DEVELOPMENT COMMITTEE
(Joint Ministerial Committee
of the
Boards of Governors of the Bank and the Fund
On the
Transfer of Real Resources to Developing Countries)

DC2005-0024
September 21, 2005

STATEMENT FROM THE MANAGING DIRECTOR OF THE IMF

Attached for the September 25, 2005, Development Committee Meeting is a Statement from the Managing Director of the International Monetary Fund to the Development Committee.

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DEVELOPMENT COMMITTEE: THE MANAGING DIRECTOR'S WRITTEN STATEMENT

I. INTRODUCTION

1. Our meeting takes place at an important juncture in the international community's efforts towards achieving the Millennium Development Goals (MDGs). It is now five years since we took up this enormous challenge, and there is a sense of renewed urgency. The recent UN World Summit on Implementing the Millennium Declaration reaffirmed the commitments made in Monterrey, but stressed the need for more progress, particularly in Sub-Saharan Africa. In addition, at the African Union and G-8 Summits, African leaders and their counterparts in the G-8 committed themselves to intensify their efforts.

2. Sub-Saharan Africa continues to present the most difficult development challenge, and is the region where the task of achieving the MDGs is most daunting. The World Bank has put forward a report for discussion by the Development Committee that sets out a program of action to support an enhanced partnership for Africa's development, including by ensuring the effective use of additional aid.[1] The Fund will play an important role in assisting these efforts as macroeconomic stability is crucial to fostering durable growth and poverty reduction. The many challenges that low-income countries face, including dealing with the macroeconomic impact of higher aid inflows, make rapid progress difficult to achieve, but where governments have established stable macroeconomic frameworks and pushed ahead with structural reforms, we have begun to see encouraging results.

3. The continued recovery in global growth provides a good opportunity to address medium-term vulnerabilities emanating from higher oil prices and large global imbalances. Countries will need to take ambitious actions to correct persistent imbalances among the major economies, remove structural impediments to growth and prepare for changing demographics through forward-looking fiscal consolidation. All countries must be able to take maximum advantage of the benefits from globalization, which will require, among other things, moving decisively to liberalize trade in the Doha Development Round.

4. During the past year, we have held extensive discussions on a medium-term strategy to guide the Fund's future operations, which is reflected in a report circulated recently.[2] This report identifies integration into the global economic and financial systems as a key challenge facing our member countries, and the Fund's assistance in designing and implementing the necessary measures and reforms as the organizing principle for our medium-term strategy. The strategy recognizes the changes that have already been made in

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[1] World Bank, *Strengthening the Development Partnership and Financing for Achieving the MDGs: An Africa Action Plan,* background paper for the Fall 2005 Development Committee meeting.

[2] *Report of the Managing Director to the International Monetary and Financial Committee on the Fund's Medium-Term Strategy* (IMFC/Doc/12/05/2, 9/15/05).

recent years to adapt to this challenge, and provides a framework within which to prioritize the Fund's activities in order to increase its focus, effectiveness, and preparedness to face the future. In this statement, after summarizing the Fund's assessment of the world economic outlook, I shall explain in more detail the Fund's efforts to review, refine and strengthen its activities to help developing member countries accelerate growth and make faster progress toward achieving the MDGs.

II. Global Environment and Policy Response

A. Overall Outlook and Policy Response

5. After very high global growth in 2004, the expansion has moderated to a more sustainable pace, with global growth in 2005 expected to be 4.3 percent, and to remain close to that level in 2006. Although exceeding expectations in the first quarter of 2005, growth appears to have slowed in the second quarter, in part reflecting the earlier rise in oil prices. The expansion continues to depend unduly on continued high growth in the United States and China.

6. Global inflation has picked up slightly in response to higher oil prices, but remains at moderate levels and appears contained in the major industrial countries. However, inflationary pressures have risen somewhat more in emerging markets with forecasts for 2005 revised upwards in most regions. Global financial conditions also remain benign. Long-term interest rates are low, corporate earnings and balance sheets are strong, and a number of emerging markets have benefited from improved economic fundamentals and the increased presence of long-term investors.

