International Monetary and Financial Committee

Sixteenth Meeting
October 20, 2007

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On behalf of Azerbaijan, Kyrgyz Republic, Poland, Serbia, Switzerland, Tajikistan, Turkmenistan, Uzbekistan

<u>IMFC Meeting Washington, October 20, 2007</u>

Statement by the Honorable Hans-Rudolf Merz, Minister of Finance of Switzerland, Speaking on behalf of Azerbaijan, Kyrgyz Republic, Poland, Serbia, Switzerland, Tajikistan, Turkmenistan, and Uzbekistan

1. Introduction

Financial market developments have recently taken center stage. Significant downside risks have materialized. The extent of recent market illiquidity and the speed of developments have been an element of surprise to most market participants and authorities. The turbulences exemplify the complexity of modern financial instruments, as well as increased international financial interdependence and cross-border service provision.

Against this background, fundamental changes in the economic and financial environment represent important challenges for the Fund. This is not the first time the institution is called upon to re-examine its role, adapt, and validate its continued *relevance*. The reform of policies and processes outlined in the medium-term strategy – including the role of the Fund in crisis prevention, resolution, and in low-income countries – should be pursued as a priority. In my view, these reforms should be strictly guided by the Fund's core mandate to foster macroeconomic and financial stability on the global, regional, and national levels. In these reform efforts, a clear delineation of tasks and responsibilities among multilateral institutions is warranted.

Carrying forward the reform agenda agreed on in Singapore will reinforce the Fund's *legitimacy*. However, finalizing a broad governance reform package requires willingness to compromise on all sides. I thus welcome the substantial discussions on the Governors' Resolution on Quota and Voice Reform held so far.

The Fund cannot fulfill its mandate without a *sound and stable financial basis* to finance its operations. A new income model that generates sufficient revenue and diversifies the Fund's income base is thus needed. This should be accompanied by a review of the Fund's overall costs, spurring additional efforts to achieve meaningful expenditure reductions.

II. Global Economic and Financial Environment

Recent developments and policy challenges

The global financial environment has changed considerably since last spring. Problems in the U.S. sub-prime mortgage market, the unveiling of unexpected risks in some structured credit products, and uncertainties about the location and size of potential losses have led to a sudden liquidity crunch and major disruptions in the credit markets. Credit, market, and liquidity risks have cumulated and are bound to remain high as liquidity remains constrained. It is notable that emerging markets have been largely unaffected by these developments.

Vulnerabilities remain, however, and these should continue to be closely monitored. Several countries, particularly in emerging Europe, appear to be potentially more exposed than others to possible adverse developments related to extensive private sector borrowing and large capital inflows.

The recent market turbulences are also a prominent reminder that in financial markets trust in one's counterparties is key. Similarly, actors in these markets must be reasonably confident about asset valuations, which should ideally include a liquidity premium for hard-to-value assets. Furthermore, the characteristics of innovative and complex financial instruments that allow for the transfer and tradability of risks should be well understood and appropriately rated. A process of repricing risks is now under way, as established practices in the markets for certain credit instruments are being examined and changed. This process should restore the conditions for a smooth functioning of financial markets.

Despite episodes of market turmoil, the large benefits of modern financial markets in terms of fostering economic efficiency and dispersing risks must be recognized. Provided the appropriate legal framework is in place, both underpin the soundness of the financial system. I agree, however, that it would be desirable to know more about the type and size of risks and who ultimately bears them, in particular under market stress. This seems particularly relevant for systemically important financial institutions and their off-balance-sheet vehicles. I thus clearly favor a policy approach that stresses transparency and disclosure and aims at improving market incentives, especially with regard to securitized structured products. This could be supplemented with more effective protection of retail borrowers in some countries. I also see considerable merit in closely examining the quality of credit ratings and the role of rating agencies in the regulatory process. I trust that the international financial community through the Financial Stability Forum will address these issues effectively.

Risks to the world economy

The confidence crisis in financial markets has put the resilience of the global financial system to the test. It is fortunate that this period of stress in financial markets occurs while the world economic environment is benign and the balance sheets of systemically important financial institutions are generally sound. The economic fundamentals supporting global growth remain generally strong, both in industrial countries and in most emerging economies. The latter group of countries have proven particularly resilient, limiting the global impact of the current turmoil. Robust growth, a positive macroeconomic outlook, prudent policies, and improved fundamentals have reduced their sensitivity to higher risk premia. Variations among these countries are considerable, however, which warrants close surveillance by the Fund.

