

EBD/08/33

April 10, 2008

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 paper 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)

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Department Heads

DEVELOPMENT COMMITTEE: THE MANAGING DIRECTOR'S WRITTEN STATEMENT

I. INTRODUCTION

1. This year's Global Monitoring Report (GMR) notes that thanks to high economic growth in recent years, many developing countries have made good progress on the poverty reduction Millennium Development Goal (MDG). Notwithstanding the expected slowdown of global economic growth in 2008, the poverty reduction MDG is within reach at the global level. Human development goals, however, are not likely to be met on current trends, and there is considerable variation in progress across countries and regions, with fragile states and sub-Saharan Africa lagging the most. The GMR outlines a six point agenda for accelerating progress toward the MDGs. The international community must intensify efforts to reach the MDGs, including meeting the commitments made at Monterrey and Gleneagles to increase aid and improve aid effectiveness.
2. The Fund remains a full partner in the international effort to achieve the MDGs. We are assisting low-income countries in dealing with key issues, such as commodity price fluctuations, financial market development, and debt sustainability, in addition to further strengthening capacity building and maintaining macroeconomic stability. Another challenge is managing the macroeconomic impact of increased aid and capital inflows. The Fund will also continue to make active contributions to the discussions on increasing aid and improving its effectiveness. We are participating in the UN MDG Africa Steering Group convened by the Secretary-General, and look forward to the High-Level Forum on Aid Effectiveness in Accra in September 2008 and the Financing for Development Conference in Doha in late November 2008.
3. In this statement, I will give you a brief assessment of the global economic outlook and the effects of the continuing financial market turbulence on the world economy, in particular the middle- and low-income countries. I will also provide an overview of the various initiatives underway to refocus and modernize the Fund's structures and activities.

