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April 20, 2006

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.

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## **DEVELOPMENT COMMITTEE: THE MANAGING DIRECTOR'S WRITTEN STATEMENT**

### **I. INTRODUCTION**

1. Since the Annual Meetings, the Fund has made significant progress in strengthening its support for low-income countries and thus contributing to the international community's efforts towards the Millennium Development Goals (MDGs). Most importantly, the Fund has started implementing the Multilateral Debt Relief Initiative (MDRI) and has established the Policy Support Instrument and the Exogenous Shocks Facility, both of which increase the flexibility of the Fund's engagement with low-income countries.
2. As this year's Global Monitoring Report (GMR) notes, there are some encouraging signs of headway towards achieving the MDGs.<sup>1</sup> In particular, the proportion of people living in poverty is declining globally and there have been major new commitments for increased aid and debt relief to low-income countries. However, while the developing world as a whole is projected to meet the MDG on reducing poverty, sub-Saharan Africa is not. Moreover, many countries are off-track to meet the human development MDGs. Stepped-up efforts must include an improvement in the business climate in many poor countries, including through better access to infrastructure. The report notes the risk that new aid commitments may not materialize. Moreover, advances in multilateral trade reform remain elusive and trade negotiations need to be accelerated. The need to improve governance emerges as a central theme in the GMR. The report calls on international financial institutions (IFIs) and donors to support the emerging global framework of global checks and balances by strengthening their own anticorruption systems, encouraging developing countries to participate, and assisting in ways that improve transparency and country systems.
3. Over the past six months, the Fund has worked on a medium-term strategic review (MTS) of its operations to guide its role as the steward of the international monetary system. The work on the MTS has moved forward and the Board of Executive Directors recently discussed my report on this subject.<sup>2</sup> This report aims to bring more precision to the ideas set out in the strategy paper published last September for helping our members take advantage of globalization and manage its risks. It covers a wide range of subjects, including Fund surveillance and our approach to emerging-market and low-income countries, on which I shall say more below. In this statement, after summarizing the Fund's assessment of the world economic outlook, I shall explain the Fund's efforts to review, refine and strengthen its activities to help developing country members accelerate growth and the implications of the MTS.

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<sup>1</sup> *Global Monitoring Report 2006—Strengthening Mutual Accountability—Aid, Trade and Governance* (SM/06/99, March 9, 2006).

<sup>2</sup> *The Managing Director's Report on Implementing the Fund's Medium-Term Strategy* (SM/06/112, March 17, 2006).

## **II. GLOBAL ENVIRONMENT AND POLICY RESPONSE**

### **A. Overall Outlook and Policy Response**

4. Global growth has continued to exceed expectations, aided by benign financial market conditions and continued accommodative macroeconomic policies. Despite higher oil prices and natural disasters, activity in the second half of 2005 was stronger than projected, particularly among emerging market countries, and global GDP growth is now estimated at 4.8 percent and expected to remain at this level in 2006. Global inflationary pressures remain modest, although in the current environment of strong global growth and diminishing excess capacity, they could increase. Global financial market conditions also remain very favorable, and are characterized by unusually low risk premia and volatility.

5. This outlook is subject to significant vulnerabilities in the short- to medium-term.

- High and volatile oil prices are of serious concern. To date, the impact of higher oil prices on the global economy has been more moderate than generally expected. However, the full effects of the recent shock may not yet have been felt, and, with little capacity for expanding production in the short term, the oil market remains vulnerable to supply disruptions.
- Financial market conditions are likely to tighten. Current benign conditions are partly due to strengthening fundamentals, but also reflect more temporary factors, including very easy monetary conditions. Over the next two years, global short-term interest rates will rise further, and long-run interest rates are likely to rise, while volatility and risk premia may pick up. The greatest risks are associated with the impact of higher interest rates on the housing market.
- Although the U.S. current account deficit is being financed with little difficulty, and exchange rate movements are relatively benign, ultimately, the U.S. deficit must fall substantially with a corresponding decline in the surpluses of other countries, particularly of East Asian countries and oil exporters. Although a low-probability event, an abrupt and disorderly adjustment could be accompanied by substantial exchange rate overshooting, a large increase in interest rates, and a sharp slowdown in growth worldwide.
- In the event of a severe avian influenza pandemic, the human costs and suffering would be devastating, the economic costs would be large, and the global financial system could be disrupted.

