



International Monetary and Financial Committee

Twelfth Meeting
September 24, 2005

Statement by Mr. Gerrit Zalm

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On behalf of Armenia, Bosnia and Herzegovina, Bulgaria, Croatia, Cyprus,
Georgia, Israel, Macedonia, former Yugoslav Republic of, Moldova, Netherlands,
Romania, Ukraine

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Washington, September 23, 2005

Representing the constituency consisting of Armenia, Bosnia and Herzegovina, Bulgaria,
Croatia, Cyprus, Georgia, Israel, Republic of Macedonia, Moldova, the Netherlands,
Romania, and Ukraine

This statement presents the view of my constituency on the topics to be addressed at this year's IMFC meeting: the global economy, the IMF Strategic Review and the role of the IMF in low-income countries, including the G8 debt relief proposal. In addition, this statement gives our opinion on surveillance, crisis prevention and crisis resolution and the issue of microfinance.

World Economic Outlook

1. World GDP growth has moderated somewhat from the high 5.1% recorded in 2004. **So far, the world economy has weathered the oil shock well and short-term global growth prospects remain relatively benign.** Although the devastation caused by Katrina in the southern part of the United States has added to downside risks, the short-term economic outlook for the US continues to be strong. Despite anti-cyclical measures, in China the danger of overheating has not yet disappeared. By strongly rebounding from a short and shallow recession in 2004, Japan is doing better than previously expected. Emerging markets – in both Asia and Latin America – fare well, with growth rates slowing to more sustainable paths. The sluggish recovery in the euro area underlines the need for further structural reforms, in order to increase flexibility of labor, product, services and capital markets, and thus economic potential.

2. Although a short-term setback in US growth due to Katrina could temporarily reduce import demand, research indicates that its global economic consequences – notwithstanding the dramatic human consequences for those affected by the disaster - are likely to be limited. While consumer confidence typically falls after the disaster, the effects on consumption are generally muted, or even absent. That said, unlike most other natural disasters, which have locally limited effects, the **hurricane Katrina has a clear 'global component'**. A number of oil facilities and refining capacities were severely damaged, generating higher oil prices (and

even larger effects on gasoline prices). It is obvious that there is a redistribution of wealth towards oil producing countries.

3. Model simulations suggest that if oil prices will indeed sustain their elevated levels, consequences for growth and inflation will continue to be felt in the years to come, both by consumers (seeing their purchasing power lowered) and firms (facing falling profits). **To forego more damaging effects of more expensive oil, it is crucial that second-round effects through inflation and wages be kept at bay.** Due to energy subsidies, a number of governments, especially in lower income countries and emerging markets, face increasing difficulties in their budgets and current accounts. It makes the well-known messages of further increasing energy efficiency, lowering oil dependency and stepping up investment in exploration and refining capacity even more acute. Furthermore, we welcome the proposed IMF shock facility within the PRGF (see also paragraph 22), where its use should be made conditional upon the phasing out of energy subsidies. Moreover, I would appreciate to further discuss in the near future the longer-term consequences of more expensive oil and the challenges the international community faces in a world of higher energy prices, building on the Spring WEO where the IMF took the lead in raising these issues.

4. Increasing global external imbalances represent an ongoing risk to the world economy. Most importantly, as **global external imbalances are expected to widen** in the coming years, the possibility remains of a disorderly adjustment. I welcome the reform of China's exchange rate regime, as it presents an important first step towards more exchange rate flexibility in Asia. For a positive contribution to lowering imbalances, the de facto appreciation of the renminbi that the Chinese authorities will allow is crucial. In any case, as simulations in the WEO indicate, an orderly adjustment of global imbalances needs primarily a structural increase of private and public savings in the United States. As a final risk, **long-term interest rates remain unusually low** and have recently touched levels not seen in more than half a century. As it is difficult to fully explain this exceptional situation by economic fundamentals, or other factors (such as the behavior of pension funds and Asian central banks), an (abrupt) increase is not unthinkable. Such a move will negatively impact on investment, consumption and financing costs for emerging economies. The substantial (and possibly unsustainable) increase of house prices in various parts of the world poses a related, additional risk.