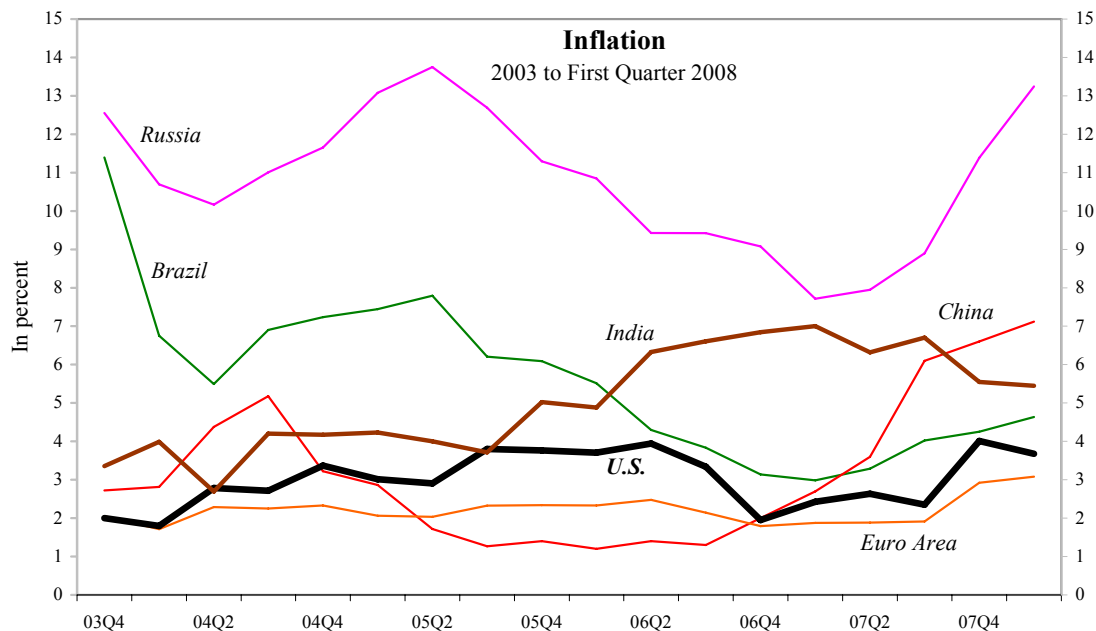
II. GLOBAL ECONOMIC PROSPECTS¹

4. The global economy grew at 4.9 percent in 2007, but financial market turmoil slowed the momentum towards the end of the year. Following a stronger third quarter than expected, activity in the United States and the Euro area decelerated quite rapidly, as the ongoing U.S. housing correction exacerbated financial stress which has started to spread to a broader range of financial markets and institutions.
5. By contrast, activity in emerging and developing economies continued to grow rapidly. These countries have contributed as much as 70 percent of global growth. China and India alone grew by 11.4 and 9.2 percent, respectively, in 2007. Growth momentum in emerging and developing economies is underpinned by strong productivity gains as they

¹ For details, see *April 2008 World Economic Outlook*, International Monetary Fund.

have increasingly integrated into the global economy and their stronger policy frameworks have helped sustain access to capital.

6. Headline inflation has increased around the world, boosted by the continuing buoyancy of food and energy prices. In the advanced economies, core inflation has edged upwards in recent months despite slowing growth. In light of the slowing economic activity, however, many central banks have reduced policy interest rates or kept them on hold. In emerging markets, the rise in headline inflation has been more noticeable due to both strong demand growth and the greater weight of energy and particularly food in consumption baskets. In response to these developments, central banks in many emerging market economies have continued to tighten monetary policy.



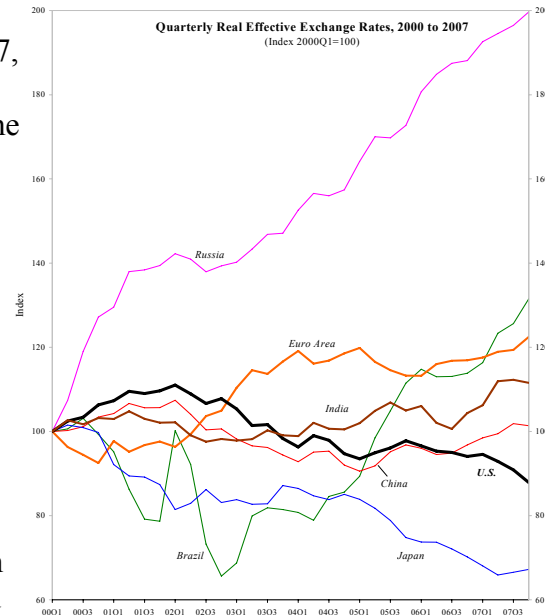
Source: WEO.

7. Commodity markets have remained buoyant overall. Strong demand from emerging economies was a driving force behind increases in many commodity prices in 2007, as were biofuels-related demand for prices of major crops and the increasing attraction of commodities as an asset class. At the same time, supply adjustment to higher prices has remained slow, notably for oil, and inventory levels in many markets have declined to medium- to long-term lows.

8. While terms of trade for commodity producers improved further in 2007, many developing countries faced higher food and oil import prices. To date, most developing countries have been able to absorb the balance of payments impact as higher export earnings or inflows of capital and transfers broadly offset the higher imports, while higher prices have been passed through to domestic markets. It cannot be excluded, however, that external positions weaken if oil or food import prices continue to rise, while non-agricultural commodity export prices ease as a result of lower global demand. Also,

increasing food and oil prices affect the urban poor disproportionately. The Fund stands ready to assist governments in designing policy responses that aim to avoid destabilizing macroeconomic effects of higher food and oil prices, while mitigating the negative effects on the poorest by targeted safety net measures. Further, we can provide financial assistance to countries in dealing with exogenous shocks of this nature.

9. The real effective exchange rate of the U.S. dollar has declined further since mid-2007, with the appreciation of floating currencies such as the euro, yen, Canadian dollar and some emerging market currencies as main counterparts. As exchange rates for a number of countries with large current account surpluses have remained relatively stable in US dollar terms, recent exchange rate adjustments have not all been in line with the overall pattern of global imbalances.



Source: Information Notice System (INS), IMF.