7. There are significant downside risks to this short-term outlook. In particular, high and volatile oil prices remain a significant global risk. Continued high oil prices or further increases could entail financial difficulties for both vulnerable emerging market economies and poor oil-importing countries and could have a significantly negative impact on global growth—particularly in light of the disruption in the wake of Hurricane Katrina. A further risk is that, in the context of surging oil prices and widening global imbalances, a sharp rise in long-term interest rates prompted by rising inflation expectations or a shift in investor preferences away from U.S. assets could weaken housing markets, undermine confidence in highly indebted household sectors, and slow growth.

8. Some medium-term vulnerabilities also persist. Global current account imbalances have increased further and little improvement is expected in the near future. This may increase the risk of abrupt movements in exchange rates. Also, although fiscal consolidation is underway in many countries, unsustainable medium-term fiscal positions remain a key risk, posing a significant threat to macroeconomic stability. Moreover, most countries and regions face significant structural challenges that constrain growth in key areas.

9. The global expansion offers a favorable environment in which to address these medium-term vulnerabilities by:

- reducing global current account imbalances, including through bolder fiscal adjustment in the United States; continued structural reform in the Euro Area and Japan to boost domestic demand and growth; higher public expenditures and accelerated structural reforms in oil-exporting countries; and faster financial sector reform with greater use of exchange rate flexibility in Asia;

- addressing constraints to long-term growth in developing countries by stepping up the pace of structural reform, including through further improvements in the investment climate in many emerging market economies;

- opening markets via a successful and appropriately ambitious trade liberalization under the Doha Round; and

- strengthening medium-term fiscal positions in both industrialized and developing countries to address, among other things, high or rising public debt and changing demographics.

B. Regional Outlooks and Policy Response

10. In the *United States*, growth remained strong in the first half of 2005, and the momentum of the expansion appears to remain solid, although hurricane Katrina has underscored downside risks. Risks include a jump in the very low household savings rate if the housing market were to cool, a slowdown in underlying productivity growth, and further increases in oil prices. With growth still exceeding its potential and interest rates low, a further measured withdrawal of monetary stimulus seems likely to be appropriate. Significant fiscal consolidation will be needed to ensure medium-term sustainability and boost domestic savings for an orderly adjustment in global imbalances. Growth in the *Euro Area* should regain its momentum gradually in the second half of 2005, although there are risks of more extended period of weakness. If inflationary pressures remain restrained, and the recovery appears to be fading, or if the euro appreciates significantly, an interest rate cut may be appropriate. In addition, further action will be required to cope with the fiscal pressures of ageing populations. In *Japan*, growth rebounded in the first half of 2005, and the growth momentum seems likely to continue. There has been considerable progress in addressing weaknesses in the bank and corporate sectors, which has put the economy in a better position to sustain an expansion. The momentum for financial and other structural reforms should be maintained. The accommodative monetary stance should continue until deflation is decisively overcome.

11. In emerging markets, economic performance remains strong.

- In *Emerging Asia*, growth continues to be robust, although there has been a marked increase in intra-regional divergences. Growth in China and India remains high, but the expansion in much of the rest of the region has slowed, reflecting the impact of higher oil prices and of a correction in the information technology sector. However, the expansion should strengthen during the remainder of 2005. The region should seek to achieve an appropriate balance between growth in domestic and external demand. In this context, the recent move to more flexible exchange rate arrangements in China and Malaysia is appropriate, and the authorities should make full use of the increased flexibility.

- In *Latin America*, growth has moderated to a more sustainable pace after a sharp rebound in 2004. Looking forward, the expansion is projected to continue at a solid pace, with growth remaining above the 1990s average through 2005-6, underpinned by both external and domestic demand. The current expansion appears to be more resilient than earlier ones, reflecting a combination of improved monetary, fiscal, and external debt management policies, and strong global growth and commodity prices. It is now a good time for undertaking reforms to address long-standing impediments to faster growth while further strengthening the fiscal and debt positions.

