05/23 As Prepared for Delivery

Speech of IMF Managing Director Rodrigo de Rato
At Circulo de Economía
Barcelona, Spain
October 20, 2005

"Globalization and the New Priorities of the IMF"

1. Thanks you very much for inviting me to be with you today. It is good to be back in Spain, and to be with friends here again. Time passes quickly: I have now been in Washington for over a year, and have had a chance to develop my views on how the IMF should evolve over the next few years. I'd like to talk to you about my thoughts on this.

2. Last year marked the 60th anniversary of the agreement at Bretton Woods in New Hampshire which set up the IMF and World Bank. This provoked reflection and analysis both about the Fund's history and about how it should adapt to be as useful as possible to its members in our rapidly changing world. Commentators made a number of observations about the past that I found interesting. The IMF at its founding was very much a creature of its time. It was founded toward the end of the second world war to establish a multilateral framework for trade and finance that would avoid the failings of the inter-war period, and especially the "beggar-my-neighbor" policies that had contributed to and made worse the great depression. Its membership covered only part of the world—40 members initially. Its activities were based on the premise that exchange rates would continue to be pegs, adjustable only when there was judged to be "fundamental disequilibrium"; capital flows were not part of its mandate; and it was dominated by the United States, which had one third of the voting power.

3. The changes in the last 60 years have been huge. The IMF's membership is now nearly global, as first developing countries and then the countries of the former Soviet Union joined the Fund. At the time of the IMF's founding only three African countries—Egypt, Ethiopia, and South Africa—were members. Now there are 53 African members. Very few of the countries of Eastern Europe were members, whereas since the end of the cold war all of the Eastern European and former Soviet Union countries have joined. The new countries that have joined the IMF have problems very different from the original members. In low-income countries, and especially in Africa, the problems center around the lack of resources to meet basic human needs. The attack on poverty has required the IMF to focus its efforts on helping these countries achieve stronger, sustainable economic growth, especially through the provision of assistance in the building of basic economic institutions and the better conduct of economic policy, including in the management of aid flows, and through the provision of financial assistance to support good policies at terms these countries can afford. In the transition economies, reform of the basic structure of the economy was the

pre-occupation for many years, and still is in some countries. All of this led the IMF to adapt its role in many respects, while remaining true to its original mandate.

4. Meanwhile the development of a massive international market in private capital has transformed the IMF's relationship with both advanced economies and emerging markets. In a world where private finance is readily available to advanced economies, their need for financial support from the IMF in times of crisis has virtually disappeared. Not since the United Kingdom and Italy borrowed from the IMF in 1976–77 has an industrial country sought financial support from the IMF.

5. The emergence of huge international capital flows—financial globalization—has also transformed the IMF's relations with emerging markets. This began in the 1980s debt crisis, when much of the IMF's work was dominated by helping countries, especially in Latin America, overcome the consequences of reckless borrowing—and, with hindsight , unwise lending. In the 1990s, turbulence in international capital markets hit Mexico, the major Asian economies, Russia, Turkey, Brazil and Argentina. And again the IMF helped, first in conjunction with others, more recently mostly alone.

6. But in responding to these problems and to the evolving needs of its changing membership, the IMF has not been consciously redesigned. The genius of its founders, shown in the 1944 Articles of Agreement, ensured that its policies and operations could be adapted to the evolving world economy and needs of its changing membership, with only three amendments to the Articles in all this time. The IMF has had a constant mission, but an evolving role. Its development resembles that of a medieval city, which starts with a core and a cathedral and then grows over time, spreading and occasionally reinventing itself, but sometimes suffers in the process, with ancient passageways never formally abandoned but fallen into disrepair, and busy new streets that sometimes sit uncomfortably with the overall design. I confess to an affection for such cities. I am after all a European. But the IMF is at a stage in its life when it needs a plan to bring harmony to its streets.

7. I think that what the Fund needs is an organizing principle that defines its mission and guides the institution in setting priorities, and also a strategy to meet these objectives. I set out both of these in a paper that I sent to the Fund's Governors last month. Our Governors have endorsed my view on the way forward. We are now at the stage of beginning to put the plan into effect. Let me tell you something about it.

8. I would like the main focus of the Fund's work in the next few years to be on helping our members maximize the benefits, and minimize the costs and risks, of globalization. Economic and financial globalization as a process is already well advanced, and the benefits are already evident. We have seen huge developments in global transfers of goods, services, technology, and jobs, and in recent decades we have been experiencing financial globalization, with the beginning of the emergence of a global savings pool. This is allowing the allocation of world savings to more productive and diversified investments. But we also need to recognize the risks of globalization, be candid about the costs, and attempt to make globalization work for us. And the IMF should be in the forefront of this work.