IMF Strategic Review

5. My constituency welcomes the report by the Managing Director on the IMF Strategic Review. The report's theme of globalization reflects several of the challenges we face today and in the future. To have a clear view of how globalization and other challenges interact with the Fund's own role, my constituency believes that we should start with a closer look at the institution's core area of promoting macroeconomic and financial stability and, supporting that, the micro functioning of public finance and the financial sector. Based on this, the Fund's activities and instruments should be evaluated and where needed, changed, intensified or discontinued.

6. Within and across the Fund's core area, coherence, effectiveness and efficiency should be enhanced through a more integrated approach across the Fund's organization. This will enhance resource efficiency and the quality and relevance of work. Thus, more attention is needed for how to derive technical assistance needs from surveillance and how to better relate bilateral to multilateral surveillance and *vice versa*. More can and should also be done to integrate financial sector issues into the Fund's mainstream work, in particular in the area of surveillance. Part of enhancing effectiveness and efficiency would be strengthening the relevant expertise and improve the division of labor with other multilateral organizations, in particular the World Bank.

7. My constituency is pleased that the report of the Managing Director envisages the implementation of a medium-term budget for 2006. The Fund requires a transparent multi-annual budget that is scrutinized by a sound audit process, and an annual decision-making cycle that promotes coherence and rationality. This will provide better insight into the match between ambitions and resources, and stimulate the Fund to set priorities.

8. My constituency fully supports the notion in the report that policy collaboration is likely to be most effective when undertaken in the context of a universal institution, i.e. the Fund. In this respect, more active Fund engagement in the policy debates determining public opinion and policy choices is of importance. Indeed, safeguarding and strengthening the central role of the Fund in the international monetary system is essential, for instance by timely discussing relevant issues, such as global imbalances and exchange rate issues. According to my constituency, the Fund should be *the* forum where coordination and decision making on issues related to the international monetary and financial system takes place.

9. On the issue of governance, my constituency would like to emphasize that the Fund is a truly global and inclusive organization, in which each country has a say on the decisions made through its constituency. In this regard, we would like to mention the advantages of mixed constituencies. **Member states' quota should remain a reflection of their relative positions in the international financial system.** If warranted, we are prepared to consider ad hoc quota increases for the most clearly underrepresented emerging economies, based on the current system of quota formulas. To enhance the voice of low-income and transition countries, we support further increasing the capacity of constituency offices, as well as increasing the number of basic votes.

Surveillance, crisis prevention and crisis resolution

10. **The build-up of global external imbalances illustrates that the effectiveness of the Fund's surveillance needs to be enhanced.** My constituency supports the call for greater focus, concentrating surveillance work on the core areas of the Fund. To this end, regular surveillance should focus more on issues regarding members' financial sector and the international monetary system – including exchange rate policies – and less on structural policies that are important but beyond the core area, such as reform of health care systems. Regular surveillance reports should also provide an evaluation of the extent to which members have followed up on earlier Fund advice as well as whether this advice was appropriate. Furthermore, the effectiveness of surveillance benefits from the Fund's transparency policy aimed at stimulating the timely publication of country reports, particularly because the public availability of reports that provide up-to date economic data and policy assessments by the Fund will contribute to market discipline. In a similar vein, my constituency encourages the Fund to increase the accessibility of reports on the implementation of international standards and codes (ROSCs) and financial sector assessments (FSAP reports) and to better integrate the main findings from these reports in Article IV consultations.

11. **My constituency welcomes the intention of the Fund to clarify its approach and role regarding capital account liberalization,** as has also been suggested by the Independent Evaluation Office. The benefits of ultimately liberalized capital flows should be the central point of departure of the Fund's work in this field.

12. My constituency is not in favor of new instruments that would serve as a financial insurance through ex ante, open-ended commitments of Fund credits. Such instruments would have several drawbacks. First of all they are likely to raise moral hazard. Secondly, insurance instruments inherently face an exit problem, as terminating arrangements of participating countries that allow policy slippages may cause an adverse financial market reaction. Thirdly, in case a crisis occurs, these instruments lack the conditionality designed to address the underlying cause of a crisis. This could severely undermine the effectiveness of the Fund's intervention and jeopardize the Fund's resources. Ultimately, being a member of the Fund, and implementing sustainable economic policies, provides the best insurance, where precautionary arrangements can be augmented if needed.

