Statement by The Hon. Peter Costello, M.P.
Treasurer of Australia[1]
to the International Monetary and Financial Committee
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The Fund's Strategic Directions

We welcome the initiative by management to review the Fund's strategic directions, along with the process that is underway to develop a medium-term strategy document as part of the reform of the Fund's budgetary framework. These are important developments.

This constituency has long advocated the need for the Fund to adopt a more strategic approach to its operations. The Fund has had to evolve to a changing international environment and to remain relevant it will have to continue to adapt. Given the many demands placed on the organisation, there is always the danger of the Fund moving in a direction without a clear understanding of what it is trying to achieve, whether it is consistent with its mandate, and an appreciation of the longer-term implications of developments. Moreover, given the need to take into account the resource implications of all decisions, the Fund's strategic planning should be centered on its budget framework.

The preliminary discussion that has taken place in the Board on the Fund's strategic directions is a good start. However, it is only the start of what should be an ongoing process. Once the broad directions of the Fund are confirmed, the challenge is to translate this into an operational plan which delivers results. This should occur in the context of the reform of the Fund's budget. We encourage the continuation of this process, which will have implications for the operation of Fund Management and the Board, and also the deliberations of future IMFC meetings.

Global Economic Outlook and Policy Challenges

The expansion in the global economy has gained momentum and broadened since the IMFC last met. World growth in 2004 will be at its highest rate in 30 years. The main drivers of growth remain the United States and East Asia, particularly China and Japan, although activity has picked up in a number of emerging markets and the expansion in the euro area, while still moderate, is strengthening. This is encouraging, although while the Fund has increased its forecast for growth in 2004, its assessment is that the risks to the expansion have increased. Some of these risks have been prevalent for some time, particularly continuing large global imbalances, the related concern over the need to strengthen medium-term fiscal positions in a number of countries as well as advancing growth-enhancing structural reforms, along with the handling of the transition toward higher interest rates. Added to these risks are the more recent developments of the volatile rise in oil prices and weaker-than-expected data

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in the second quarter of 2004 in the United States and Japan. The rise in oil prices reflects strong demand growth, but there are also significant supply concerns and additional capacity is limited. There is the risk of adverse geo-political developments and we would also note the risk of rising protectionist and trade-distorting pressures.

There are thus grounds to temper the optimism that normally accompanies a strengthening in the world economy. The challenge is to ensure that these risks do not undermine global economic growth. What does this mean for policy? The key message we should draw is that a benign and supportive international environment should never be taken as a given. As events in the past have demonstrated, economies must be prepared to respond to the unexpected.

With this in mind, we are concerned that many industrial countries are relying on the expectation of strong, uninterrupted growth to drive their fiscal consolidation. Moreover, even taking this into account, the fiscal consolidation objectives of some industrial countries are not sufficiently ambitious. There is also a tendency to ascribe the improvement in economic conditions of some developing countries and emerging markets to policy advancements, with insignificant recognition that the source of much of the gains is the upturn in the global business cycle and commodity prices. Policy complacency is a major risk to the world economic outlook but, unlike many of the other risks, is something within the control of countries.

The policy challenges facing the global community have not changed since the IMFC met last April, and that is that countries should use the strengthening in global growth to push ahead with measures to address medium-term vulnerabilities and strengthen the capacity of economies to respond to shocks. While the risks to the global economic outlook and the required policy responses are not new, it is disturbing that the Fund's assessment is that progress in addressing these problems can only be described as mixed at best, and that there are signs of policy fatigue in a number of countries.

