International Monetary and Financial Committee

Sixteenth Meeting
October 20, 2007

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 Financial Markets

1. Let me begin by quoting John Maynard Keynes, the greatest of the brains involved in the founding of this institution: "The expected never happens; it is the unexpected always."

2. When we gathered at the Spring Meetings, who would have predicted that the international economy would evolve the way it has, in the six months since then? There was concern about global imbalances and the deterioration in the financial markets, particularly in the United States. But, as Keynes said, "it is the unexpected always." No one would have believed that a few months later the United Kingdom, for example, would be facing a classic run on banks, like the kind we used to see in the 19th century, and that simultaneously emerging, merely emerging economies like Brazil's would receive, shortly after the international crisis, abundant inflows of capital and face upward pressure on their exchange rates.

3. While various emerging economies—not all of them, evidently—are suffering from an "embarras de richesse" in terms of supply of foreign capital, the United States and a considerable part of Europe are having serious difficulties in financial systems. Allow me to point out the irony of this situation: countries that were references of good governance, of standards and codes for the financial systems, these are the very countries that are facing serious problems of financial fragility putting at risk the prosperity of the world economy. Decidedly, Keynes was right: "It is the unexpected always."

4. The Fund appears to be inadequately equipped to face such a situation. It became clear that the technical staff of this institution needs to fine-tune its knowledge of financial markets, as the Independent Evaluation Office has already emphasized in recent documents.

5. Might not the Fund also be lacking equilibrium? When crises broke out in Latin America and Asia, the IMF promptly came up with a standard package of recommendations

in macroeconomics, finance, and other fields. There was no hesitation in expressing opinions and dictating policies. Subsequently, many of those recommendations were shown to be mistaken or questionable, to say the least.

6. The present crisis has its epicenter in the United States, and for the time being, has affected primarily U.S. and European financial markets. The Fund had little to say that was practical about this crisis. It has been excessively cautious in its recommendations. It justifies this caution by pointing to the unprecedented nature of the problems.

7. Brazil today is in a relatively solid position. We are a developing country with many of the problems typical of developing countries. But our macroeconomic situation has evolved for the better since 2002. Inflation is under control, as are public finances. The public debt/GDP ratio has shrunk somewhat. There has been a notable reduction in external vulnerability. In 2007, we will experience the fifth consecutive year of surplus in the current account. Brazil's international reserves have increased considerably. We can already speak about a cycle of sustainable growth.

8. The domestic financial system is quite solid and subject to advanced requirements in terms of regulation and transparency. Credit has increased in recent years and there has been considerable reduction in interest rates and a lengthening of terms. We continue to work to strengthen the system and prudential regulation.

9. In Brazil, hedge funds are subject to regulation and supervision. We have established prudential requisites for governance and transparency. Among the most important aspects are requirements for diversification and transparency of investments and the disclosure of information to investors regarding the value of shares, with daily marking-to-market, and regarding the risks and profile of the investments. The recent crisis in global markets was caused by "hedge funds," which are not subject to regulation or supervision.

10. In developed countries, and in other countries too, there is a need to strengthen the regulation of derivatives markets and to pay close attention to hedge funds. Much of the fragility resides apparently in those speculative funds that are highly leveraged and not subject to regulation and supervision. It does not seem to me that regulation of the financial system as a whole, and of those sectors in particular, has received the attention it deserves from the IMF. The present crisis denotes a need for progress in terms of legislation and prudential measures. It is appropriate to submit concrete proposals that increase the transparency and solidity of those markets. Probably this would include the full adoption of Basel II and other specific prudential rules.

11. The Fund could contribute, for instance, in the design of proposals for regulation or could coordinate initiatives for that purpose, making use of its knowledge of country experiences, besides deepening its analysis of cross-border capital flows. This could be an

important element in strengthening the fundamentals of financial markets, limiting leverage, and establishing suitable preventive measures.

Quotas and Voice

12. Since April, progress has been made in quota reform from the conceptual standpoint, as shown in the report of the IMF Executive Board to the Board of Governors. But we have gone no further than that. Additional effort is needed on the part of the Executive Board to ensure tangible results in identifying a new quota formula and allocation mechanisms for the second round of quota adjustments.

13. The slow progress is chiefly attributable to resistance to change on the part of developed countries, which are overrepresented in terms of voting power. These countries need to understand that while the reform process is a zero sum game from an arithmetical point of view, it is not a zero sum game from the political point of view.

14. The incoming Managing Director, Dominique Strauss-Kahn, is right to say that Europe must grasp that it would be better for Europe to have a reduced, albeit still very meaningful, representation in a thriving institution that enjoys global acceptance, than to have exaggerated, inflated representation in an institution that suffers from growing problems of credibility and legitimacy.

15. Brazil and the other countries in our constituency have endeavored to make a contribution to this reform process, working together with other countries, from the developed and developing worlds.

