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**In Search of Stability and Broadly-Shared Prosperity:
Reform of the International Monetary System**

Address by Horst Köhler
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at the Meeting with EU Parliamentary Committees
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Ms. Ranzio-Plath, Mr. Westendorp, ladies and gentlemen, I am grateful for the opportunity to meet with you today in this informal setting. Many of us have collaborated closely on other occasions, on matters such as European unification and the transition in Central and Eastern Europe, and it is good to see you again. In my prepared remarks, I would like to review where we stand in the critical debate on the reform of the international monetary system, in the wake of the recent Annual Meetings in Prague. Subsequently, I am at your disposal for any questions you may have.

The IMF's Annual Meetings took place against a background of a strong global economic upturn—in fact, the best growth performance since the fall of the Berlin Wall. While the outlook has been affected since then by rising oil prices, we still expect the coming year to bring further solid expansion in the global economy. There are clearly risks, which are now coming mainly from the advanced industrial countries. They include the volatility of equity market prices, particularly in the United States, and the large US current account deficit; the fragility of the economic recovery in Japan; and, of course, misalignments among the major currencies—especially the euro and the US dollar.

With good policy management, these risks should not materialize. There are increasing signs of a soft landing in the United States. That is encouraging. But beyond that, we also know that there is a need to increase private savings and for continued fiscal prudence. For Japan, the priority is to sustain the economic recovery and give it a stronger structural foundation.

It is clear that the euro is undervalued and that this poses problems, not least for growth in emerging market and developing countries. This misalignment needs to be corrected. But dramatization is not productive. There will be a reversal. The fundamentals of European economies have clearly improved. Growth in Europe is now catching up to the United States. I expect some dampening of the euphoria for transatlantic mergers, which could lead to a normalization of capital outflows. In my view, the ECB has done a good job under difficult circumstances. The Europeans themselves should stop talking down the ECB. The political debate in Europe should concentrate on accelerating the agenda of structural reforms and on clarifying the future process of European integration and EU enlargement.

There is an important debate in both governmental and non-governmental circles about the costs and benefits of globalization, and this was clearly the central topic of the discussions at the Annual Meetings in Prague.

In particular, I see two major challenges to which the international community must respond.

- First, international private capital flows have become a major source of growth, productivity and job creation. Net private capital flows to developing countries were on the order of \$220 billion in 1997, about four times as large as official aid flows, and they are recovering again toward similar levels. But international capital markets can also be a source of volatility and crisis. The crises that began in 1997 have heightened the awareness that the stability of the international financial system is an important international public good.
- Second, ten years after the end of the Cold War, there are more opportunities than ever to promote a better world. Ideological divides have faded, and new technologies and the expansion of the market place have opened new horizons for shared prosperity. But at the beginning of the new millennium we are also aware of huge unsolved problems. The most pressing of these is poverty, which is becoming a major threat to political and economic stability in the world.

In Prague, I had the opportunity to outline my vision of the future role of the Fund. It is a vision in which the IMF responds to these challenges by helping countries to take advantage of the opportunities of the global economy while finding ways to contain the risks. Our 182 member countries overwhelmingly endorsed this vision. There is an awareness among our members that globalization requires cooperation, and they consider the Fund as an institution which is uniquely placed to help organize this cooperation and deal with globalization. As the Finance Minister of South Africa, Trevor Manuel, put it, "If there were no IMF, we would have to invent

one.” Our members want a strong IMF, but also a reformed IMF. In particular, they want to see an IMF which:

- strives to promote sustained non-inflationary economic growth that benefits all people of the world;
- is the center of competence for the stability of the international financial system;
- focuses on its core macroeconomic and financial areas of responsibility, working in a complementary fashion with other institutions established to safeguard global public goods; and
- is an open institution, learning from experience and dialogue, and adapting continuously to changing circumstances.

In these ways, I see the IMF as an active part of the workforce to make globalization work for the benefit of all. I believe that the international community can and must succeed in this task. But all will need to do their part.

Reducing world poverty requires sustained economic growth. Growth is not everything, but without growth we get nowhere. The responsibility lies, first and foremost, with countries themselves—to mobilize the energies and talents of their citizens and take advantage of the opportunities of the global marketplace. Governments must provide sound policies, strong institutions, and good governance. Moreover, growth requires innovation, adaptation, and structural reform as a permanent feature of societies.

