International Monetary and Financial Committee

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Statement by Mr. Teixeira dos Santos
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Statement by Minister of State and Finance Fernando Teixeira dos Santos in his capacity as Chairman of the EU Council of Economic and Finance Ministers, to the IMFC Autumn 2007 meeting

1. I submit, in my capacity as Chairman of the EU Council of Economic and Finance Ministers, this statement which focuses notably on the world economy – and in particular the outlook and policies for the European Union -, quotas and voice reform in the IMF and the implementation of the IMF's medium term strategy.

Economic Situation and Outlook

2. Global economic activity was strong in the first half of 2007, with GDP growth of about 5%. Going forward, a continued dynamism in emerging economies, including China and India, is expected to balance the likely slowdown in the United States. Macro economic fundamentals in the EU are healthy and growth should remain robust in the rest of 2007, despite some likely temporary deceleration in the second quarter. Recent turmoil in financial markets, triggered by the difficulties of the sub-prime mortgage market in the United States, is foreseen at this stage to have only a limited impact on global growth. Nevertheless, uncertainties and downside risks to the economic outlook have increased.

3. Annual inflation in the EU has been running around 2% in the first half of 2007. The rise in unit labour costs has been subdued thanks to moderate wage inflation and significant productivity gains. Nonetheless, capacity constraints; including higher than-expected wage increases on the back of tightening labour markets as well as higher commodity prices, could constitute an upside risk to the inflation outlook, depending on the strength of economic activity.

4. The challenge at the current juncture is to support the global economy through sound policies, while continuing to promote openness and at the same time delivering adequate responses to the energy- and climate-related challenges.

In this context:

- Financial turmoil erupted in July and August, originating in the US sub-prime mortgage market. It is not possible to assess the duration of the phase of higher volatility and market stress and it is too early to quantify the likely impact on the real economies. It will crucially depend on future developments in the financial markets. The international financial system as well as the global economy in general are in a good position to withstand this disturbance. We should nevertheless continue to carefully monitor these developments. While these developments may reflect a healthy correction towards a sounder pricing of risk, they have also raised issues related to the proper functioning of some markets and to the assessment of risk transmission channels. A careful examination of the underlying causes of the recent turmoil should help identify problem areas as well as possible remedies. This will require a thorough analysis with a global perspective, including in an IMF framework and with the involvement of the Financial Stability Forum. EU Finance Ministers and Governors also gave a mandate to its Economic and Financial Committee to review alongside our international partners how to further improve transparency of complex financial instruments, of institutions and vehicles as well as how to improve valuation processes, risk management and liquidity stress testing. They will also take a closer look at the role of rating agencies in structured finance.

- Global imbalances remain an important challenge, although recent largely cyclical developments have gone some way towards a rebalancing of global growth and thereby containing current account imbalances. The orderly unwinding of the global imbalances is a shared international responsibility and we welcome progress made in the context of the IMF multilateral consultation on global imbalances. At this point the implementation of policies, consistent with the strategy endorsed by the IMFC in September 2006, is key. In this light, we ask for continued attention for this issue and urge all participants to continue, and where possible speed up, the implementation of the agreed policy plans.

- On international trade policy, the EU remains fully committed to support the re-launch of the Doha trade negotiations announced in Geneva. In this regard, we stress the need for an ambitious, balanced and comprehensive agreement. Maintaining and strengthening the multilateral trade system based on the WTO is of key importance for the growth and employment prospects of the global economy, as well as for development. We call on key partners to act in the same spirit of constructive commitment in order to bring the negotiations to a successful close.

- The EU economic policy strategy remains oriented towards improving the conditions for more growth and jobs and fostering the success of the European Economic and Monetary Union (EMU). Sound macroeconomic policies are essential to support a well-balanced economic expansion and to realise of Europe's current growth potential. Prudent fiscal policies and implementing structural reform remain important**,** not least to underpin long-term sustainability of public finances in the context of population ageing. In a number of EU Member States the budgetary situation improved in 2006, partially due to the improvement in cyclical conditions, with government deficits falling below the reference value of 3% of GDP. Reforms of pension systems have been implemented in a number of countries, but more needs to be done to improve the long term sustainability of public finances and address increasing age-related expenditure. Fiscal consolidation remains a challenge and Member States are committed to ensure sound fiscal positions in line with the Stability and Growth Pact.