The task for the Fund is to help restore a sense of urgency in addressing medium-term concerns, in particular, more ambitious fiscal consolidation programs in a number of countries, accelerating structural reforms, and facilitating more widespread exchange rate flexibility as appropriate. This work is ongoing and, to avoid the Fund's policy messages being seen as becoming stale, it will require an innovative approach and a targeted communication strategy. Towards this end, it is important for the Fund to highlight the benefits of decisive policy action along with the costs of doing too little. A priority in this regard is promoting the benefits of multilateral trade liberalisation through the successful conclusion of the Doha Round. The Fund should be a catalyst for greater international cooperation and continue to highlight the global implications of developments. The Fund should also take the lead in highlighting the cost to a country of economic inflexibility and the inability to take advantage of technological change.

We particularly welcome the attention given in the latest World Economic Outlook to the economic implications of demographic changes, including the impacts on developing countries as well as the likely resulting global interactions. Pre-emptive policy action is needed, although the opportunities are closing fast for those countries where demographic trends are well advanced. Policy responses will vary among countries, but they will need to center on moves to boost labor supply, increasing savings (both public and private), and lifting productivity. While attention needs to be directed towards the longer-term challenges of an aging population, it has to be reinforced that the required policy measures are consistent with reducing short-term vulnerabilities and boosting growth prospects.

As part of the move towards greater strategic planning within the Fund, we would encourage the Board and Management to develop a work plan as to how the Fund can, through multilateral and bilateral surveillance, research work and communication strategies, help advance faster progress in addressing the medium-term challenges confronting the global economy.

Strengthening Surveillance

The move towards a more strategic, output-oriented management approach within the Fund is a key step towards strengthening surveillance. The recently completed biennial review of surveillance identified many measures to further strengthen surveillance – the challenge now is implementation. Some of the areas requiring progress which we would highlight include:

- identifying the specific objectives of each surveillance exercise, having regard to the circumstances facing the country(ies) concerned;
- closer integration of multilateral, regional and bilateral surveillance;
- ensuring that the issues being addressed are appropriately focused and prioritised, having regard to a country's circumstances;
- increasing the use of cross-country studies;
- promoting the depth and robustness of the policy dialogue between Fund staff and country authorities, as well as focusing on building trust with the authorities;
- strengthening the communication of the Fund's policy messages, not only through the publication of staff reports but also through increased outreach activities; and
- countries themselves should be encouraged to take the initiative to gain maximum value from Fund surveillance.

Greater attention must be given to assessing the effectiveness of Fund surveillance. The shortcoming with the biennial review was that it focused more on the processes of surveillance rather than attempting to assess the ultimate objective of surveillance, which is assisting countries implement appropriate policies. Each Article IV consultation should include an assessment of the responsiveness of the authorities to Fund policy advice in the past. While it is difficult to determine when Fund surveillance has had a positive influence on a country's policy choices, it is obvious when Fund surveillance is not effective. In such situations, it is important to identify why a country may not be following Fund policy advice, for this should be an important influence in determining the future direction of surveillance.

We believe that more strategic management of surveillance has the capacity to free up resources for other activities. Further consideration should be given to moving from a fixed timing for country consultations to one where both the timing and intensity of Fund surveillance is tailored more to the country's circumstances and, most importantly, the extent to which the Fund can add value.

In this regard, country authorities have an important role to play in setting out their expectations to the Fund of the role of surveillance in their own countries. This includes providing guidance to the Fund on areas where it may be most beneficial.

The Fund continues to debate whether there is a need to introduce a new policy on exceptional access under precautionary arrangements. The promotion of sound policies is the best form of crisis prevention. As such, we believe the focus of the Fund's role in crisis prevention should be on the measures identified to strengthen surveillance and assist countries implement appropriate policies. Precautionary arrangements within normal access limits have been successful because the focus of the program has been on the country implementing the necessary policy adjustments to reduce its vulnerabilities. Fund financing has been a secondary consideration. The extension of the policy to cover precautionary arrangements with exceptional access will change the emphasis from the role of the Fund in promoting policy adjustments to one of the Fund financing possible capital account crises. Moreover, it is not possible to assess a member's potential balance of payments needs should it be hit by a capital account crisis, and shifting the emphasis to the Fund's role in providing financing raises moral hazard concerns. The Fund has demonstrated that it can quickly provide financial support to members facing a crisis and can be flexible as to the size of the resources provided.