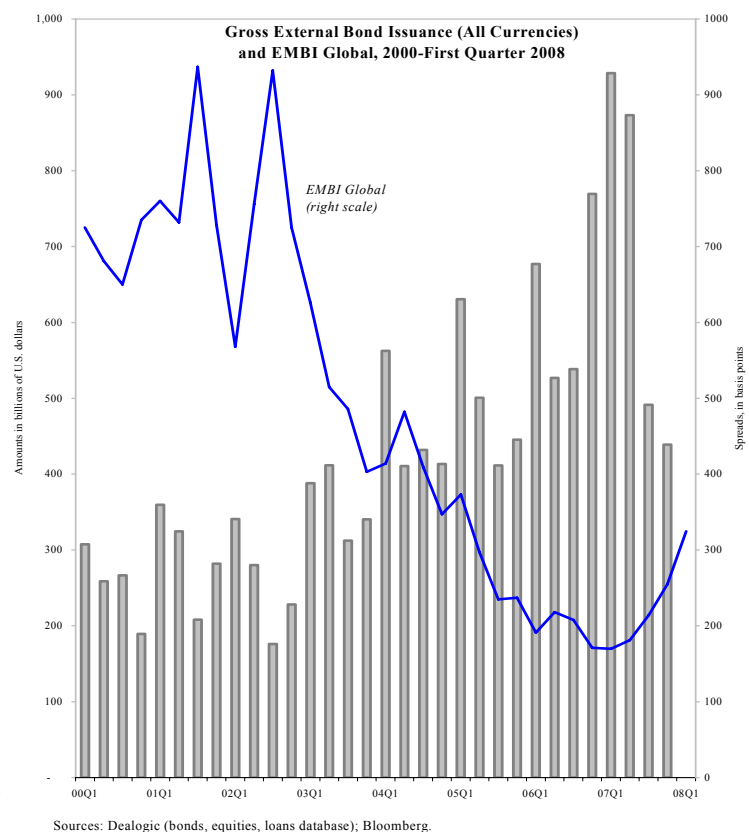
10. Spreading turbulence in financial markets has dampened the global outlook further. The U.S. is projected to tip into a mild recession in 2008, as restraint on demand from the housing cycle may intensify the downward swing of the credit cycle. Global growth will slow from 4.9 percent in 2007 to 3.7 percent in 2008, and will only gradually regain momentum in 2009. Growth in most emerging markets and developing countries is expected to slow on account of both trade and financial spillovers from advanced economies, although the link to advanced economies' business cycles has loosened somewhat as intra-regional trade and domestic investment has grown. In emerging Asia, growth is expected to decelerate, but remain robust this year on the back of strong consumption and continued investment. Activity in Africa and the Middle East is expected to remain relatively strong on account of continued high commodity prices and strong macroeconomic policies as well as some improvement in the business environment. In Latin America, Eastern Europe, and the Commonwealth of Independent States (CIS), overall activity is projected to slow in 2008 due to a weakened global economy and slower credit growth despite the support from commodity prices for many economies.

11. The overall balance of risk to the global growth outlook remains tilted to the downside. The greatest risk comes from the still unfolding events in financial markets, and particularly the concern that the deep losses in the U.S. subprime mortgage sector and other structured credit products could seriously impair financial systems and cause the current credit squeeze to mutate into a full-blown credit crunch. Inflation risks also remain a concern, especially given the tight conditions in commodity markets, which could limit the room for maneuver for central banks to respond to downside risks to output.

III. IMPACT OF FINANCIAL MARKET TURBULENCE AND POLICY RESPONSES

12. Financial strains in advanced economies have intensified and spread across markets reflected in a general repricing of risks. Credit spreads have increased sharply, particularly on lower-grade borrowers, while bank lending standards have tightened substantially in the United States and Western Europe. Concerns remain about the potential impact of the weakening in the financial strength of monoline insurers in the U.S. that provide insurance against credit defaults. In addition, softening housing markets are weakening household balance sheets in advanced economies, with potential dampening effects on private consumption. On the corporate side, however, strong balance sheets and high profitability offer some buffer to deal with higher borrowing costs, especially in the United States.