- Progress in implementing structural reforms is crucial to increase the growth potential of the EU, promote stability and support a smooth functioning of EMU and promote the resilience to shocks. The re-launched Lisbon strategy reinforces the Union's priorities of achieving growth and employment by strengthening the Internal Market and Europe's competitiveness, promoting knowledge and innovation, unlocking business potential and increasing employability. The EU is building upon the reforms already underway and focuses on areas such as fostering competition and improving the adaptability of labour markets. The structural reforms carried out in the EU have had positive effects. In particular the relatively robust employment growth coupled with the marked drop in unemployment and well contained inflationary pressures, suggests that there has been some structural improvement in the functioning of labour markets. Strengthened reform efforts are needed in most countries to achieve higher rates of sustainable growth and employment creation in the long run, ensure smooth adjustment processes in the euro area, cope with the challenges of ageing and reap the full benefits of globalisation. A well-functioning Internal Market remains at the heart of the Lisbon Agenda for Growth and Jobs. Given the challenges and opportunities of globalisation, it is important to further improve the functioning of the Single Market, including through the Single Market Review.

- An effective, efficient and equitable response to the challenges of climate change and its consequences for global economic development require collective international action. The EU has committed to transforming Europe into a highly energy-efficient and low greenhouse-gas emitting economy. We invite all countries to contribute. It is vital that we now move this integrated approach forward with cost-effective policies to promote competition, diversification of sources and cooperation between Member States as well as a positive framework for investment in the EU to ensure our common objective of a secure, affordable and sustainable energy supply. The cost-effectiveness of our approach will be particularly important in demonstrating that ambitious action can be taken in parallel with continued robust economic growth.

Quotas and voice reform in the IMF

5. EU members reiterate their commitment to reach an agreement, within the timeframe provided by the Singapore Board of Governors' resolution, on a satisfactory outcome of the reform on quotas and voice aimed at ensuring fair and adequate representation for all members of the IMF. They recognise the need on all sides to show flexibility and willingness for compromise. The outcome of the reform should be a sound and balanced package resulting in a shift of actual quota shares of advanced economies to emerging market economies, and the voting power of low income countries should be enhanced. The reform should set appropriate incentives to pursue policies consistent with IMF principles, namely openness and global integration, contribution to the global financial stability, contribution to growth and development.

New Quota formula

6. EU Member States continue to work constructively for a new quota formula to ensure an outcome which better represents the relative weight and role of members in the world economy and fully reflects the Fund's mission and purposes, particularly its role in fostering the stability of the international monetary system and in promoting economic integration. We strongly support a principle-based formula, with a clear and strong rationale in economic terms. GDP at market exchange rates and openness should be the main variables in the new quota formula. Specifically, EU members could support the IMF proposal to attach a weight of 50% to GDP as part of a comprehensive reform package. They consider a factor of no less than 30% for openness, and a weight of variability and reserves of no more than 15% and 5% respectively. EU Member States acknowledge that inclusion of financial openness at this stage raises issues of data availability. Nevertheless they call on the staff to continue its work in this area.

7. There is no principled case for the calculation of GDP in the formula using anything other than market exchange rates. In the international monetary system, whose stability is the core responsibility of the Fund, countries' interactions (through trade or financial relations) take place at market exchange rates. Also, GDP converted at market exchange rates is the

relevant measure of a member's ability to contribute to the Fund's finances, as it reflects the international market value of resources generated by an economy. In addition, as a measure of access in the event of crisis calculations at market exchange rates provide a better measure of potential need and of a member's possibility to borrow from the Fund. EU Member States reconfirm that there is no case for the exclusion from the openness variable of trade flows within economic or currency unions, since it would be inconsistent with the organization and the principles of the Fund. We strongly support the arguments put forward by the Fund against such exclusion and are not ready to accept other considerations.