6. The global expansion continues to offer a favorable environment in which to address these medium-term vulnerabilities by:

- Making more rapid progress in addressing global current account imbalances, including through measures to reduce the budget deficit and spur private savings in the

United States; structural and other reforms to boost domestic demand in surplus countries; and greater exchange rate flexibility in China and some other countries to allow necessary appreciations to take place;

- Ensuring sustainable medium-term fiscal positions, not least among many major industrial countries. Despite some progress in Europe and Japan, pension and health systems across the globe remain unsustainable, and failure to accelerate progress will—over the longer term—pose risks to macroeconomic stability;
- Establishing the preconditions for all countries to take advantage of globalization and support global growth in the future, including by resisting protectionist pressures and ensuring an outcome to the Doha Round that goes far towards liberalizing world trade; and
- Addressing the risk of an avian influenza outbreak by moving ahead with necessary public health precautions, and providing the necessary assistance to developing countries to do so. In this context, the Fund is helping members prepare for, and minimize, the risk of economic and financial dislocation that might result from a pandemic.

## **B. Regional Outlooks and Policy Response**

7. In the *United States*, the economy slowed sharply in the fourth quarter of 2005, but appears to be rebounding. However, the large current account deficit could lead to a swing in investor sentiment creating downward pressure on the dollar and a sharp increase in interest rates. Furthermore, a weaker housing market and higher energy prices could trigger a more abrupt withdrawal of consumer demand than anticipated. A bolder fiscal adjustment effort is needed to put the budget in a stronger position to respond to unexpected future developments and absorb upcoming pressures from population aging, as well as contribute to the resolution of global current account imbalances. In the *Euro Area*, overall growth is expected to increase in 2006. In general, plans for more ambitious fiscal consolidation of about 0.5 percent of GDP per year on average will have to be implemented to attain balance by the end of the decade in line with the Stability and Growth Pact and to address upcoming demographic challenges. In *Japan*, the expansion remains solidly on track and the growth momentum seems likely to continue. Policy priorities should include restoring fiscal sustainability and moving forward with the structural reform agenda to raise productivity. Monetary policy should remain highly accommodative until positive inflation is better established.

8. In emerging markets, economic performance remains strong.

- In *Emerging Asia*, growth eased slightly in 2005 given, among other factors, higher oil prices and weakness in the information technology sector, but the momentum will continue in 2006. In the context of addressing global imbalances, countries with current account surpluses should seek to achieve an appropriate balance between growth in domestic and external demand. Reforms to domestic financial systems and

other measures to improve the investment climate will need to be at the center of efforts to boost domestic demand, and further exchange rate appreciation will also be necessary.

- In *Latin America*, growth remained robust in 2005 and the expansion is projected to continue at a solid pace. However, a softening in global demand for the region's primary and manufacturing exports could weaken the contribution to growth from the external sector in many countries, while a deterioration in the global financial environment would also pose risks given the still high level of public debt in the region. Maintaining the downward trajectory of debt is a key challenge for policymakers.
- In *Emerging Europe*, following strong performance in 2004, growth in 2005 was uneven, and is projected to remain close to its present level in 2006. Nevertheless, concerns remain about possible overheating in some countries.

9. In the *Middle East*, oil-exporting countries continued to enjoy robust growth. With oil production near capacity, strong but moderating growth is expected in 2006. The current oil cycle has been accompanied by a significant rise in money and credit growth, which has contributed to surging property and equity prices, with the latter also benefiting from increased profitability of financial institutions and petrochemical companies. A key challenge to the region is to increase productive investment in both the oil and non-oil sectors to raise potential growth and provide employment for the growing working-age population.