13. The impact of the mature market turbulence on low- and middle-income countries so far has been uneven but generally contained. With the exception of selected emerging markets with high external vulnerabilities, low- and middle-income countries in general have not yet experienced the liquidity problems that are affecting the mature money markets. Moreover, the widening of credit spreads on emerging market debt instruments has been moderate relative to past crises, about 120 basis points since mid-October. Aggregate capital flows to these economies have moderated, in part because large banks are focusing their efforts on consolidating their balance sheets and potential sovereign bond borrowers are deferring borrowing until market turbulence subsides.



14. If the turmoil continues and intensifies, however, emerging economies are likely to be affected in a more profound way. Improved resilience notwithstanding, more persistent and deeper turbulence in mature financial markets than currently anticipated and a corresponding slowing of global growth would pose significant risks to economic conditions in emerging and developing economies. Countries most at risk are those that have large current account deficits and have experienced sharp increases in asset prices fueled by foreign currency lending, or have large balance sheet vulnerabilities, including substantial currency and maturity mismatches. Examples include various countries in Central and Eastern Europe, some of which exhibit all of these characteristics.

15. Reducing the risks of a more serious global downturn requires joint efforts in advanced and developing economies. In the face of financial strains, the first line of defense would be monetary policy, and the Federal Reserve has already eased aggressively in view of the risks to the U.S. economy. At the same time, it is important for central banks, regulators, and fiscal authorities to continue with their efforts to coordinate—both at the national and at the multilateral level—targeted financial sector policies that help rebuild counterparty confidence, ease liquidity problems, and safeguard the solvency of the financial system. Policies should be aimed at quickly restoring stability in the financial markets while avoiding moral hazard in the medium term. Additional initiatives to help support the U.S. housing market, including the possible use of the public balance sheet, could help reduce uncertainties about the evolution of the financial system, although care would be needed to avoid moral hazard. More generally, fiscal policy can play a role as automatic stabilizers kick in, while some economies have also room for additional discretionary fiscal support. Many emerging and developing economies still face the risk of overheating, however, and have appropriately continued to tighten monetary policy. If global growth should slow sharply and pressures on prices begin to subside, monetary and fiscal policy could provide support depending on country circumstances. The IMF is assisting its members in designing an optimal policy mix that supports economic activity while mitigating the risks of inflation.

16. Drawing the lessons from the recent market failures, longer-term reforms in advanced and developing countries should include a review of lending standards in the mortgage markets; broadening prudential supervision to include commercial banks' off-balance sheet exposures; strengthening the framework of supervisory cooperation among countries; and improving crisis resolution mechanisms. The recent experience with the demise of financial institutions in some advanced economies has shown the need for effective mechanisms to mitigate systemic risks of bank failures while avoiding the moral hazard of infusions of public capital. The Fund is working with national authorities, supervisors, and the private sector to identify information gaps and making specific policy recommendations.

IV. CLIMATE CHANGE

17. Addressing climate change is rapidly emerging as one of the world's top policy priorities. Although the damage inflicted by climate change is uncertain, it is likely to have significant macroeconomic effects that are unequally distributed across countries, sectors and generations. Rising temperatures will have profound structural effects on domestic economies, especially in developing countries dependent on agriculture, but also in advanced economies.

18. The Fund contributes to the analysis of the macroeconomic and financial implications of mitigation policies, in line with its comparative advantage and mandate. The April 2008 World Economic Outlook,² for example, presents a simulation of the

² International Monetary Fund, *World Economic Outlook*, Chapter 4, Washington, April 2008; and *The Fiscal Implications of Climate Change*, SM/08/59, Washington, February 2008.

macroeconomic implications of global carbon taxes and cap-and-trade schemes, It finds that economic costs of mitigation could be contained, provided policies are well designed. However, mitigation costs are likely to differ considerably across countries depending on how efficient they are in lowering CO₂ emissions and the extent of reductions they undertake.

19. Effective mitigation policies will require a high level of international collaboration. Wide participation by countries—advanced, emerging market and developing—in pricing emissions is critical. As a projected 70 percent of emissions during the next half century will originate in emerging markets and developing countries, they should be fully included in a future policy framework. International collaboration on a global scale would lead to important economic efficiency gains—a common ‘carbon’ price would ensure that emissions are reduced where it is least costly to do so.