To a remarkable extent—and notwithstanding severe strains and hardships—developing countries and transition economies have embraced this challenge. But the process cannot be understood as a one-way street. Many industrial countries have not yet developed enough of a sense of urgency to deliver their part of structural change in speed and depth to make globalization work for all. In particular, there is a need for more ambition on trade liberalization. Most estimates of the potential welfare gains for developing countries from a 50 percent worldwide reduction in barriers to trade are in excess of US\$100 billion per year. This drives home just how crucial better access for developing countries’ exports is for the fight against poverty.

I very much welcome the commitment of the EU to the early launch of a new round of multilateral trade negotiations, as well as the European Commission’s latest initiative to provide free access for exports of the poorest countries. I trust that the EU will also develop the resolve to push forward with further reform of the Common Agricultural Policy.

The recent financial crises taught us a number of important lessons. Not the least, it became clear that the IMF needed to do a better job of identifying sources of external and financial sector vulnerability at an early stage. We learned that countries must be well prepared for capital account liberalization, and that they need to consider the implications for the sustainability of their exchange rate regimes. And we were reminded that, for adjustment programs to succeed, there must be careful attention to institution-building, the social dimensions of structural change, and a country's political and cultural traditions.

In the three years since the beginning of the Asian crisis, there has been considerable progress in applying these lessons in a process to reform the international financial architecture. This has involved efforts by a variety of multilateral institutions, such as the IMF and the World Bank; standard-setting organizations, like the Basle Committee on Banking Supervision; and other regional and international bodies. The Financial Stability Forum was established in 1999 and has played a particularly important role in helping to identify gaps in the coverage of existing institutional arrangements and supervisory capacities, including through its three working groups on capital flows, offshore financial centers, and highly-leveraged institutions. The architecture work program of the international community has mainly involved six building sites:

- First, activities to improve the ability to detect sources of vulnerability and to propose timely corrective measures. This work is focused, especially, on increasing the availability of key data; developing vulnerability indicators and techniques for stress-testing; and providing guidelines on debt and reserve management.
- Second, the IMF will pay particular attention to the appropriateness of countries' exchange rate systems. This will include the need to find a better balance and sequencing between capital account liberalization and financial sector development, regulation and supervision.
- Third, strengthening financial sector surveillance. The IMF and World Bank have started a joint Financial Sector Assessment Program (FSAP), to assemble detailed information on weaknesses in financial systems and supervisory frameworks. We have worked closely with other international organizations, standard-setting bodies, and the Financial Stability Forum, to develop standards and codes for sound monetary and fiscal policies, economic data and banking supervision. A number of European countries have already participated in the Financial Sector Assessment Program or assessments of the observance of standards and codes, and the ECB has asked to join in as well. The IMF also recently began an assessment program specifically for offshore

financial centers (OFC's). Work in all of these areas helps to promote financial stability, and it serves as a guide to institutional development and related technical assistance to help countries take advantage of the enormous potential of private capital markets.

- Fourth, improving the transparency of members' policies and the IMF's assessments and policy advice. Many countries now provide more timely and comprehensive information to the public on their economic situation and policies. Most IMF staff reports and country papers are now published, and the IMF's website contains a huge and rapidly-growing volume of information on its own policies and operations. The IMF is also preparing to establish a independent Evaluation Office. These transparency efforts are intended to improve the functioning of financial markets and to strengthen national and international governance.
- Fifth, involving the private sector appropriately in crisis prevention and management. The IMF Executive Board recently adopted a framework, whose guiding principle is that the IMF's financing is and will remain limited, so that private creditors know that they must bear the responsibility for the risks they take.
- Finally, streamlining and reforming the IMF's financing facilities. The changes now being introduced will give countries incentives to avoid excessively large or prolonged use of IMF resources, while making our facilities more effective in preventing and responding to crises.

As a result of these ongoing reforms, the world should already be better placed today than it was three years ago to prevent financial crises and contain their cost. But there is no room for complacency. There is a risk that financial sector reforms could lose momentum. And we have to live to some extent with the risk of crises as part of an open and innovative economy. But we can and must work to make financial systems more resilient. Implementation is only beginning, and much remains to be done. In the coming months, we will be deepening the IMF's work on architecture reform, in cooperation with other organizations, and progressively implementing our vision of the future role of the Fund.