10. In the *Commonwealth of Independent States*, real GDP growth was lower in 2005, mainly reflecting a particularly sharp slowdown in Ukraine, and is projected to slow further in 2006. Investment has remained weak in the area, but consumption has expanded strongly, thus raising concerns about growth going forward. A combination of tighter monetary policy and exchange rate appreciation would keep inflation in check. To encourage investment, a more hospitable business climate needs to be created. Structural reforms to boost productivity in the service sectors are needed to improve competitiveness in the face of upward pressures on exchange rates.

11. In *sub-Saharan Africa*, economic growth remained strong at 5.3 percent in 2005, though slightly below the recent high level of 5.6 percent in 2004.<sup>3</sup> The outlook remains favorable, underpinned by high commodity prices, improved macroeconomic policies, and structural reforms in some countries. Sustaining and further strengthening the recent economic performance is critical to making a lasting impact on poverty reduction. In this regard, continued implementation of key fiscal and financial sector reforms is essential for sustaining the recent growth accelerations. Further improvements in economic institutions will help secure stable growth over the long term.

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<sup>3</sup> *Sub-Saharan Africa Regional Economic Outlook* (SM/06/100, March 10, 2006).

### **III. THE FUND'S EFFORTS TO IMPROVE SURVEILLANCE**

12. As my report on the MTS recognizes, surveillance, which is central to the Fund's role in preventing crises, must be made more effective and continue to evolve to keep up with the changing needs of the global environment. To achieve these goals, the Fund is taking or considering a number of key steps.

- New multilateral consultations would allow the Fund to take up issues collectively with systemically important members, and even non-member entities, and foster agreements on actions by all the parties to a problem. Staff would prepare a report on the exact modalities for such consultations after discussions with the key parties.
- Our analysis and coverage of exchange rate issues need further strengthening. The in-depth analyses based on a multilateral framework that we currently undertake only for industrial countries will be extended to emerging markets. We will also review the 1977 Decision on surveillance over exchange rate policies, to make it more relevant to a world of capital mobility and floating exchange rates regimes.
- The Fund is placing financial sector issues at the center of its work. Better integration of financial sector and macroeconomic analysis will be achieved through an enhanced analytical framework currently being developed, organizational changes, and further improvements to the World Economic Outlook and the Global Financial Stability Report.
- The focus of bilateral surveillance needs to be sharpened to avoid covering too much, too thinly. Multi-year planning of priorities and streamlined procedures for selected cases will help focus on the most important and urgent challenges.
- We are also enhancing regional surveillance, to draw on shared experience and highlight common risks. In addition, Article IV consultations need to pay more attention to the implications and spillovers of a country's policies for its partners.

### **IV. ROLE OF THE FUND IN EMERGING MARKET COUNTRIES**

13. Against a backdrop of favorable financial conditions, many emerging market countries have strengthened policies and lowered vulnerabilities. Some have also reduced their borrowing from the Fund, while others, particularly in Asia, have built high levels of liquidity through reserve accumulation and regional agreements. These new conditions in emerging market economies provide a unique opportunity to address remaining vulnerabilities in order to enhance medium-term growth potential. The current circumstances, and the growth of large-scale private sector capital flows, also necessitate a reexamination of the Fund's policy advice, the focus of its technical assistance, and modalities for lending. My follow-up strategy report contains some specific proposals in these areas.

14. There is continuing interest among emerging market countries and others in exploring ways that Fund financing might be used to provide a seal of approval and contingent lending support for members with strong policies. Over the next six months, staff will concentrate on proposals for a crisis prevention instrument. Staff will also explore how the Fund could play a role in supporting regional reserve pooling arrangements.

15. The Fund is continuing to promote the orderly resolution of financial crises. In particular, we have been analyzing cross-country experience with debt restructuring and the policy issues raised by specific cases, and monitoring the adoption of collective action clauses (CACs) in international sovereign bonds. The Fund is following the progress of the monitoring process for the Principles for Stable Capital Flows and Fair Debt Restructuring in Emerging Markets.

