International Monetary and Financial Committee

Fourteenth Meeting
September 17, 2006

Statement by Guido Mantega
Minister of Finance, Brazil
On behalf of Brazil, Colombia, Dominican Republic, Ecuador, Guyana, Haiti, Panama, Suriname, Trinidad and Tobago

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The Global Economy and IMF Surveillance

1. We do not wish to delve here into the diagnosis and prescription regarding the persistent imbalances in the global economy, which are already well known and understood. While we continue to regard the disorderly unraveling of the global imbalances as a low-probability event, it is a scenario that ought to be kept in mind because of the enormous costs it would entail, and because timely and well-designed action will be necessary to keep that probability low. It is not sufficient, however, to ensure that the imbalances are scaled down in a manner that preserves the orderly functioning of the international financial markets. The common interest of all parties most directly involved, shared by the world at large, dictates that the correction should be coordinated in a way that redistributes aggregate demand without taking the global economy off its growth path.

2. While the calls for coordinated action reflect the caution to unwind global imbalances without seriously dampening the global growth momentum, such worries have now ceded ground to the risk that the US economy might go into a cyclical downturn even without measures having been taken to tackle the imbalances. Interrelated factors such as the lagged effects of the monetary tightening, the cooling of the housing boom, the continued high oil prices and a loss of consumer confidence might be leading to a slowdown in the US economy. Although the growth of the world economy has become more broad based, with clearer signs of a pickup in activity both in Japan and in the euro area, on balance the risks to the global growth outlook seem to be tilted to the downside. This is an important conjunctural element to be factored into any plan to reallocate global demand. Together with the complications added earlier by the oil price increases, it is also a reminder that the gradual resolution of the global imbalances will require continued adaptation to an ever-changing economic environment.

3. Another new element in the landscape has been the recent launch by the Fund of multilateral consultations on the subject of the global imbalances. First and foremost, of course, success in this exercise could unlock the process of an orderly and growth-preserving correction of the imbalances themselves. But the significance of the ongoing multilateral consultations extends much beyond their specific theme. If successful, they may also herald a new phase of enhanced effectiveness of the IMF in providing advice to and facilitating policy coordination among countries that neither borrow nor contemplate borrowing from the Fund. Ineffectiveness of the Fund in promoting policy adjustment in these countries has had more to

do with their own unwillingness to take on board the Fund's advice than with the Fund's inability to lay out the advice in a clear and cogent manner. Accordingly, the key to the success of the multilateral consultations is mostly in the hands of the members directly involved in the exercise. The decisive factor will be their readiness to make progress in a concerted fashion, even if each one of them might not be disposed to move unilaterally.

4. The fate of the multilateral consultations will also have far-reaching implications for how to proceed along several dimensions of the proposed review of the Fund's surveillance practice. Such review is progressing on different fronts and more time will be necessary for the different components to be brought together into a coherent package. Parts of the reform seem to be motivated by the good housekeeping objective of bringing the statements of policy more clearly in line with the way practice has evolved in the area of surveillance, removing quaint and anachronistic elements – although it is not yet entirely clear whether any of this is indeed necessary and whether the potential benefits trump the difficulties of crafting a new and untested surveillance framework. Other parts of the reform would try to sharpen the Fund's statement of conjunctural priorities for surveillance, or to bring all members together in a symbolic renewal of the vows already expressed in the Articles of Agreement. The merits of these more substantive innovations are also not entirely established yet, but they will find a perfect testing ground in the multilateral consultations. After all, the consultations amount to a very clear statement of surveillance priorities and their outcome will rest on the willingness of prominent members to make good on the mutual obligations entailed by membership in the Fund. The review of surveillance, therefore, cannot afford to ignore the lessons that will be possible to extract from the multilateral consultations as they go along.

5. However, insofar as correcting global imbalances is to become a fruitful application of IMF surveillance, it is imperative that the legitimate interests and collective experience of all IMF members be heard in a comprehensive, balanced and adequately proportionate manner. Multilateral consultation among members stands to gain in scope and efficiency of results only when *de facto* appraisals of past IMF actions and recommendations by those countries that experienced them firsthand are duly taken into account. These lessons from the perspective of the membership at large are also something that the reviews of surveillance cannot afford to ignore.

Emerging Markets and Crisis Prevention

6. While crisis management has been the keynote of IMF action in the 20^{th} century, crisis prevention has become the overarching goal for the 21^{st} century. Given that there is no better long-term insurance against the recurrence of crises than steady and self-sustained growth, it may be time to conduct an in-depth reflection on future IMF policy design to be geared towards promoting, aiding and inducing growth. A serious commitment to address and correct existing imbalances, not only among major economies themselves but also among those and the economies of the remaining IMF members, seems to offer a promising way forward.