20. Carbon pricing would raise macroeconomic issues. For instance, under a global cap-and-trade regime, financial transfers to countries that are net sellers of permits may be very large, raising issues of macroeconomic stabilization. Receipts which accrue nationally—whether from tax revenue or auctioning emission rights—can ease pressures on public finances and foster opportunities for wider tax reforms. Conversely, adaptation to climate change is likely to require increased public expenditure.

21. While not taking the lead in this area, the Fund has a contribution to make to the task of understanding and dealing with macroeconomic, fiscal and financial risks from climate change. The Fund stands ready to support our members with specific advice in this area. Also, the Fund can provide financial support to its members facing exceptional balance of payments needs that might arise in cases of extreme climate events.

V. STRENGTHENING SURVEILLANCE

22. Surveillance is at the core of the Fund’s mandate, and current developments confirm the need for Fund surveillance to adapt continuously to the changing global economic environment. Building on the almost universal membership of the Fund that lends a unique value to surveillance, more emphasis is being placed on the multilateral perspective in bilateral surveillance and on making better use of cross-country experience and knowledge. In addition, the recent financial market turbulence has shown the need for deeper analysis of the linkages between the real economy and the financial sector, for which the Fund is well equipped given our expertise in both of these areas.

23. To make our surveillance activities more effective and bring out these institutional advantages, we are in the process of an internal reorganization aimed at improving the quality and focus of surveillance, which will be further discussed in the context of the 2008 Triennial Surveillance Review. Methodologies for analyzing exchange rates and current account positions are being clarified, and the classification of member countries’ de facto exchange rate arrangements is being made clearer.³ Consideration is being given to

³ *Review of Exchange Rate Arrangements, Restrictions and Controls* (SM/07/378), November 2007.

producing shorter and more timely staff reports, which should allow them to have a greater impact. Finally, we are also working with countries and sovereign wealth funds (SWFs) to develop a set of voluntary best practices that can improve the understanding and transparency of SWFs and their impact on international financial systems.

VI. CRISIS PREVENTION AND THE ROLE OF THE FUND IN EMERGING MARKETS

24. Financial globalization has amplified the need for a global perspective in assessing and dealing with vulnerabilities. We are strengthening in several ways the monitoring of risks at the country, regional, and global level. The semiannual vulnerability exercise, established in 2001, provides cross-country assessments of vulnerabilities and crisis risks in emerging market economies. In light of the financial market turmoil, a similar exercise will be designed to cover vulnerabilities in mature markets. We are also deepening our analysis of how financial innovations have affected the transmission channels of financial crises and the potential implications for the Fund, which complements our work to strengthen crisis preparedness, adapt program design, and enhance financial stability surveillance.

25. The Fund is exploring whether our instruments for financial support meet the needs of emerging economies. To this end, we will expedite work on developing a new liquidity instrument to prevent capital account crises in market access countries, and draw on suggestions for a facility to help countries integrate into global capital markets.

VII. THE FUND'S EVOLVING ROLE IN LOW-INCOME COUNTRIES

26. In many low-income countries, macroeconomic policies and performance have improved markedly since the beginning of the decade. Better economic policies have contributed to higher growth and lower inflation, while debt relief and the favorable global economic environment have helped strengthen their external positions. Private capital flows have gained in importance as source of external financing. As a result of these developments, the needs for Fund advice and financing of many low-income countries are evolving rapidly. We will continue to refine and adapt the analytical underpinnings of our advice to low-income countries in line with their needs, concentrating on the Fund's core areas of expertise—macroeconomic policies and institutions that support the stability necessary for sustained growth and poverty reduction. We will build on cross-country experiences and perspectives while providing policy advice tailored to country needs, capacity building assistance, and financial and policy support through programs.