9. Before I talk about what I would like the IMF to do, let me elaborate on some of the ways in which globalization affects people's lives.

10. The size of world current account imbalances today, and the associated risk of disorderly adjustment of those imbalances, would not have been possible were it not for globalization. The global savings pool made possible by financial integration has allowed some countries—most notably the United States--to run up very large current account deficits, as countries with surpluses build up reserves to self-insure against crises. There are ways in which the pent up tensions implied by these imbalances can be addressed—and the IMF has been forthright in saying what countries need to do—but the risks are large in part because of the ease with which money can move from country to country, and from currency to currency.

11. Just as global imbalances and the way they are corrected can affect the welfare of all, so can the developments in trade in goods and services. Political actors are still coming to terms with these changes. The response to liberalization of trade in textiles is a case in point. It has produced a protectionist backlash in some quarters, but elsewhere there have been consumer rebellions in importing countries against attempts to re-impose quotas that would raise prices. The protectionist pressures that have evolved in some quarters must be resisted. Experience shows that lowering trade barriers and eliminating trade-distorting subsidies facilitate trade, enhance growth, and help reduce poverty. The ongoing Doha Round of trade negotiations—and particularly the upcoming Hong Kong Ministerial—are an opportunity to take decisive steps toward further liberalization.

12. The most dramatic effects of globalization of financial markets have so far been seen in emerging market countries—in the capital account crises in Mexico, Asia, and elsewhere. But globalization also poses specific challenges for advanced economies—challenges for their macroeconomic policies, financial sector policies, and other policies needed to deal with international economic integration. These challenges are too little recognized and too often misjudged by decision-makers.

13. Let me give you a couple of examples. In 1998, the U.S. financial company, Long-Term Capital Management, collapsed. The consequences for the U.S. financial system could have been very serious. They were averted, partly because of the resiliency of the system, and partly because of swift action by the New York Fed. But if one looks at the origins of Long Term Capital Management's problems, they stemmed partly from the Russian default of 1998. Interlinkages in capital markets were such that the Russian default could have done great damage to the U.S. financial system. And while I hope that defaults will not become a regular feature of 21st century crises, there are very likely to be surprises and discontinuities in emerging markets that will affect financial institutions in advanced economies.

14. Another example is more benign, but also profoundly important. The world will experience major demographic change in the coming decades. Declining fertility will result

in slower population growth, while increasing life expectancy will result in a rise in the share of the elderly in the general population. Aging populations will put pressures on government budgets by increasing pension and health expenditures on the one hand and reducing tax revenues on the other. And many countries need to adjust their budgets to deal with this, particularly given the current under-funding of pensions in many countries.

15. But globalization can help smooth the difficult adjustment needed in individual economies. This is because different countries are at very different stages of demographic change. In most advanced economies the process of aging is already well-advanced. In many developing countries, on the other hand, the transition is still at an early stage, and the share of the working-age population is likely to continue to grow for some time. So the countries at the demographic stage where the working share of the population is higher, and hence saving is higher, can lend to the rest of the world, while others with older populations can draw down their investments abroad. International labor mobility can also help individual countries deal with the impact of aging. This is certainly the case in Spain, where recent immigration has helped strengthen the Social Security accounts, although in Spain as in other countries the movement of labor across borders is a sensitive cultural and political issue.

16. There is a great deal we don't know about how such transitions will play out. For example, changes in savings, investment and growth trends are likely to produce large changes in current account balances and financial flows, suggesting that the global imbalances of twenty years time will be very different from those of today. This is one reason why I have suggested that we need not just solutions to the problems of today but also a structure to deal with the global imbalances and other economic problems of the future.

17. We have such a structure, and such an organization. The International Monetary Fund, as the institution of global monetary cooperation, should be and is the forum for cooperative economic policy action. Consider the assets of the IMF: a global membership, established mechanisms for regular, in fact continuous, consultation and decision making; a technically proficient and experienced staff; and resources to support its members financially when they need help.

18. But to perform these functions well, the IMF needs to be able to give all of its members—in country, regional, and global surveillance—concrete advice on policies to address the consequences of increasing integration. To do this, we need to understand the issues more deeply ourselves, and especially the benefits, imbalances and fragilities associated with cross-border flows of goods, services, capital, and people.

