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Statement by the Hon. Wayne Swan, Treasurer of the Commonwealth of Australia

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Treasurer of the Commonwealth of Australia
to the International Monetary and Financial Committee
12 April 2008

On behalf of the constituency comprising Australia, Kiribati, Korea (Republic of), Marshall Islands (Republic of the), Micronesia (Federated States of), Mongolia, New Zealand, Palau (Republic of), Papua New Guinea, Philippines, Samoa, Seychelles, Solomon Islands and Vanuatu

The 2008 Spring Meetings are taking place in the midst of financial market turmoil and a slowing world economy. The strains that originated in the United States sub-prime mortgage market have spread throughout financial markets, leading to a substantial tightening of financial conditions, a significant reassessment of risk, and a more moderate outlook for economic growth across the globe. Much depends on how successfully confidence can be restored in global financial markets, which would be assisted by decisive policy actions.

We are committed to the reform and refocusing of the Fund as envisaged by the new Managing Director, Dominique Strauss-Kahn, building on and enhancing the IMF's Medium-Term Strategy. We note the substantial progress that has been made since the 2007 Annual Meetings on key institutional aspects. The Executive Board's finalisation of a package of quota and voice reforms, representing an important step in delivering on the objectives of the 2006 Singapore Resolution, is a significant accomplishment. Agreement has also been reached on a new income model and budget strategy that will place the IMF's finances on a sustainable footing over the medium term.

In this context, we would like upfront to congratulate the Managing Director and his senior management team on the IMF's considerable achievements during the Managing Director's first six months in office.

The Global Economy and Financial Markets – Outlook, Risks and Policy Responses

The world economy has entered a more moderate growth phase. The United States and Euro area lost considerable momentum heading into 2008 and it now appears that the U.S. could be in recession in the first half of this year, with growth in major advanced economies as a group likely to remain below-average through 2008 and 2009. However, global growth remains supported in aggregate by continued robust growth in the large emerging market economies, where fiscal consolidation and strengthened policy frameworks have improved resilience to economic and financial shocks. While this suggests that the slowdown in global growth will be moderate by historical standards, the risks remain firmly tilted to the downside.

Events in financial markets are still unfolding, with the full implications of the reassessment of credit risk across global financial markets triggered by defaults in the U.S. sub-prime mortgage market still unclear. Rising estimates of bank losses from exposure to securities backed by U.S. sub-prime mortgages, ongoing liquidity strains in inter-bank markets, continuing worries regarding counterparty risk, and increasing concerns about contagion to other – often seemingly unrelated – markets are all contributing to significant uncertainty in financial markets. There are also uncertainties regarding the transmission of negative financial shocks to the real economy, particularly in the U.S. and Europe, and how significant the slowdown in major advanced economies will be for the pace of growth elsewhere. Capital flows to emerging market economies have remained strong, however credit spreads have increased across emerging markets and demand for exports is likely to slow. Therefore, it is reasonable to expect that all countries will experience some moderation in growth over the coming period, where the magnitude will depend on the strength of (direct and indirect) financial and trade linkages to major advanced economies. At the same time, inflationary pressures remain elevated, with the potential for high food and energy prices to exacerbate core inflationary pressures.

This combination of risks and uncertainties implies difficult choices for macroeconomic policy, both in advanced economies that are expected to slow significantly and in many emerging market and commodity producing economies where growth is currently robust and inflationary risks are most acute. In this context, it is appropriate to consider the range of possible paths for world economic growth. Policymakers will need to remain nimble in the short term while continuing to work towards establishing policy settings that reduce risks and susceptibility to economic shocks over the medium term. Given growing trade and financial linkages, there is also a case for considering not only the appropriate policy mix within economies, but also the consistency of macroeconomic policies across economies, where the IMF is a logical forum for such discussions.

Restoring confidence in global financial markets rests largely on the responses of financial institutions themselves, with assistance from well-designed policy actions. In this regard, we support the recommendations emerging from within the IMF and through the Financial Stability Forum (FSF). First and foremost, we must secure improved global standards of transparency and disclosure by financial institutions. We also need strengthened international cooperation to address the complexity and cross-border nature of financial structures, instruments and risks. We need to ensure that regulatory gaps are covered, that risks are identified and carefully monitored, and that national authorities respond effectively when specific risks are revealed.

A key question for the IMFC is what changes in the international architecture may be needed to achieve these objectives — and, specifically, what is the IMF's role? The FSF brings together national and international regulatory, supervisory and standard setting expertise which is extremely valuable. On the other hand, the IMF could deepen the policy context of this work and seek to gain traction for its advice through its surveillance activities. Accordingly, strengthened cooperation between the FSF and the IMF would be beneficial. We also need to keep in mind the differing composition of their memberships. While much of the FSF and IMF work has been concentrated around capital markets and institutions in advanced economies, systemically-important emerging market economies will need to be partners in strengthening the system against future crises, where both the IMFC and the G-20 may provide appropriate fora to facilitate this process.