## **V. ROLE OF THE FUND IN LOW-INCOME MEMBER COUNTRIES**

16. In accordance with the MTS, work is underway to make Fund engagement in low-income countries more focused and flexible. One of the challenges ahead will be to marshal the rise in aid flows that has been committed, including from debt relief, to achieve higher growth and the MDGs. This will require a deeper, but more focused, engagement by the Fund, including new understandings with the World Bank and other agencies on the division of labor.<sup>4</sup> As its resources—both financial and human—are limited, the Fund's policy advice, capacity building, and financial assistance should focus on macro-critical issues, including on institutions relevant to financial stability and economic growth. While sustained growth and poverty reduction would require more than good macroeconomic policies and institutions, the Fund cannot be engaged in too many areas without compromising its effectiveness—including in its core macroeconomic mandate. Thus, clear understandings with other development partners will be crucial.

### **A. Delivering Debt Relief**

17. Much progress has been made in addressing debt sustainability. Following its adoption of the MDRI in December 2005, the Fund moved rapidly to approve and deliver debt relief of SDR 2.3 billion (about US\$3.4 billion) for 19 low-income countries, including two non-HIPCs.<sup>5</sup> In approving this debt relief, the Board considered qualification criteria in the areas of macroeconomic performance, implementation of poverty reduction policies, and the quality of public expenditure management systems. Other HIPCs are expected to qualify for debt

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<sup>4</sup> Among other issues, the demarcation of responsibilities between the Bank and the Fund will be considered in the forthcoming Review of Bank-Fund Collaboration to be conducted by an External Review Committee comprising six external members.

<sup>5</sup> *The Multilateral Debt Relief Initiative (G-8 Proposal) and Its Implication for the Fund—Further Considerations* (SM/05/353, November 1, 2005); *Multilateral Debt Relief Initiative and Exogenous Shocks Facility—Proposed Decision* (EBS/05/158, November 16, 2005); Public Information Notice (PIN) 05/164, December 8, 2005; and PIN 05/168, December 27, 2005

relief under the MDRI from the Fund in 2006, upon reaching the completion point of the enhanced HIPC Initiative.<sup>6</sup>

18. There has also been progress in implementing the enhanced HIPC Initiative. In total, 18 countries have reached the completion point, and the Republic of Congo recently reached the decision point, bringing the total number of countries in the interim phase to 11.<sup>7</sup> The IMF has committed SDR 1.9 billion as debt relief to the 29 countries that have reached their decision points. Of this amount, SDR 1.6 billion has been disbursed. To avoid perverse incentives, the Fund and World Bank Boards have “ring-fenced” participation by finalizing the list of countries that could potentially be eligible for HIPC assistance on the basis of end-2004 data on the income and debt burden indicators.<sup>8</sup> With the forthcoming expiration of the sunset clause (end-2006), some of these countries may not be able to establish a policy track record in time to benefit from the Initiative. In this context, Fund and World Bank staff will consider options regarding the sunset clause for the Initiative in the coming months. Grant resources will need to be mobilized to finance HIPC and MDRI debt relief for the countries that are newly eligible and for the three protracted arrears cases (Liberia, Somalia, and Sudan).

19. It is important that the Fund’s financing capacity for promoting economic reforms and mitigating exogenous shocks in low-income countries is preserved after the full implementation of the enhanced HIPC and MDR Initiatives. In this context, the IMF welcomed the G-8’s commitments to provide an additional subsidy contribution of SDR 100 million (in end-2005 NPV terms), contribute to the resources necessary for debt cancellation for the three protracted arrears cases, and share the cost of debt relief for countries that may become eligible for the HIPC Initiative under the extended sunset clause.

## **B. Refining the Fund’s Policy Advice and Strengthening its Instruments**

20. For some time now, the Fund has been considering how it could better serve its low-income members. The Poverty Reduction and Growth Facility (PRGF) will remain the main instrument for assisting these members. However, the Fund’s mission to support low-income members’ efforts to secure and maintain macroeconomic stability and achieve sustainable growth and reduce poverty requires the institution to adapt as members’ needs evolve. This adaptation is proceeding on two fronts: refining policy advice and strengthening instruments for engagement with low-income countries.