19. We also need to expand our coverage of globalization in reports on the world economy and sharpen the focus of our surveillance work on individual countries. In our country reports, we don't need to comment on every aspect of every economy, in every year. What Ministers need most from the IMF is the benefit of the Fund's long experience in dealing not only with the particular country in question, but with other economies—there is no comparable economic think-tank which can bring such experience or perspective to bear.

20. Globalization clearly has important effects on advanced economies as well as emerging economies. But when problems of globalization hit emerging-market economies, the Fund is going to have a different relationship with them, because we will often be called on to support them financially. Emerging-market economies are most at risk from volatile capital flows, and the risks to them have increased markedly as a result of globalization. In part this arises from an increase in the volume of global transactions. Trade has risen from some 8 percent of world GDP in 1948 to about 25 percent today. Financial flows have increased even more sharply. And with the larger volume of transactions, the external shocks facing countries and their potential financing needs are likely to be larger too.

21. And the emerging markets are vulnerable. They are in a phase of development growth where they should have high investment, but with limited resources, this is often highly leveraged, and not very diversified—at least compared to mature economies. Emerging market economies also often have fragile balance sheets, and institutions that are mostly young and sometimes weak. These factors all contribute to high demand for, and unstable supply of, market financing, and to periodic demands on the Fund for support. In response to the capital account crises of the 1990s, the Fund provided the largest financial packages in its history: US$18 billion for Mexico in 1995 and US$21 billion for Korea in 1997. Those sums represented 6.3 and 4.4 percent of those countries' GDPs respectively. Now consider the situation of China and India. As their GDP and GDP per capita grow, and as they become more integrated into global financial markets, they could become vulnerable to the kind of pressures that hit Mexico and Korea, and the potential demands for Fund resources, scaled to provide a similar level of support relative to future GDP, could be very large in relation to the Fund's total resources. Fortunately, this is not an immediate problem, and unlike in the past cases of Mexico and Korea, China and India also have very substantial reserves at present. But it does illustrate the fact that issues of capital account crisis in emerging markets have the potential to threaten systemic instability and lead to demands on the IMF, and we need to be prepared for them.

22. The first priority here is crisis prevention. The Fund has made significant improvements in its work on crisis prevention over the past few years. I am thinking in particular of our internal work on vulnerability assessments, and the development of the balance sheet approach to financial crises. But much remains to be done. We need to do more work in the Fund both on the underlying vulnerabilities in emerging market countries and on the risks from disturbances originating in advanced country financial markets.

23. We also need to think about crisis resolution. We have, of course, provided support for members when they have needed it. But here too we need to continuously review the effectiveness of the Fund's instruments. I have said in the past that we need to have a Fund that can say no, not necessarily loudly, but clearly. I still believe that. We also need to consider further the possible ways in which the Fund's instruments can offer a quick and adequate reaction when its members face crises, for example by offering large contingent or precautionary credit lines to members with strong policies. The IMF actually developed an instrument for this a few years ago—the Contingent Credit Lines, but it was not used. The problem was the difficulty of balancing countries' need for assurances that they can

draw on the Fund's resources quickly if needed, with countries' natural desire not to be tarnished as a potential crisis case, and with the institution's need for assurances that the Fund's support will be part of a package of financing and policy measures that works—one that enables the member both to get out of trouble and eventually repay the Fund. We need to keep looking for a solution that achieves this balance.

24. Another issue very relevant to emerging market economies is capital account liberalization. All industrial countries, of course, now have open capital accounts—which is very different from the situation only 20 years ago. And many emerging market and developing countries are choosing to liberalize their capital accounts, because they want to take advantage of the huge and growing pool of global savings. This liberalization brings challenges that require careful management, particularly in relation to macroeconomic policies, financial sector policies, and the appropriate sequencing of liberalization and financial sector reforms. It is important that the Fund deepen its knowledge of the issues surrounding capital market liberalization, and we will do so in the months ahead.

25. We also need to deepen our work on low-income countries. Low-income countries need macroeconomic policy advice from the Fund and they often need financial support from us. Moreover, we are at a critical juncture in trying to help countries achieve the Millennium Development Goals, and we have an opportunity arising from the growing consensus in wealthy countries that aid must be increased and debt must be reduced. We have a great opportunity at this time to make a difference in the lives of millions of people.