7. Conditions in international capital markets have been benign to emerging markets in the last few years. Many emerging markets have taken advantage of these favorable conditions not to launch themselves onto unsustainable economic programs, but instead to

build up their ability to withstand adverse developments in the global environment. Most of these countries have persevered in their efforts to entrench sound macroeconomic policies and to enhance resilience to negative exogenous shocks. A more comfortable buffer of international reserves and the reduction of the foreign currency exposure of governments have been important elements of the self-insurance strategy adopted by a number of emerging markets. The latest *World Economic Outlook* acknowledges, in particular, the great progress made by Brazil and Colombia in that direction.

8. The recent episode of market turbulence in May-June of this year has amply demonstrated the virtues of such self-insurance measures. In earlier crises, foreign currency exposure of the government was an important mechanism by which adverse shocks were magnified, as reversals of capital flows caused domestic currencies to depreciate, thereby worsening debt dynamics and giving investors greater reason to flee – or to stay only if country risk premia had already widened considerably. In countries that did reduce their governments' foreign currency exposure, this element was conspicuously absent in the last turbulence episode. As a result, there was no fear that market movements might spiral out of control, and these movements were either temporary or limited to a natural correction in some asset prices that had undergone more substantial increases. It is particularly remarkable that these same countries, as markets calmed down, managed to continue with their previously envisioned macroeconomic policy programs, without the need for any major reassessment as a consequence of the temporary volatility.

9. In Latin America, many countries have also given demonstration that sound macroeconomic policies are a widely supported option and are not necessarily threatened by the political cycle in their vibrant democracies. The mere fact that a large number of countries in the region were going through elections this year had been mentioned as a cause for concern over their macroeconomic stability. Yet the countries have maintained their commitment to responsible macroeconomic management regardless of the political orientation of the elected presidents. Key election campaigns have also caused no major market anxiety or deviations from the commitment with prudent fiscal and monetary policies. The significance of this break with the region's past should not be underestimated, especially in terms of creating an economic climate more conducive to investment and growth, and in terms of protecting the income of the poorer against the ravages of macroeconomic instability and inflation.

10. Emerging market countries have been insisting on the need for the Fund to complement its toolkit with a financing mechanism aimed at crisis prevention. The fact that these countries have become increasingly resilient through their own self-insurance efforts does not diminish the importance of a multilateral insurance mechanism, not only for their own sake but also for that of an increasing number of countries destined to gain access to international capital markets and to be exposed to the vagaries of capital flows. The realization that emerging market countries have also become much less prone to instability associated with their own political cycle may actually help reduce the resistance of skeptics to the merits of such a facility, which would be available to strong performers in terms of policy that may still want to reinforce their insurance against exogenous shocks to their capital accounts. In addition, there are natural limits to self-insurance efforts, given the opportunity

cost of holding the class of assets currently available for reserve accumulation, and the difficulties faced by countries to diversify risks and obtain more favorable returns on their official reserves.

11. The time is uniquely propitious, as a result, for the creation of a crisis prevention facility by the IMF. Such facility would in no way induce emerging market countries to adopt lax or complacent policies towards their remaining vulnerabilities, and that, quite to the contrary, it would act as an important additional catalyzer of sound policies. Such policies are often akin to investment with sunk costs, requiring a concentrated upfront sacrifice and yielding a long-lived, and sometimes deferred, stream of benefits. For this kind of proposition to be even more attractive, it is important that future benefits be secured from the dangers represented by exogenous shocks, which might otherwise rob countries of the full payoff in the name of which they made sacrifices in the first place. That would be exactly the role played by a financial facility for crisis prevention.

12. We are encouraged by the fact that the topic is advancing in the IMF Executive Board, with a number of chairs that have traditionally expressed skepticism towards crisis prevention facilities showing a constructive willingness to engage in the discussions and to consider concrete design options. An important step forward was taken recently with an exchange of views motivated by a sample design put forward by IMF staff, under the name of *Reserve Augmentation Line* (RAL). Although much remains to be done in refining the design of the RAL – in particular, to enhance the reliability of access to financial resources and to reinforce the positive signaling effects provided to customers – it has been a very productive starting point. We now look forward to further progress following the Singapore meetings, and a realistic timetable would aim at having the design finalized by the Spring Meetings of 2007.