16. Certain developed countries, including the United States, have shown more interest in this issue. The United States government could be more actively involved, however. It has not escaped the attention of the United States—nor of anybody else, for that matter—that this reform process is crucial to ensuring the IMF's viability. Any modest result, which simply tinkers at the margins, would call into question the relevancy and the legitimacy of the Fund. Developing countries, or many among them, would go their own way, were the perception to arise that reform will not happen or that we will be left with a purely cosmetic reform. We will seek self insurance by building up high levels of international reserves, and we will participate in regional reserve-sharing pools and regional monetary institutions. The fragmentation of the multilateral financial system, which is already emerging, will accelerate.

17. Brazil can do little to halt this trend if the major developed countries do not take an interest in transforming the IMF into an institution that is truly representative.

18. If the Fund is to have legitimacy, it is essential that quota reform result in a substantial shift in voting power from developed countries to developing countries.

International public opinion will not take seriously any reform that fails to give significantly more weight to emerging and developing countries. The Fund cannot continue with a voting structure that essentially dates back to the time of its establishment over 60 years ago.

19. It is premature to set a numerical target—a transfer of voting power amounting to x or y percentage points from the developed countries to the emerging and developing countries. And yet, for the good of this institution, we will not accept proposals that merely consolidate the status quo. Reforms of this kind occur quite infrequently, and accepting a pseudo-solution would mean that hopes for change would be dashed for years and years to come. We have to wonder: could the Fund survive this?

20. In closing, I would like to touch upon a number of points that we regard as crucial for this negotiation:

First: GDP should be the dominant variable in the quota formula. A 50 percent weight is an improvement in relation to the traditional formulas, but it may prove insufficient to achieve the objectives that I have mentioned.

Second: it is necessary to include PPP-GDP in calculating this variable. We accept a "blend"—however, the PPP component should be dominant.

Third: the presence of a "blend" in the formula does not rule out the use of quota allocation mechanisms or "filters" that favor developing countries.

Fourth: the openness variable has well-known problems of definition (essentially it takes account of gross flows and not value added in foreign trade). If, for reasons of statistical limitation or other considerations, it proves impossible to correct the definition, we would recommend a considerable reduction in the weight of this variable.

Five: Further work is needed to redefine the concept of variability. The current definition suffers from serious deficiencies, as it has little or nothing to do with the potential need to borrow from the Fund.

Sixth: the interests of smaller and low-income countries should be taken into account through the use of a compression factor and a sizable increase in basic votes.

Seventh: the second-round quota adjustment should include a substantial increase in total quotas, far exceeding the level considered in the exercises so far presented by Fund staff.

21. Our constituency stands ready to discuss these and other reform issues in a spirit of pragmatism and flexibility.

Development of New Income Model for the Fund

22. Our chair supports the development of a new income model for the Fund that would produce a better distribution among member countries of the burden of financing the Fund's diverse activities in a sustainable way. Given the complexities involved in the proposed framework, a better understanding of the whole process is necessary before a formal decision to amend the Articles is presented. Although <u>we do not consider that the issue of the Fund's expenditure is of lesser concern, our chair concurs to proceed with the development of the income model independently of the discussions on the expenditure side.</u>

23. We agree with the general framework for the new income model. Our chair considers the proposal of gold sales an effective way to raise the Fund's income. Therefore, we support the selling of a limited amount of gold. Moreover, we agree with the proposal to broaden the Fund's investment authority.

24. On the use of quota resources for investment, we agree in principle with the proposed framework, but further clarifications are necessary. The proposal needs to be well assimilated as it may imply a fundamental change in the use of quota resources. For a clear understanding by the membership, each of the necessary steps to implement the proposal needs to be well explained.

25. On the issue of charging for bilateral technical services, we reiterate our view that technical assistance (TA) is an integral part of the core functions of the Fund as it is instrumental in supporting the implementation of policies by member countries. TA, as a public good, generates international positive externalities. We do not support charging for TA.

New Liquidity Instrument – Reserve Augmentation Line (RAL)

26. Our chair encourages the Fund to continue its work in establishing a new liquidity instrument specifically designed to support crisis prevention efforts by members active in international capital markets. A well-designed instrument could benefit members and the financial system as a whole by reinforcing strong policies and reducing the likelihood of crises. We welcomed some of the new features discussed informally since the Spring Meetings, but the instrument still falls short of attracting potential demand by member countries.

27. The external conditions for emerging market countries continue to be favorable so far. However, recent turbulences in the global capital markets pointed once more to the potential need for multilateral mechanisms that provide an extra degree of insurance for

emerging market countries against a more severe deterioration of the external economic environment.

28. We reiterate our view that it would be unreasonable to condition the establishment of the new instrument on the ex ante verification of firm customer pledges. Potential customers will only be able to decide whether to subscribe once the facility is fully specified.