Most fundamentally, the IMF needs to refocus. As a precondition for sustained growth, it should concentrate on fostering sound monetary, fiscal, and exchange rate policies, along with their institutional underpinnings and closely related structural reforms. And more important than ever in the modern world economy is the IMF's mandate to oversee the international monetary system and ensure its effective

operation. This obliges the IMF to give particular attention to the stability of financial markets, both domestic and international.

To fulfill this task effectively requires the Fund to gain a better understanding of the dynamics of international capital markets and the operations of private financial institutions. I recently established a Capital Markets Consultative Group to foster a regular dialogue with the private sector. In addition, I have formed a working group of senior representatives of private financial institutions and central bankers, to investigate how the IMF can best organize its work on international capital markets. With the buildup of further expertise in these areas, the Fund should quite naturally assume a coordinating role among the various agencies and fora dealing with financial markets issues.

We need to stick to conditionality in our lending but at the same time work to enhance real ownership of programs. I am convinced that ownership and implementation are promoted when the Fund's conditionality focuses on what is really crucial for the achievement of macroeconomic stability and growth. Less can be more if it helps to break the ground for a sustained process of adjustment and reform. Moreover, program design must take into account the social dimensions of adjustment programs and the unique characteristics of each country. This approach to strengthen ownership and streamline IMF conditionality will need to be well coordinated with the World Bank, based on the complementarities of our two institutions which Jim Wolfensohn and I outlined in a recent statement to our Executive Boards.

Implementation of the standards and codes developed by the international community poses objective difficulties for emerging market and developing countries. Our recommendations in this area will need to be tailored to the circumstances of individual countries and, especially, the stage of development of their capital markets. Implementation will also require us to mobilize expanded and better coordinated technical assistance. These issues will all be reviewed by the IMF's Executive Board in the coming months.

Building on their ongoing work on standards and codes and governance, the IMF and World Bank have also been asked by the IMFC to report on their respective roles in combating money laundering and abuse of the financial system. This report should become available at the time of the next IMFC meeting, in April.

There have been calls for the IMF to end its work on low-income countries and leave this entirely to the World Bank and other development institutions. My own conclusion—which was endorsed by our member governments—is that the IMF should clearly stay engaged. We are, after all, a universal and cooperative institution dedicated to making globalization work for the benefit of all, including the poorest

countries. This means that we will continue to work closely with these countries, and the World Bank, to make our Poverty Reduction and Growth Facility (PRGF) and the development of country-owned Poverty Reduction Strategy Papers (PRSPs) a success. In addition, I can assure you that the IMF and World Bank are doing their utmost to ensure that debt relief under the enhanced HIPC Initiative is provided to as many countries as possible, as soon as possible, while seeking to ensure that the resources will be used effectively for poverty reduction. For this effort to succeed, it is crucial that other countries participate in the initiative and support it financially. We appreciate and depend upon the continued leadership of European countries.

It is both a moral imperative and a matter of rational self-interest for the international community to support self-help efforts by low-income countries. In addition to debt relief, this will require increased aid and expanded opportunities for trade. The total debt relief expected under the enhanced HIPC Initiative is estimated at about \$50 billion, over a number of years. If these resources are used correctly, they should make an important contribution to poverty reduction. But the advanced economies also need to deliver on their promises to provide much higher levels of aid. Unfortunately, official development assistance by the OECD member countries is only 0.24 percent of their combined GNP, far below their commitment to provide at least 0.7 percent of GNP in ODA. In absolute terms, the shortfall amounts to about \$100 billion a year.

Finally, while adequate official support is necessary to launch poverty-reduction efforts in the poorest countries, over the longer run a real breakthrough will be possible only if these countries succeed in tapping fully the energies of the private sector. Here for me lies the main logic behind the PRSP process, and the main focus of cooperation between the IMF and the World Bank. We must help these countries put in place the legal and institutional foundations for a vibrant private sector at home, and for eventual access to international capital markets.

The IMF and its member governments have a challenging work program ahead. We look forward to active engagement with the European Union to help meet achieve our shared goal of promoting stability and broadly-shared prosperity. I thank you for your attention, and look forward to your questions.