Quotas and Voice Reform

13. We share the view that quota and voice reform is very important for the legitimacy of the IMF, and the Fund's legitimacy is in turn a particularly strong concern in developing countries, where the institution has played its most active role in influencing policies. With that consideration in mind, we have initially approached the two-stage process proposed by the Managing Director with a sense of what we termed cautious but positive expectation. We have repeatedly expressed our willingness to support a small ad hoc increase in the quotas of countries found to be unequivocally under-represented, to be interpreted as a down payment towards a second stage of more fundamental reform. The more fundamental reform would involve an overhaul of the arcane and imbalanced system of quota formulas currently in place, and an increase in the Fund's basic votes.

14. Our vision for the reformed system of distribution of the voting power in the Fund includes three key ingredients. The first would be a new, simple and transparent quota formula, having GDP as its natural cornerstone, but also reflecting in an important manner criteria that capture both the potential need for Fund resources – the variability of external accounts – and the actions by which individual countries self-insure against such need – international reserves – thereby contributing to the stability of the international monetary system. The second would be a device to prevent the already sizable shares of the largest

advanced economies from increasing further, once a formula with greater weight on GDP is adopted. The third is an ambitious increase in basic votes, in order to protect the interests of the smaller economies, particularly in a context of greater alignment of quota shares with economic size. Combined, these three elements would promote a rebalancing of quota shares while protecting and enhancing the consolidated share of developing countries.

15. Regrettably, we cannot conceal our disappointment with the final terms of the resolution recently put before the Board of Governors, especially in light of the progress in consensus building that was being made under the auspices of the G-20. The particular reference to the openness variable in the proposed resolution, although not a precommitment to any particular set of weights in a new formula, sends a message that is quite worrisome to developing countries as a group. Although many developing countries have indeed benefited from greater trade openness, it would seem to us a paradox that while the Doha Round is regrettably paralyzed and progress toward greater openness is, therefore, limited – despite the efforts and goodwill of developing countries – that a variable so dependent on political economy considerations, and not controlled by market forces, is mentioned as a component to play an important role in the new formula. Such concerns are aggravated by the well-known methodological problem of taking into account trade conducted in a common currency.

16. The report accompanying the resolution mentions the possibility of large advanced economies forgoing share increases to which they might be entitled under the new formula. Besides being a fragile discretionary arrangement, only one of the shareholders involved responded favorably to the proposal. Moreover, the commitment included in the resolution with respect to an increase in basic votes is meant to avoid further erosion of the voting stakes of low-income countries as a result of upcoming increases in the Fund's total quota, and not to redress, as it should, some of the substantial erosion already suffered by the share of basic votes in the total voting power.

17. These features of the resolution point in the direction of a realignment of quota shares that might well end by increasing even more the already ample majority held by the advanced economies in the total voting power in the Fund. This would certainly be a preposterous result and clearly inimical to the avowed objective of promoting the Fund's legitimacy worldwide. Even if the consolidated share of developing countries is not reduced, the result would be highly unsatisfactory if it entailed an increase in the share of certain emerging markets at the expense of all other countries in the developing world. This is not an unrealistic scenario when one takes into consideration that the largest advanced economies would be entitled to share increases with the new formula, and would at best forgo such increases to maintain their current shares, and that a crucial group of advanced economies holding enough voting power to block any progress have indicated that they would not accept a realignment that reduced their share. The only way the realignment can take place is at the expense of a large number of developing countries, which may lack, precisely because of the existing imbalance of voting power, the ability to block such an outcome. If the reforms deliver on the protection promised to low-income countries, the realignment would be entirely at the expense of a selected group of middle-income countries.

18. For these reasons, our chair has voted in the Executive Board against the decision to submit the resolution to the Board of Governors. We have also cast our vote of disapproval of the resolution at the Board of Governors. Looking forward, we will remain engaged in the discussions and will strive to prevent the materialization of a result that is inequitable and counterproductive to the desirable enhancement of the Fund's legitimacy. We stand ready to openly remove our objections to the reform process once it has advanced sufficiently to present material elements that dispel our present misgivings.

19. In conclusion, whether dealing with specific issues in surveillance, crisis prevention or quota and voice, no significant or worthwhile progress can be achieved in redressing asymmetries among the positions of members, unless expanded representation and continual consultation mechanisms are pursued in earnest. Advancements in these pursuits will be greatly facilitated by an early and widespread acceptance, prior to getting down to key topical and technical discussions, of the imminent need for overall reappraisal of the Fund's role in a changing world. From our perspective, we stand convinced that in order to renew, in this century, the relevance and weight it enjoyed in the global scene in the past one, the IMF shall be increasingly urged to carve out an objective and a committed role for itself in the equitable promotion of growth and development worldwide.