8. Given that a linear formula with a higher weight on GDP tends to result in a higher calculated quota share for advanced countries as a group and a lower share for developing and emerging market countries, EU Member States support the use of a non-linear compression factor in the formula. It would rebalance the quota distribution by shifting calculated quota shares from those countries with large shares to those with smaller shares. Thus, it would protect the relative quota shares of low-income countries and emerging market countries, many of which are small economies, more efficiently than other alternatives, such as a GDP/PPP-blend.

Second round of ad hoc quota increases

9. Once a new quota formula has been agreed and with a view to achieving a significant further alignment of members' quotas with their relative positions in the world economy, a second round of limited ad hoc quota increases must take place to adjust the situation of the most under-represented members. EU members recognise that an eligibility criterion (filter) is likely to be necessary to select eligible countries for the 2nd ad hoc increase and are willing to consider the use of this filter in possible future quota increases. They are ready to consider employing PPP as an element in a filter, as part of a comprehensive package, where a satisfactory solution for other elements under discussion would be found. The filter should be non-discriminatory, and in allocating the quota increases, EU members must be treated equally with other under-represented members. The EU will actively support its under-represented members' reasonable demands.

10. To ensure equality of treatment of all under-represented countries in the IMF, the 1st round of increases agreed in Singapore should be considered as a down-payment, and for the allocation of the 2nd round of quota increases, the pre-Singapore quotas should be the point of reference.

11. EU members agree that future general reviews of quotas should be guided by IMF liquidity. They note that an established need for additional Fund liquidity is an essential pre-condition for any general increase in quotas.

Basic votes and capacity strengthening

12. EU members strongly support the objective of enhancing the voice and participation of low income and transition countries in the Fund. It is therefore essential that their voting share is increased through this process. Consequently, the firm decision in Singapore to significantly increase basic votes, providing for at least a doubling, would need to be implemented in line with the timetable in the resolution. EU members are ready to consider a tripling of basic votes. They also support introducing a mechanism to safeguard the share of basic votes in total voting power. Similarly, EU members are ready to support other options that would strengthen the voice of low-income countries.

Other governance issues

13. EU member states welcome the appointment of Dominique Strauss-Kahn as Managing Director of the IMF and look forward to working closely with him. They are willing to discuss the criteria and the procedure for the selection process of the Managing Director as part of a broader reform including top management from other international financial institutions. As for the IMFC chair, EU member states welcome the nomination of Tommaso Padoa-Schioppa, and support a time-limited chairmanship and the principle of geographic diversity.

Implementing the IMF's Medium-Term Strategy

Surveillance

14. EU member states are committed to the implementation of all elements of the reform of the IMF surveillance framework. They welcome the adoption of the 2007 Decision on Bilateral Surveillance over Members' Policies as well as its prompt implementation. The new decision will provide a comprehensive basis for the Fund's bilateral surveillance. It should enhance the focus, candor, even-handedness and effectiveness of surveillance. A greater emphasis on multilateral and regional issues will be vital to identify the spill-over effects of members' macroeconomic and financial policies on other countries. Bilateral surveillance should fully reflect the spirit of the revised decision in all of these areas. In Article IV consultations, a close focus should be given to financial sector issues.

15. In this context, EU member states welcome the Executive Board decision to set a statement of surveillance priorities and responsibilities. This will define economic and operational priorities for surveillance, clarify responsibilities and strengthen accountability. The implementation should draw on and streamline existing procedures, and should not entail an increase in administrative burden. The statement should be prepared by the staff, and its content set by the Board and endorsed by the IMFC. The Managing Director should report each year on how the management and staff are meeting their responsibilities. This report should also consider whether, in the light of global developments, surveillance priorities should be revised.

Crisis Prevention and Resolution

16. Progress should be made to further clarify the design of a new liquidity instrument for market access countries. It is important that the proposed Reserve Augmentation Line strikes a broadly appropriate balance between predictability of access and maintaining adequate safeguards for Fund resources, and is consistent with existing IMF facilities.