In this context, we see three distinct roles for the IMF:

1. Identification: The Fund must monitor risks and assess vulnerabilities arising from the financial sector at the country, regional and global levels, including through its surveillance activities and the very valuable IMF/World Bank Financial Stability Assessment Programs.

2. Reporting: The Fund must report on threats to financial stability and work with the FSF and bodies such as the G-20 to identify best-practice responses for policymakers, supervisors and regulators.

3. Implementation: Finally, progress in addressing identified risks – including implementing proposed policy responses – should be embedded into the Fund's bilateral and multilateral surveillance, ensuring periodic monitoring of implementation.

Performing these functions effectively will require the Fund to strengthen its expertise on the channels of transmission and feedback between the real and financial economy, taking into consideration the spillover implications for cross-border capital flows and potential systemic impact on global financial markets. It will also require: further work on how the Fund's identification and reporting roles in collaboration with the FSF can be fashioned into an early warning capability; incorporation of advanced economies into a strengthened Fund vulnerability exercise; and analysis of how financial innovations have affected the transmission channels of financial crises. Each of these areas is consistent with the directions that the Managing Director has set out in his report on the Medium-Term Budget aimed at strengthening the IMF's role in crisis prevention.

We also support further work on a possible new contingent financing facility for emerging market economies - subject to demonstrated demand for such a facility - and further consideration of the case for increasing limits on access to IMF financing, both of which could provide an important line of defence should the current financial turmoil manifest through a reversal of capital flows to emerging market economies.

The potential for a disorderly unwinding of large global imbalances also remains a risk to the outlook. While growth and exchange rate dynamics are expected to reduce global imbalances somewhat, the major trend observed thus far is a redistribution of the U.S. current account deficit to other regions with flexible currencies - primarily the Euro area and Japan, but also other countries such as Canada, Australia and Korea. Meanwhile, large current account surpluses in emerging Asia are only stabilising and surpluses of major oil exporters are continuing to increase. This highlights the importance of continued progress towards the policy plans established during last year's multilateral consultations.

We welcome the IMF's latest contribution to the climate change policy debate in the April 2008 World Economic Outlook. We consider that, given the medium- to longer-term significance of this issue in economic, social, environmental and political terms, the Fund has a legitimate role in shaping the future debate. In our view, the Fund's strategy, with its core mandate, should be to focus on: (i) analysis of macroeconomic consequences; (ii) fiscal policy development and design in relation to revenues (from mitigation) and expenditures (for adaptation); and (iii) financial market developments to catalyse new products to assist adaptation.

As a constituency that both owns sovereign wealth funds and is a recipient of their investment, we are encouraged by progress in designing a voluntary code of practice for sovereign wealth funds and look forward to discussing the final product at the 2008 Annual Meetings.

IMF Reforms and Policy Agenda

We welcome the Managing Director's report on the IMF's Policy Agenda. The Fund is undergoing substantial change under the Medium-Term Strategy and now under the Managing Director's refocusing exercise. We strongly support these efforts and congratulate the Managing Director and his predecessor for their leadership in responding to the needs of the membership. The result should be a Fund that has greater legitimacy, relevance and therefore influence; that is leaner and better focused on a more clearly defined set of core responsibilities; that has an up-to-date policy tool-kit; and that is more adaptive to changing circumstances.

Quota and Voice Reform

The 2006 Singapore Resolution recognised the critical importance of realigning the quota and voice of its members with weight in the world economy to improve the Fund's legitimacy. Governors have now been presented with a package of quota and voice reforms that places us on a path towards achieving this objective. If the proposed package receives the necessary support, it will greatly simplify the method of calculating quota, achieve a realignment of voting shares with economic weight – including by increasing the quota share of the world's fast-growing, dynamic economies – and introduce measures to improve the voice of some of the Fund's smallest and lowest income members. It also sets an important foundation, recognising that these are the first steps in a longer-term exercise. The proposed Governor's resolution includes a clear directive to the Executive Board to recommend further realignment of members' quota shares at future general quota reviews (starting with the 14th General Review of Quotas), establishing the realignment of quota shares as a dynamic process and acknowledging that there is much more to do. This is an important step towards improving the Fund's legitimacy and therefore we lend our full support to the proposed Governor's resolution and strongly encourage others to do likewise.