26. One way we can do this is by strengthening the Fund's work in advising countries on how to deal with the macroeconomic effects of higher aid flows. For example, large aid flows sometimes complicate fiscal management, and the quality of spending can suffer. So there is a need to improve public expenditure management to ensure that additional aid does not lead to wasteful and inefficient spending. Higher aid flows can also cause real exchange rate appreciation, and thus weaken external competitiveness. The Fund can advise on macroeconomic problems and also suggest solutions to them. For example real exchange rate appreciation can be countered by enacting structural reforms and using aid resources for imports that improve productive capacity or by measures to increase domestic saving.

27. I may have given the impression that I would like the Fund to do more on a lot of issues. I should make it clear that I think the Fund can do less of some things too. Over the last few years, we have been pulled in a lot of different directions. For example, we have been involved in initiatives on data transparency, standards and codes, financial sector assessments, and combating money laundering and the financing of terrorism. We also coordinate more than in the past with other international financial institutions, with regional organizations, and with donors in our low-income country work. Much of this work is valuable, and indeed essential to some of the objectives I've talked about today, including crisis prevention. But we have to continue to look at it with a critical eye, to ask if we really need to be doing things that we started doing ten years ago, or if we need to exit from some of them. One thing I'll be doing over the coming months is talking with my colleague Paul Wolfowitz at the World Bank about how we can rationalize the work that the Fund and the

Bank do through more effective specialization as well as collaboration. I think we can, and also that we can cut back on other work. Let me give one specific example. We've done a great deal of work on standards and codes over the past few years, but we're now at a point where great progress has been made and what's mostly needed is follow-up work, with occasional review and revision of guidelines and practices, which should be less labor-intensive. I'm also concerned that the Fund's work on low-income countries is overloaded with procedures that absorb substantial resources. These should be streamlined.

28. Let me wrap up by talking about two specific issues that I want to focus on in implementing the medium-term strategy—communication, and the governance of the Fund.

29. The Fund needs to communicate better. It is not only the quality of the Fund's advice but also our effectiveness in communicating that advice that influences whether the Fund's recommendations are followed. Obviously, in cases where there is disagreement on the analysis of an issue, we need a serious, engaged dialogue with the member on the nature of the problem and how to fix it. But there are also plenty of cases where there is agreement on the analysis but a reluctance to act on it, for political reasons. In these cases I would like the Fund to be more forthright in making the case for the policies we support, including to the public. In democracies public opinion can be changed by persuasive argument, and changes in public opinion can change the positions of policy makers. We should certainly make sure that the Fund's position is not misunderstood or misstated—that our views are clear. And in the best cases, where we help generate public support for good policies, we can go further, and do a service to our member governments by making the case for reform in a clear and forthright way. But of course the Fund will continue to listen as well as talk. In all of my time in public life, I've never been in a debate in which I haven't learned something from the person I'm talking with, whether I agreed with them or not, and interactions between the Fund and its members are an opportunity for both to learn from each other.

30. The other issue that I'd like to talk about is the need for change in country voting shares and representation at the IMF. The Fund's credibility with its members rests as importantly as anything on the Fund's perceived legitimacy as an international organization representative of its members. Our legitimacy suffers if we do not adequately represent countries of growing economic importance. This means, in particular, a need for increases in voting power for some emerging-market economies, especially in Asia. We must also ensure that our members in Africa, where so many people are profoundly affected by the Fund's decisions, are adequately represented.

31. IMF quotas are not immutable. As I said at the beginning, the United States once had a quota share of more than one third of the total, and its quota is much less now, though still the largest individual country quota in the IMF. But in recent years, there have been only gradual changes in IMF quotas, and a rebalancing is needed to bring the quota structure more into line with today's world. Changes in quotas are a matter on which the IMF's members are going to have to come to a political consensus. In considering this issue, they will need to consider the interests of the institution as well as their national interests. Indeed, I think the two are consistent. Decisions on quotas are not a zero-sum game. If there

is broad acceptance of the IMF's legitimacy, the institution and all of its members will benefit.

32. As you will gather, the agenda for the medium-term strategy is a long one. We have much to do over the coming months. We have acceptance of the broad outlines of what I proposed from the Fund's Governors. Now we will come up with specific proposals to implement the strategy.

33. In doing so, we can be guided by the IMF's history, which is a great one. But one of the lessons of that history is that the IMF has survived by a process of adaptation, of evolution, to new demands and new challenges. Like a great city it has grown and changed, and matured. My goal is to persuade the members of the institution that we need to manage the process of change, not to resist it, and to make the institution ready for the challenges of the next five to ten years, while preserving the strength and flexibility that will allow my successors to manage the Fund's adaptation over the next 50 years.

34. Thank you very much.