Role of the Fund in Assisting Low-Income Countries

The ongoing review of the role of the Fund in low-income countries is an important exercise. As this constituency has noted in the past, while the Fund has a valuable contribution to make in assisting with the development of low-income countries, it is essential that it operate within its mandate and area of expertise. The main contribution the Fund can make is through policy advice, providing technical assistance and, where appropriate, temporary financial assistance depending on a country's balance of payments needs. Consistent with our views on the need for more strategic planning, we welcome the development of a statement clarifying the role of the Fund in low-income countries. However, in order to give this greater operational meaning, we believe a similar statement should be tailored for each low-income country which would serve as a guide for the Fund's interaction with that country.

While the Fund can make a contribution, and must do so in close collaboration with other international institutions and bilateral donors, ultimately it is up to individual countries to put in place the policies and institutions needed for development.

The various reviews related to the Fund's activities in low-income countries which have been undertaken by the Fund and the Independent Evaluation Office (IEO) have been very informative. In particular, they have highlighted the tension between the Fund's traditional macroeconomic role of short-term stabilisation and the longer-term task of assisting low-income countries address their deep-seated problems. We are concerned that the Fund has centered its relationship with low-income countries through a financial program involving the use of Fund resources. The Fund's expertise and mandate do not sit well with it being a source of long-term development finance. More attention must be directed towards assisting countries exiting from a Fund financial arrangement, as well as responding to those that either do not want or need a financial arrangement with the Fund, but would still benefit from the intensive policy dialogue that is associated with a program.

We believe there is still a "gap" in the Fund's means of interacting with countries which needs to be rectified, and this will essentially involve increasing the intensity and effectiveness of Fund surveillance. The proposal for a Policy Monitoring Arrangement is one approach towards delivering more intensive policy monitoring outside a Fund financial arrangement. While the design features of the Policy Monitoring Arrangement will determine its attractiveness to members, an arrangement focused more on meeting the perceived needs of donors wanting a "signal" from the Fund in terms of an "on/off" measure of the adequacy of a country's policies will fall short of addressing the wider needs of low-income countries.

The IEO has provided a number of constructive recommendations regarding Poverty Reduction Strategy Papers (PRSPs) and the Poverty Reduction and Growth Facility (PRGF). In response to the IEO's findings, we welcome the proposed changes to the Joint Staff Assessments and Annual Progress Reports, particularly the effort to shift the emphasis from the production of documents to the development and implementation of policies. There are a number of other areas identified by the IEO which still need to be addressed in order to strengthen the Poverty Reduction Strategy process. Importantly, the focus should be on ensuring that the PRSP is a fully country-owned "strategic vision" for development and is targeted at the people in the country concerned.

Much progress has been achieved with the HIPC Initiative in providing debt relief to the world's poorest countries. It is unfortunate that a number of eligible countries have not qualified by establishing a policy track record that would allow their consideration for HIPC relief. We therefore support extending the sunset clause for HIPC availability for another two years. However, the HIPC and the newly-developed debt sustainability framework need to be linked. There cannot be a separate approach for determining when it is appropriate to stop lending to a country because of concerns over debt sustainability and a separate framework for determining when debt relief should be provided. The debt sustainability framework appropriately links debt thresholds to institutional strength and the quality of policies. However, we are concerned that the thresholds may be portrayed more as lending/borrowing targets rather than guideposts. The growth optimising level of debt for a country may be at a level well below that which puts it in risk of debt distress.

Quotas, Representation and Voice

Progress has been disappointing in addressing the under-representation of countries in terms of the distribution of quotas and the concerns of developing countries over "voice and participation". This is an issue that goes to the heart of the Fund's legitimacy, relevance and effectiveness. We trust that when the IMFC meets in 2005, there will truly be a "progress" report on this issue.