The Fund's outlook for the global economy appropriately rightly points to increased uncertainty and downside risks. Immediate concerns are the ramifications of tighter credit conditions and increased funding costs for banks' lending to households and firms. But the main uncertainties relate to the spillover effects within the U.S. economy and the effects of a significant slowdown in U.S. demand on the rest of the world; the repercussions on the real economy are thus uncertain at the present juncture and it is unclear how prolonged this impact will be. Finally, the persistence of global imbalances remains an important risk factor.

As a result of these developments, the task of central banks has become more difficult. Although inflation has remained moderate and inflation expectations are low and stable, there is upward pressure from higher food and commodity prices, which is a particular problem for developing and transition countries, including in Central Asia. Moreover, in several countries low real interest rates suggest that the monetary policy stance might still be tightened. In these cases, an envisaged monetary policy tightening must consider the risk of financial market conditions deteriorating further.

III. Policies and Governance Reforms

Strengthening the surveillance framework

The adoption of the *2007 Decision on Surveillance over Members' Policies* by the Executive Board in June of this year was key to aligning with best practice the guidance provided to the Fund and members on exchange rate and domestic policies. I particularly welcome the clarification achieved on the scope and modalities of bilateral surveillance. In its consultations with members, the Fund needs to focus on its core competences in fiscal, monetary, exchange rate, and financial sector policies. In conducting this cooperative dialogue, the Fund must also continue to be evenhanded, candid, and pay due regard to country circumstances. While an assessment of exchange rate policies is indispensable as a surveillance tool, it is appropriate that the new Decision clearly acknowledges the uncertainties related to the assessment of exchange rate misalignment, requiring considerable judgment in each case. I believe that the 2007 Decision is crucial to making Fund surveillance more effective.

It is desirable to give surveillance a medium-term orientation. I am thus pleased that the Executive Board has also reached a broad agreement principle on a *Statement of Surveillance Priorities,* which will contain Fund-wide priority objectives, drawn from both bilateral and multilateral surveillance. The statement should highlight themes of joint interest and reflect the Fund's pursuit of its multilateral role. It also has the potential to be a useful tool for communicating with members, other stakeholders, and the broad public. The statement will thus provide a clearer benchmark against which the effectiveness of surveillance is assessed. While the Board should be in charge of setting the surveillance priorities, I consider that the importance of the statement warrants its endorsement by the IMFC. I am looking forward to a first statement on priorities in the context of the 2008 Triennial Surveillance Review.

Regarding multilateral surveillance, I welcome the Board's discussion of the first round of *multilateral consultations*. The first of these consultations – on global imbalances – has provided a constructive forum for dialogue and yielded valuable insights, including on participants' differences of views. However, drawing on the experience with this first round, I believe that the role of the Executive Board in the process needs to be enhanced. Recommendations should be consistent with those given in the context of the traditional surveillance procedures. An appropriate way remains to be found for monitoring implementation efforts by participants. A second round of multilateral consultations should focus on financial stability issues. The scope of these consultations must be adequately delineated beforehand.

The recent financial market developments have highlighted market imperfections that call for further work by the international community on the underpinnings of the financial system. National authorities, international bodies, and market participants should contribute to optimizing the regulatory frameworks in order to better manage these risks and enhance systemic stability. In this respect and with its comprehensive surveillance framework, the Fund can and must play an essential part. By integrating traditional macroeconomic and financial sector assessments and exploring their complex linkages, the Fund can provide new insights that are bound to push the frontier of good policy-making outward.

Ensuring financial soundness of the Fund

In January of this year, the Committee of Eminent Persons delivered recommendations on a *new income model* for the Fund that address the shortcomings of the current arrangement well. Taken together, the proposed measures would diversify the risk to the Fund's income. To finance its activities in a sustainable manner, the Fund's income sources should be appropriately linked to its various activities. This would also ensure an adequate burden sharing among the membership. As to the different income sources within this package, I support the limited sale of gold to set up an endowment, given that these sales would be strictly limited to the amount acquired since the Second Amendment. While I generally agree to using quota resources for investment, my preference would be that the Articles of Agreement specify an upper limit as to the share of quota that can be used for investment. The investment mandate should be broadened to optimize potential revenue within a pre-defined investment strategy. As a matter of principle, but also given income realities, the Fund should be reimbursed for the expenses incurred from administering the PRGF-ESF Trust.