13. My constituency calls for measures to discourage longer term exceptional use of the Fund's financial support and to ensure the timely exit from Fund support. This would require a revision of the system of charges in order to introduce an equal financial incentive structure in all GRA facilities with two main purposes: 1) reducing the attractiveness of longer-term exceptionally large borrowing and 2) preventing facility (s)hopping, in which countries request support under the cheapest, but not necessarily most appropriate, facility. Furthermore, my constituency encourages the Fund to secure an exit policy for countries which have exceptional access to the Fund's resources. In this regard, we believe that low access precautionary arrangements should be the central element of exit strategies for countries that have no acute financing need, but are not yet ready to return to a surveillance-only relation. To ensure a steady decline in Fund exposure, (precautionary) access under such an exit policy should be low and subject to strict and declining overall access limits.

14. More analytical work is needed on timely, orderly and effective crisis resolution that ensures an appropriate involvement of the private sector. In this regard, consistent and strict adherence to the exceptional access framework remains crucial. My constituency invites the Fund to clarify its role in sovereign debt restructuring, and design an integrated approach to the different elements of this role, such as lending-into-arrears and information dissemination. Regarding the latter, my constituency believes that the dissemination of timely and accurate information (e.g. debt sustainability analyses) by the Fund is of primary importance, as this may facilitate restructuring negotiations between the debtor and its private creditors. Furthermore, a more comprehensive follow-up discussion on the IEO's evaluation of the role of the Fund in Argentina is warranted. Finally, we strongly encourage leading bond

issuing emerging countries and the private sector to make progress with the implementation of the Principles for Stable Capital Flows and Fair Debt Restructuring in Emerging Markets, and invite the IMF to monitor this progress carefully.

Debt relief

15. My constituency was among the first to support a new round of multilateral debt relief to low-income countries in order to help these countries achieve the Millennium Development Goals. We therefore welcome the G8's initiative.

At the Spring meetings my constituency noted that any initiative for further multilateral debt relief should be built on three key principles: First, its financing should be additional, making more resources available for development. Second, it should be based on uniform treatment. Third, it should benefit countries that follow strong economic policies, to reduce moral hazard and increase MDG effectiveness. The G8's initiative is largely in line with the wishes of my constituency, but **in order to improve the initiative further, I believe it can and should be strengthened in each of these three areas, in particular regarding additionality.**

16. **Additionality** is needed to ensure that the initiative truly helps countries to bring the MDGs closer to realization, and to protect the financial solidity of the participating institutions. To safeguard the long-term financial strength of the institutions involved, IDA and AfDF should receive their compensation on top of regular donor contributions. Donors should give binding commitments for the compensation and guarantee a generous minimum growth rate for the volume of IDA's and AfDF-assistance. For those countries that have not reached the 0.7% target yet, commitments in the framework of this initiative should be additional to existing commitments. The OECD DAC should monitor whether contributions truly help countries reach the 0.7%. With regard to the IMF, I am open to the use of Fund resources for debt relief, but I do think further discussion is needed on the pros and cons of the various ways to implement this. The resulting financing proposal should guarantee the financial solidity of the Fund and its capacity to provide financial support to all members facing temporary balance of payments difficulties. This includes i.a. ensuring that sufficient resources remain available within the interim, as well as the self-sustainable PRGF to meet the foreseen lending demand of all PRGF eligible countries. In this regard, my constituency finds that the debt relief proposal, together with the introduction of new instruments for low-income countries (see paragraph 5), requires further IMF analysis on the consequences for the financing need of the self-sustainable PRGF. Regarding the latter, depending on the outcome

of this analysis and the details of a possible request, the Netherlands continues to stand ready to provide extra temporary bilateral loans to support the PRGFs loan capacity.

17. In order to guarantee the principle of **uniformity of treatment my constituency advocates** broadening the group of eligible countries for *IMF* debt relief. This is both a matter of principle and effectiveness, especially when considering Fund resources as a source of financing. In this regard, we would favor the principle of including all IDA-only countries in the initiative.

18. To increase the **MDG-effectiveness** of the initiative it is important that sound economic policies are in place as debt relief takes its effect. This will contribute to macroeconomic stability, which we regard to be a crucial precondition for achieving the MDGs. If countries have reached completion point more than one year ago, if their Fund supported program is off-track or if they have never participated in the HIPC initiative, rigorous Fund and World Bank assessments should point out that their policies meet a standard similar to HIPC completion point triggers, specifically with regard to prudent public expenditure and debt management, in order to receive the debt relief.