27. As detailed in the 2008 Global Monitoring Report, not all low-income countries have seen improvements in their growth performance in recent years. In particular, the conditions of fragile states continue to give reason for serious concern. The Fund has recently completed a review of its engagement with fragile and post-conflict states, and is

now refining the modalities of its engagement, as part of the joint international efforts to stabilize these countries and lay the basis for sustained growth.⁴

28. At the same time, we have taken steps to strengthen the effectiveness of the Fund's capacity building program in low-income countries. Technical assistance will place greater emphasis on macro-financial linkages and challenges related to integration into the global economy. We will also strengthen the coordination with recipients and other technical assistance providers while at the same time stepping up our fund-raising efforts for TA with potential donors. Greater dissemination of technical assistance reports will leverage the effectiveness of Fund capacity-building efforts.

29. Helping low-income countries maintain debt sustainability remains a top priority. We have initiated a project aimed at enhancing their debt management capacities. On the creditor side, Fund staff worked closely with the OECD's export credit group to define the sustainable lending principles agreed in January 2008. The principles commit OECD export credit agencies to observe Fund and World Bank concessionality requirements in low-income countries where they exist, and to take into account the results of debt sustainability analyses for other low-income countries. The joint Bank-Fund Debt Sustainability Framework is also an effective starting point for discussions with other creditors.

30. Additional countries have benefited from debt relief under the HIPC and MDR Initiatives. To date, 33 members have reached their HIPC Initiative decision point and 23 have reached their completion point, while 25 members have received Fund debt relief under the MDRI. Also, changes have been introduced to the HIPC initiative framework to reduce delays in the process for HIPCs with protracted arrears to the Fund or other multilateral institutions. Performance under Staff-Monitored Programs that meet the upper credit tranche policy standard—as under the PRGF—may count toward the track record of performance needed to reach the HIPC Initiative decision point. Liberia, one of three HIPC-eligible countries with protracted arrears to the Fund, was the first country to benefit from the above change and reached its decision point in March 2008.

VIII. BANK-FUND COLLABORATION

31. Fund and Bank staff have worked together to implement the Joint Management Action Plan (JMAP) to enhance collaboration.⁵ In particular, Fund and Bank country teams have initiated the country-level work program discussions that were a central component of the JMAP. Such discussions are intended to facilitate agreement between country teams on instruments, macro-critical sectoral issues, the division of labor, and the inputs needed from each institution in the coming year. In addition, web-based mechanisms —“Country Portals”—are being piloted to improve the flow of information between country-teams and

⁴ *The Fund's Engagement in Fragile States and Post-Conflict Countries – A Review of Experience – Issues and Options*, March 2008. Available at: <http://www.imf.org/external/np/pp/eng/2008/030308.pdf>

⁵ See: <http://www.imf.org/external/np/pp/2007/eng/092007.pdf>

to create shared working spaces. In parallel with efforts at the country level, web-based mechanisms to improve information flows and collaborative working are also being piloted in the fiscal area and in central policy operations. Actions have also been taken to improve the sharing of TA reports and information on job opportunities.

32. In parallel with implementing the JMAP at the institutional level, the Fund's Africa Department and the Bank's Africa Region have worked together with a group of members to identify ways to improve the coordination of support for growth-critical reforms in public financial management, the financial sector, and natural resources management. The lessons from this experience are being drawn together and will be disseminated across all regions and area departments.

IX. QUOTA AND VOICE REFORM

33. On March 28, the Executive Board recommended the adoption by the Board of Governors of an important package of quota and voice reforms. The reform package, currently being considered by the Board of Governors, includes agreement on a new simpler and more transparent quota formula, increased representation for dynamic economies, and, to enhance the voice and representation of low-income members, amendments to the Articles to (i) triple basic votes and maintain the share of basic votes in total votes going forward, and (ii) to enable Executive Directors elected by a large number of members to appoint an additional Alternate Executive Director. The package also includes agreement that the Executive Board will recommend further realignments of quota shares in the context of future general quota reviews, beginning with the Fourteenth General Review of Quotas. The Managing Director's report to the IMFC on reform of quota and voice provides more details of the reform package.⁶

⁶ *Report of the Managing Director to the International Monetary and Financial Committee on Reform of Quota and Voice in the International Monetary Fund* (SM/08/83, 3/21/08).