Given the current revenue shortfall and the further deteriorating budget outlook over the medium-term, there is an urgency to address the Fund's financial situation in a comprehensive way. Drawing down reserves is neither a viable nor a prudent medium-term policy. Further measures to control *expenditure* and *increase cost efficiency*, independently of a new income model, are thus called for. While I welcome the administrative real expenditure reductions already planned in, the medium-term budget will have to be more ambitious, reflecting that the core mandate of the Fund lies in the realm of macroeconomic and financial stability.

Quotas and voice

Substantial discussions on implementing the Governors' Resolution on Quota and Voice Reform have taken place and some common ground among members is emerging. But the timeline remains ambitious. I hope that a necessary broad consensus on the elements of reform, including a revised quota formula, an increase in basic votes, and the size of the second-round ad-hoc quota increase, can be found. I will support a balanced and comprehensive agreement that meets the principles and objectives laid down in Singapore last year.

The new quota formula must mirror the mandate of the Fund as a monetary institution with global financial stability as its core mission. It should have a sound economic basis and be based on comparable and robust country data in order to stand the test of time. A member's quota has to duly reflect its economic and financial importance in the global system and its contribution to the stability of this system. This includes the ability to provide financing to the Fund as well as to international initiatives more generally. *GDP* at market exchange rates is the appropriate measure to accurately reflect members' size in the context of the Fund's mandate. It reflects prices as used in international transactions. Equally crucial for a durable and principle-based new formula is the dimension of *financial openness*. It is clearly relevant in terms of the Fund's mission and objectives. The formula should, therefore, include a measure of financial openness (such as the International Investment Position, IIP) so as to modernize the traditional openness variable. Since a significantly higher weight for GDP will largely benefit the quota shares of large members, I strongly support the inclusion of a meaningful *compression* factor in the formula. This would redistribute quota shares to developing countries in a transparent way, thereby enhancing their voice.

The second round ad-hoc quota increase will further align members' quotas to their relative positions in the world economy. It should rely on the new formula and should ensure that members are equally treated. Therefore, the quota increase should serve to proportionately reduce the difference between calculated and actual quota shares for all underrepresented members. Given abundant Fund liquidity, the size of the increase should be limited. Beyond this, I am not convinced of the application of an additional filter as a way of selecting further members eligible for quota allocations. While I acknowledge that this could be an element in a comprehensive agreement for a second-round increase, it would be problematic as a rule for future quota increases. Additional political objectives could always be achieved with discretionary ad-hoc quota increases. Future quota increases in the context of general reviews should, however, primarily be determined by the Fund's need for liquidity. Enhancing the voice of smaller members in the Fund can effectively be achieved by an increase in basic votes. In this context, I support at least a doubling of basic votes as well as the mechanism to keep this higher share of basis votes constant in the future.

Engagement in low-income countries

While the Fund clearly has an important role to play in low income countries, I believe that it must remain focused on supporting these members in establishing and maintaining macroeconomic stability. Achieving and maintaining debt sustainability are key objectives of the Heavily Indebted Poor Countries and Multilateral Debt Relief Initiatives. Fund technical advice in its core areas, namely strengthening monetary and public financial management frameworks, is also warranted in order to help members deal with increased inflows of aid and private capital as well as revenue windfalls resulting from high commodity prices. To make this technical assistance more effective, the sources of financing as well as the monitoring and evaluation processes must become more transparent.

The Fund must not play an active role in mobilizing aid flows. Also, the Fund's mandate provides only a limited basis for lending for long-term structural reform purposes. A focused role of the Fund implies strong country ownership and a clear division of labor with other multilateral institutions and bilateral donors. A clear division of labor regarding instruments, responsibilities, and accountability with the World Bank is particularly important for effectively delivering services to low-income members, and especially to post-conflict countries and fragile states.

Fostering institutional learning

I am pleased to note that the Independent Evaluation Office (IEO) is contributing substantially to the review of established policies and practices in the Fund. The ongoing assessment on IMF Corporate Governance will go beyond the realm of policies and shed light on the institutional aspects of the Fund's decision making processes. This is highly important as the institution responds to concerns of relevance and legitimacy. It is welcome that the recommendations of the IEO's reports are now being followed-up by the Executive Board according to a given timetable.