennial review of surveillance, the Executive Board will consider how best to address the needs of low-income members when Fund financial assistance is not critical to ensuring that the country's balance of payments needs are met. The discussions will center on how best to provide regularly macroeconomic advice and the signals sought by donors from the Fund to assure them that the macroeconomic policies of the country provide a sound basis for their aid.

D. Debt and Debt Sustainability

17. Implementation of the enhanced HIPC Initiative has continued, as outlined in the recent progress report prepared by Bank and Fund staff.[5] Of the 27 HIPCs that have reached their decision points, 14 countries have also reached their completion points and received irrevocable debt relief of US$17.5 billion in NPV terms.[6] The Fund's disbursement of debt relief at completion points, together with disbursed interim relief, already accounts for just over 70 percent of the total amount that the Fund has committed to the enhanced HIPC Initiative. These savings have resulted in a significant increase in poverty-reducing spending, particularly in the areas of health and education.

18. Eleven (11) HIPCs have not yet reached their decision points, reflecting problems with conflict or substantial external arrears. [The Executive Boards of the Fund and World Bank have extended the HIPC sunset clause by another two years to end-2006, to provide the opportunity for the remaining countries to establish a track record that would allow their consideration for HIPC relief. However, eligibility for participation in the Initiative will be limited to those countries that would qualify on the basis of end-2004 debt burden data.]

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[5] *Enhanced HIPC Initiative—Status of Implementation* (SM/04/300, 8/23/04), and *The Acting Chair's Summing Up* (BUFF/04/171, 9/8/04).

[6] Ethiopia, Ghana, Niger, and Senegal reached the completion point since end-March 2004.

19. Looking forward, all approaches that hold out the prospect of reinforcing debt sustainability for low-income members should be explored—including deeper debt relief and increased grant financing—taking careful account of issues of equity between low-income members; the linkage between forms of financing and policy incentives, and how such operations might be financed. The Fund and Bank are continuing to work together to refine a broader debt sustainability framework for low-income member countries, which uses country-specific debt sustainability thresholds, based on the strength of policies and institutions, and projections subjected to a variety of standardized stress tests.[7] This new framework should help ensure that countries' large financing needs to make progress toward the MDGs will be provided on terms that will not lead to an unsustainable build-up of debt. To this end, the framework is designed to minimize the possibility of such an outcome by signaling to low-income borrowers and creditors the appropriate financing terms that will keep debt indicators at manageable levels. Implementation of the framework will require close collaboration between the Fund and the World Bank, and modalities have been defined to support a consistent assessment of debt sustainability by the two institutions. The framework should result in more emphasis on signaling to a member country and donors of a need to shift to more grants when there is a strong likelihood of debt distress. Similarly, PRGF program design will also incorporate an explicit focus on debt sustainability.

E. Aid Effectiveness and Financing Modalities

20. Increased aid flows will create opportunities for achieving the MDGs, as well as challenges. Coordination of financing for the MDGs figures prominently on the international agenda, especially over the next year as the international community prepares for the United Nations Summit on the Millennium Development Goals to be held in September 2005. In this context, Fund staff presented a paper, prepared jointly with the World Bank, at an Executive Board seminar in September, which reaffirms that more aid is needed to help accelerate progress toward the MDGs, and considers several proposals for mobilizing increased aid.[8]

21. The most effective way to increase development assistance would be for countries to increase their ODA contributions. If the international community is unable to achieve sufficient increased ODA through current avenues, any alternative financing mechanisms should increase total development aid, rather than simply crowding out contributions from current sources. The Fund sees a potential role for some of the alternative mechanisms proposed to increase aid volumes, although many operational details, including some legal issues, remain to be worked out before any of these proposals could be implemented. Further consideration of the International Finance Facility (IFF) is merited, as are proposals for global taxes, but these could not be operational in the near future.

[7] *Debt Sustainability in Low-Income Countrie —Proposal for an Operational Framework and Policy Implications* (SM/04/27, 2/3/04), and *Debt Sustainability in Low-Income Countries—Further Considerations on an Operational Framework and Policy Implications* (SM/04/318, 9/10/04).

[8] *Aid Effectiveness, and Financing Modalities* (SM/04/329, 9/22/04).

22. Aid absorption constraints can be partly addressed by increasing harmonization and coordination in aid practices and delivery among donors and with the recipient countries, using vehicles such as the PRSP as a platform. Appropriate targeting and sequencing of aid, to remove bottlenecks and to build on previous reforms and investments, is another important component. Policy reform and more effective management of public resources by developing countries are also needed, as is a greater commitment to reforming international trade.

23. The Fund is looking closely at ways of helping developing countries manage higher aid inflows, including consideration of how to adjust macroeconomic policies to cope with large aid disbursements. Fund policy advice and technical assistance is also directed at helping countries increase their absorptive capacity for aid. The Fund also participates actively in the work of the OECD-DAC and the multilateral development banks' roundtables to promote the harmonization and simplification of donor procedures and practices, and the alignment of their support with recipient country priorities. These efforts will be important for enhancing the overall effectiveness of aid delivery, as multiple and overlapping conditions for aid delivery, including diverse analytical and reporting requirements, impose high administrative costs on recipient countries and can contribute to difficulties in meeting financing conditions and to unpredictability in aid flows.

V. Doha Negotiations and the Trade Integration Mechanism

24. The August 1 agreement on a framework for negotiations and extension of the Doha Round is a necessary step for keeping the negotiations on track. However, there is little time to waste and strong political commitment is now required to ensure that the Round can deliver liberalization that is commensurate with the challenge to promote global growth and development. The Fund remains committed to provide support in its areas of competence, including through stepped-up surveillance of the systemic impact of trade policies in the major countries, technical assistance for customs and tariff reforms, and research on issues of importance in the Doha Round, especially for developing countries.

25. Earlier this year, the Fund established the Trade Integration Mechanism (TIM), designed to address low-income country concerns that global trade liberalization might worsen their competitive positions in export markets or their food terms of trade. The TIM is not a new facility, but a policy designed to increase the predictability of resources available under existing facilities. While balance of payments shortfalls are unlikely to be large for most countries, the TIM is expected to create a modest increase in IMF financing.

- In July, augmentation of access under Bangladesh's PRGF arrangement was approved in accordance with the TIM to address balance of payments pressures stemming from the forthcoming expiration of WTO textile quotas. Discussions have also been underway with some other members.

VI. Voice and Participation of Developing Countries and Countries in Transition

26. The Fund continues to monitor closely the adequacy of Fund resources, and is considering measures to improve the distribution of quotas and voting power in the context of the Thirteenth General Review of Quotas. The Fund's Executive Board has discussed a package of measures that, in the context of the next general quota increase, would involve:

- a general quota increase with a relatively large selective element allocated by means of a new quota formula;
- ad hoc quota increases aimed at addressing the most out-of-line cases; and
- an increase in basic votes aimed at correcting the erosion of the voting power of the smallest members.

27. However, in view of the Fund's satisfactory liquidity position, it has been recognized that there is no need for a quota increase at present. Also, the required majority for an amendment of the Articles of Agreement to increase basic votes does not exist. A status report has been provided to the IMFC and DC on quotas, voice and representation.[9] It notes that significant further progress on these issues will require a broader consensus among the Fund's shareholders.

28. Progress has been made in improving the administrative capacity of Executive Director's offices, especially those representing developing and transition countries, including additional staffing in the offices of the largest constituencies, and facilitating closer communication with capitals.

[9] *Draft Report of the Executive Board to the International Monetary and Financial Committee on Quotas, Voice and Representation* (SM/04/324, 9/16/94, and Rev.1)