19. **In my view, escaping the vicious cycle of lend and forgive is as important as debt relief itself.** Debt relief should remain highly exceptional, as it poses a moral hazard and undermines countries' credit culture. Therefore, a prudent approach to new borrowing and lending is warranted. To this end, the new debt sustainability framework for low-income countries should be applied strictly. This framework should not only apply to international financial institutions' lending policies, but should be relevant to *all* lending to low-income countries. We therefore encourage the IMF and WB to provide all low-income countries with forward looking DSAs as soon as possible. Self evidently, countries should not be unduly excluded from new borrowing, as prudent borrowing can facilitate development and nourish a credit culture. Therefore, we do not yet see the need to adjust the debt sustainability framework for low-income countries, but would prefer to assess its appropriateness at the review foreseen for spring 2006.

The role of the IMF in low-income countries

20. My constituency believes the IMF has an important role to play in all its member countries, including low-income countries. **We are in favor of countries being able to give a**

strong signal towards donors on the quality of their macroeconomic policy without necessarily a substantial financial involvement of the Fund. As the positive experiences in my constituency illustrate, precautionary arrangements and low-access PRGF programs provide a valuable signaling instrument without leading to a significant build-up in debt levels. **My constituency welcomes the recent IMF proposal for a Policy Support Instrument (PSI) for low-income countries, as it foresees in an *additional* instrument with a voluntary, demand-driven nature and a clear focus on mature stabilizers.** To guarantee equal treatment and effectiveness and to preserve the value of existing signaling instruments, my constituency finds it essential that a PSI contains similar levels of conditionality, Board involvement and ownership as those of borrowing programs.

21. **My constituency welcomes the IMF proposal to increase the use of assessment letters in order to help fill information gaps.** These letters should provide open and nuanced information and are ideally formulated automatically when regular program information ceases.

22. **My constituency welcomes the proposed IMF shock facility within the PRGF, as it provides financial support for those low-income countries that do not have a financial relationship with the Fund, including future PSI users.** My constituency is of the opinion that the shock window should have the same level of conditionality and Board involvement as PRGF arrangements and that automatic access of future PSI users to the new shock facility would not be appropriate. Every country's financing request should be accompanied by a (new) Letter of Intent, on the basis of which the IMF Board is able to make a well-informed decision. Again, in order to prevent an unnecessary accumulation of instruments, we also call on the IMF to verify whether the introduction of the new shock facility makes other instruments redundant.

23. Since IMF financial support is relatively expensive for poor countries, IMF financing should remain as limited as possible and especially have a catalyzing effect towards less expensive support from other donors, among which the World Bank. Apart from financial assistance to mitigate the negative effects of exogenous shocks, **technical assistance and policy advice aimed at strengthening countries resilience to shocks is also of great importance.** **My constituency therefore calls on the IMF and the World Bank to further analyze this issue in the near future.** In doing so, the development of the financial sector

should be central, since this can contribute to better risk allocation mechanisms through the development of markets for insurance- and hedging instruments.

Microfinance

24. We welcome the attention that is given to microfinance during this *UN International Year of Microcredit*. **The potential benefits of microfinance are large**, not only for poverty reduction but also for broad-based macro-economic performance. In order to reap these benefits, efforts are needed at different levels. At the **micro level** capacity building, for example better governance and risk-management and the adoption of new technologies, can improve the functioning of microfinance institutions. At the **meso level** adequate data is needed for all those involved in the microfinance sector, including supervisors, donors and commercial banks. I would like to encourage the IMF and the World Bank to review data availability on microfinance and assist in the accumulation of data that is accurate and standardized in order to enhance comparability. Data availability will facilitate the establishment of national strategies directed at increasing access to financial services for the poor. At the **macro level**, maintaining macroeconomic stability is a prerequisite for microfinance and the functioning of the financial sector in general. A sound regulatory framework, appropriate supervision and a healthy investment climate are essential as well. Through its regular surveillance work, the IMF can continue to address these policy issues where relevant. We therefore welcome the attention the IMF and World Bank have paid to the microfinance sector in certain Financial Sector Assessment Programs and encourage the Fund and World Bank to continue to examine this sector in FSAPs where appropriate.