Quota and voice reform is not the only governance challenge facing the Fund. In our view, there is significant scope to improve the operation of the Fund's Executive Board. In this regard, we look forward to discussing the Independent Evaluation Office review on *Aspects of IMF Corporate Governance – Including the Role of the Board*. We are ready to engage constructively within the Board and management on how we can make the Board more strategically focused and more effective and efficient in its decision-making processes. For the future, we also believe that the selection of the senior management of the Fund and World Bank should be based on merit, conducted transparently and ensure broad representation of all member countries. This would help to reinforce the legitimacy of the Bretton Woods institutions in the 21st century and therefore we will continue to push for full merit-based selection of these positions.

<u>A Sustainable Model for the Fund's Finances</u>

We are committed to placing the Fund's finances on a sustainable footing through both additional income measures and targeted reductions in real expenditures. We take this opportunity to again thank the committee chaired by Mr. Andrew Crockett for their report, whose recommendations on the long-term financing of the Fund formed the basis of the proposed new income model. We support the package that is now proposed, namely:

Expansion of the Fund's investment authority for both the Investment Account and the Special Disbursement Account. Responsibility for establishing the parameters of the expanded investment authority rests with the Executive Board, which will take decisions on eligible asset classes, strategic asset allocation and risk controls. We agree with the objective of increasing expected returns within the limits of a conservative, long-term investment approach that takes into account the public nature of the IMF's finances and the importance of protecting the value of shareholder capital.

The sale of gold acquired by the IMF since the second amendment to the Articles of Agreement. Our constituency includes the world's fourth and ninth largest gold producers and therefore we will take a close interest in ensuring that the proposed gold sales are conducted in strict accordance with the parameters agreed by the Executive Board. These stringent safeguards reflect the Fund's systemic responsibility to avoid causing disruptions that would adversely impact gold holders and gold producers, as well as the functioning of the gold market.

Resuming reimbursement of the General Resources Account (GRA) for the administrative expenses of the PRGF-ESF Trust. The Executive Board's decision to put this into effect includes an important assurance that reimbursement of the GRA will not reduce the PRGF-ESF Trust's future financing capacity.

We look forward to the Fund reviewing its policy on precautionary balances following implementation of the new income model, including with a view to introducing a dividend policy that ensures an ongoing discipline between income and expenditure.

Strategic Directions in the Medium-Term Budget

The Managing Director's statement on the Strategic Directions in the Medium-Term Budget provides a strong framework for refocusing the IMF on its comparative advantages. We have been impressed with the inclusive manner in which the Managing Director has embarked on the difficult downsizing and refocusing exercise and look forward to the Executive Board being kept informed of strategic choices during the implementation phase.

The current financial market turmoil has highlighted the importance of the Fund deepening its analysis of macro-financial linkages and cross-country spillovers to inform its bilateral and multilateral surveillance activities. It also highlights the importance of properly embedding financial market analysis and assessment into Article IV surveillance in order to address clear deficiencies in this area. The forthcoming Triennial Surveillance Review will provide both an opportunity to assess recent measures to improve Fund surveillance and a starting point for discussions on a statement of surveillance priorities and responsibilities. Our assessment thus far is that implementation of the 2007 Decision on Bilateral Surveillance has placed too much emphasis on the evaluation of equilibrium exchange rates per se, at the expense of considering exchange rate policies and the implications for associated policy frameworks. This should be addressed in the surveillance guidance note, which will support the 2007 Decision being implemented consistently and effectively.

The Fund's work in low-income countries (LICs) is very important to our constituency. As stated in the Managing Director's report, the IMF is not a development agency: its role in LICs is to help create stable macroeconomic frameworks in which development institutions and agencies can be effective. Given all the various strands of LIC work, we look forward to a comprehensive statement on the role of the Fund in LICs, which should bring together the full range of Fund objectives, roles and responsibilities in these countries. While we welcome the Joint Management Action Plan on Bank-Fund Collaboration, various recommendations from the Malan Report have not been addressed. Given the current budget exercise, we are more steadfast than ever in our view that there should be more emphasis on the division of labour between the Fund and the Bank as a more effective means of delineating responsibilities, and enforcing accountability for the delivery of quality outputs.

We also support the move to a demand-driven approach to capacity building and look forward to considering a graduated charging mechanism to rationalise the demand for technical assistance (TA) on the basis of a specific proposal. The move towards greater external financing is necessary, although this needs to be complemented by strong management oversight to ensure that the provision of TA does not become donor-driven, fragmented and/or compromise the strategic objectives and quality of the Fund's capacity-building programme. We also support the reallocation of the Fund's AML/CFT work towards assessments of countries that are systemically important or that present acute risk. At the same time, there is also a need to ensure strong coordination with the World Bank so that developing and low-income countries are able to receive AML/CFT support, particularly given that volatility and disruption of financial flows can have a relatively greater impact on their economic development and financial stability.