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<sup>6</sup> *The Multilateral Debt Relief Initiative: Progress Report on Implementation* (SM/06/116, March 21, 2006).

<sup>7</sup> *Heavily Indebted Poor Countries Initiative—Statistical Update* (SM/06/118, March 22, 2006).

<sup>8</sup> *HIPC Initiative—List of Ring-Fenced Countries Potentially Eligible under the Initiative* (EBS/06/35, March 14, 2006).

21. Reaching the MDGs is the overarching objective. The most important contribution that the Fund can make is to provide advice on the macroeconomic and financial policies that will support growth and reduce poverty. In particular:

- As noted in my recent report on the MTS, the Fund is well placed to give advice on the macroeconomic implications of scaled up aid flows, including debt relief, and on how to deal with them. For example, Fund staff have been advising countries on how to handle the increased complexity of managing monetary, fiscal, and exchange rate policies when aid is increased. They could assess if projected aid flows are consistent with maintaining macroeconomic stability and with the costs of achieving the MDGs as estimated by multilateral development banks. They could also inform donors and country authorities candidly when there is scope for more aid to be absorbed, or when more aid would jeopardize its effectiveness. Staff are also working on strengthening analytical tools to underpin this policy advice.
- The Fund is also in a position to advise low-income countries, particularly HIPC, on how to achieve and maintain debt sustainability. Both the HIPC and the MDRI have already lowered external debt in a number of countries. The new borrowing capacity this has created must be used prudently to avoid a reaccumulation of excessive debt. In this context, the World Bank and IMF staffs are working towards strengthening the joint Debt Sustainability Framework in light of the experience with its implementation so far.<sup>9</sup> Based on this framework, the staffs will assist low-income countries in developing coherent medium-term debt strategies. They will also continue the analysis of the new financing landscape and the increasingly important role of non-Paris Club creditors.

22. Steps have been taken to strengthen the instruments for IMF engagement with its low-income members. The new instruments, the Exogenous Shocks Facility (ESF) and the Policy Support Instrument (PSI), provide the Fund with greater flexibility in customizing its assistance to low-income countries.

- The ESF became effective in January 2006, and provides financial assistance if a low-income member country has a balance of payments need caused by a significant adverse shock beyond its control.<sup>10</sup> The ESF covers a wide range of exogenous shocks experienced by low-income members, such as natural disasters, commodity price shocks, and conflicts in neighboring countries, and is more concessional than instruments under the Emergency Assistance Policy.

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<sup>9</sup> *Review of Low-Income Country Debt Sustainability Framework and Implications of the Multilateral Debt Relief Initiative (MDRI)* (SM/06/123, March 27, 2006).

<sup>10</sup> *Establishment of an Exogenous Shocks Facility Under the Poverty Reduction and Growth Facility Trust* (SM/05/365, October 4, 2005) and Public Information Notice No. 05/163, December 8, 2005.

- The Fund established the PSI to accommodate low-income members that may not need, or want, Fund financial assistance, but seek Fund advice, monitoring and endorsement of their economic policies.<sup>11</sup> PSIs are voluntary and demand driven, and so far, two countries have agreed arrangements. An on-track PSI would be a basis for rapid access to ESF financing in the event of a shock, even though such access would not be automatic.
- As highlighted in my report on the MTS, more needs to be done to use conditionality flexibly. Most IMF-supported programs require a standard of upper credit tranche conditionality. While this is generally appropriate, in some cases such as post-conflict situations, such a standard may be too high. The Fund's Emergency Post-Conflict Assistance policy recognizes these constraints and emphasizes the need for technical assistance, but a facility with a still more flexible standard and a larger capacity-building component could be considered.