17. In addition, we emphasize the importance of continuing to strengthen the framework for resolving crises, in particular, the need to review the lending-into-arrears policy. This should inter alia address issues such as probabilistic debt sustainability analysis, price incentives, the "good faith principle" and the appropriate role of the Fund in setting the 'resource envelope' for a restructuring.

18. Sovereign wealth funds may have implications for the functioning of global financial markets due to their potential size and uncertainty surrounding the investment strategy, governance and institutional set-up. We ask the IMF to continue its analysis of these funds,

building on the work carried out by other international institutions, with a view to possibly identifying set of best practices.

Trade

19. We acknowledge the importance of Aid for Trade as essential in helping many developing countries gain the full benefit from trade. We reaffirm our pledges to delivering on our Aid for Trade commitments and call on all other donors to do the same. In this context, we look forward to the full funding and early launch of the Enhanced Integrated Framework.

Low income countries

20. EU members recognize the importance and support a continuing role for the Fund, under its existing facilities, in low income countries according to its mandate as set out in the medium term strategy. We consider that the IMF should give priority to enhancing the effectiveness and efficiency of its work in low income countries by focusing on macroeconomic stability and sustainable growth that support the achievement of the MDG's.

21. We note the importance of increasing the effectiveness and efficiency of public financial management including debt management in low-income countries. In this context, EU Member States call on the IMF to encourage responsible borrowing and lending and to actively support the use of the debt sustainability framework (DSF) by all borrowers and creditors. Meanwhile, EU Member States, as official creditors, commit themselves to adhere to these same principles. Furthermore, we commend the OECD and export creditor agencies (ECAs) on coming to an agreement on the provision of ECA data to the IMF in order to improve the accuracy of the DSF. We welcome the IMF's ongoing role to support the implementation of the HIPC and MDRI initiatives and its work on its own role in low-income countries in helping to manage aid flows.

22. Concerning Liberia, we call on all IMF members to contribute to the financing of the clearing of its arrears towards the IMF in line with the package proposed by the IMF in August 2007. The participation of commercial creditors is crucial to ensure debt sustainability for Liberia and we urge commercial creditors to play their full part in providing debt relief under the HIPC initiative. We look forward to the Fund's expeditious work on all the issues concerning Liberia's arrears clearance.

IMF finances

23. The EU Member States welcome the ongoing work on developing a new income model for the Fund. We support the Committee of eminent persons' analysis of the financial challenges that the Fund is facing. The measures proposed in the report and explored further by the staff offer a sound basis for further work towards putting the Fund's financing on a more sustainable basis. The proposed measures should be treated as a comprehensive package, in order to diversify the IMF's sources of income.

24. While expenditure was outside of the remit of the Committee, EU Member States believe that new revenue measures cannot be considered in isolation from what shareholding countries view as the Fund's mission, and the costs implied by that mission. This was set out in the Managing Director medium term strategy and welcomed by the IMFC. However, specific proposals should follow and reflect the continuing debate on the framework for implementation of that mission. These proposals should establish an integrated income and

expenditure framework. Raising revenues and controlling costs, both by increasing efficiency and actions on administrative expenditures, and by establishing long term budgetary rules to keep expenditures within limits after having brought the new revenue generating instruments into existence, should be pursued in the context of a comprehensive exercise. For the Fund's reputation as a prudent financial advisor it will also be important to demonstrate that the Fund itself can adapt its costs to a lower level of lending activity.

25. Since the main measures envisaged by the Committee and the continued development of the Fund's cost control framework will take time to be approved and implemented, we need to agree timely on arrangements for this process, and call on the IMF to address theses issues without delay.

Other issues

26. EU countries call for continued action by all countries to develop and implement strong programs against money laundering and terrorist financing according to the 40 Recommendations and the 9 Special Recommendations of the Financial Action Task Force (FATF). We urge the FATF to review jurisdictions that have failed to recognise the international standards. We call on the IMF and the World Bank to closely cooperate with the FATF. EU countries are committed to the effective and timely implementation of UN Resolutions 1540, 1718, 1737, 1747 and have taken action to that effect; we call on other countries to do likewise. We support the recent decisions of the FATF on the financing of proliferation of weapons of mass destruction.