23. IMF staff have explored the implications of the Fund's concessional and emergency assistance as well as the debt relief under the MDRI and extended HIPC Initiative for future financing need.<sup>12</sup> The conclusion was that there is a need for additional loan and subsidy resources. With regard to the ESF, the IMF has so far received total subsidy pledges of about SDR 214 million from eight countries—Canada, France, Japan, Norway, Oman, Russia, Saudi Arabia, and the U.K. However, this is still well short of the target of SDR 500 million (in end-2005 NPV terms) needed to ensure that the Fund is ready to provide timely concessional financing for its low-income members experiencing shocks.

### **C. Improving Governance and Building Capacity**

24. There is a consensus that improvements in governance are critical to utilizing increased aid effectively and to making progress in achieving the MDGs. As the GMR notes, since improving governance and controlling corruption are cross-cutting issues, they will require concerted efforts from low-income countries and the international community. Donors should take responsibility for international corruption originating in home-based companies or facilitated by their financial institutions, while developing countries should design and implement good governance and anti-corruption programs. Because of their global reach and the important role they play in many countries, IFIs can provide advice and technical assistance to carry out these efforts and must pursue for themselves high standards of anti-corruption. Careful monitoring is absolutely vital to the success of all of these efforts and initiatives, and requires the cooperation of all—governments, private sector, civil society, donors, and IFIs.

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<sup>11</sup> *Implementation of the Policy Support Instrument* (SM/05/343, November 2, 2005) and Public Information Notice 05/145, October 14, 2005.

<sup>12</sup> *Review of Financing of the Fund's Concessional Assistance and Debt Relief to Low-Income Member Countries* (SM/06/119, March 22, 2006).

25. The Fund contributes to improving governance and the quality of institutions in areas within its mandate. For example, the IMF, jointly with the World Bank, provides advice on improving public expenditure management systems including promoting fiscal transparency, which is critical for a more efficient use of public resources, including aid, and for ensuring that resources are directed to intended purposes. The Fund also helps build more transparent and effective institutions in the monetary and financial sectors. In addition, the Fund supports low-income countries in their efforts to implement vital structural reforms that would improve investment climates and competitiveness.

## **VI. DOHA NEGOTIATIONS AND AID FOR TRADE**

26. The successful conclusion of the Doha Round remains one of the most vital contributions that could be made to bolstering global growth, including for low-income members, over the medium term. But deadlines continue to be missed, and the Round is at risk of failure. Political leadership is required to reduce market access barriers and trade-distorting subsidies. Both developed and developing countries must play a role in removing the remaining impediments to trade. The Fund stands ready to provide stronger support for trade-related assistance (“Aid for Trade”).<sup>13</sup> Existing vehicles for the Fund’s provision of aid for trade include the Trade Integration Mechanism, analysis and policy dialogue on trade-related issues, technical assistance for customs administration, and our work, jointly with other agencies, in the Integrated Framework for Trade-Related Technical Assistance (IF). The Fund also endorses efforts underway to strengthen the IF’s governance, and an increase in donor financing for capacity building projects financed through an IF-supported trust fund. Aid for Trade must not substitute for ambitious liberalization under the Doha Round, and care should be taken to ensure that the principles of the Paris Declaration on Aid Effectiveness are observed.

## **VII. QUOTAS AND VOICE**

27. The IMF’s legitimacy and effectiveness depend crucially on its members’ sense of ownership and participation in the Fund as an institution. Imbalances in representation at the Fund must be corrected. The strategic review has given an impetus to tackling quotas and voice issues, and we are examining the options for making progress by the time of the Singapore Annual Meetings. The most effective way forward would likely involve a sequenced approach in which ad hoc quota increases take place for the most under-represented members in the near term. Ahead of the Annual Meetings, we aim to gather the broadest possible consensus on the elements of a strategy and on the technical work to be undertaken by staff.

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<sup>13</sup> *Trade Progress Report—Doha Development Agenda and Aid for Trade* (SM/05/327, Rev. 1, September 16, 2005), and Public Information Notice No. 05/169, December 27, 2005.