- In *Emerging Europe*, growth remains resilient although the pace of expansion has eased since the middle of 2004. Nevertheless, concerns remain about possible overheating in some countries. Where credit is expanding at an unsustainable pace, measures are needed to reduce credit growth and associated risks. Fiscal consolidation and structural reform are also needed to manage demand pressures and improve medium-term sustainability.

12. In the *Middle East*, oil-exporting countries have enjoyed a robust growth performance. With continued prudent financial policies and oil production close to capacity, growth is expected to moderate slightly in 2006. With a significant proportion of the oil revenue increase expected to be permanent, managing the revenue will be a central challenge. The revenue will provide the opportunity to address some of the long-standing economic problems in the region, including the financing of reforms aimed at generating employment opportunities for the rapidly growing working-age population.

13. In most *Commonwealth of Independent States* countries, real GDP growth slowed in early 2005, mainly reflecting sluggish investment and lower oil sector growth, while inflation rose after a long period of sustained disinflation. A combination of tighter monetary policy and exchange rate appreciation will be needed to keep inflation in check.

14. In *Sub-Saharan Africa*, the outlook remains favorable, even though the expansion is expected to slow somewhat this year following an eight-year high in 2004. Growth is supported by improved macroeconomic policies, higher commodity prices, lower external debt burdens, progress with structural reforms and fewer armed conflicts. In 2006, growth is expected to accelerate to 5.9 percent, which, if achieved, would be the strongest expansion in the region since the early 1970s. However, to accelerate progress towards achieving the MDGs, major efforts are still needed to promote private sector activity, develop infrastructure, and strengthen institutions.

III. The Fund's Efforts to Improve Surveillance and Global Financial Stability

15. Surveillance remains central to the Fund's role in preventing crises, and must continue to evolve to keep up with the changing needs of the global environment. We have embarked on a range of reforms geared to enhancing the effectiveness of surveillance, in line with the conclusions of the 2004 Biennial Surveillance Review.[3] Recent changes include:

- issuing revised internal guidance on bilateral surveillance, to update and streamline our procedures and policies;
- requiring more in-depth internal discussion before beginning bilateral surveillance discussions, with the aim of improving the selectivity and focus of analysis;
- devising a new vehicle to apprise the Board of recent trends in trade policy, permitting Article IV consultations to treat these issues more selectively;
- giving greater prominence to the discussion of exchange rate issues in bilateral surveillance documents and expanding work on assessing equilibrium exchange rates;
- mainstreaming financial sector issues in surveillance work; and
- revising the Fund's framework for debt sustainability analysis to address concerns about overoptimistic projections and help integrate such analyses more fully into the surveillance process.

The strategic review has confirmed these changes and is expected to give new impetus to efforts to sharpen the focus of surveillance and ensure that the Fund's voice is heard.

16. The Fund is also giving more emphasis to regional surveillance to highlight spillover effects of country policies, and bring an analytical focus to regional issues. The increased use of regional surveillance to analyze economic and policy development, such as in Central America, Central and Western Africa, the Eastern Caribbean, the Pacific Islands and Asia, helps to inform bilateral surveillance and the Fund's engagement with country authorities.

17. The Fund continues to support timely and effective resolution of financial crises by encouraging the use of collective action clauses in international sovereign bonds and working on relevant issues aimed at helping ensure that it is in a better position to meet the challenges that future crises could pose. In this context, a recent report reviews advances in the adoption and design of collective action clauses, reports on recent cases of sovereign debt restructuring with private creditors, and discusses the evolution of the Evian approach and other Paris Club

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[3] Public Information Notice No. 04/95, August 24, 2004, *IMF Executive Board Reviews the Fund's Surveillance* (http://www.imf.org/external/np/sec/pn/2004/pn0495.htm).

debt initiatives.[4] It also provides a brief update on progress by the Institute of International Finance in broadening the consensus among emerging market issuers and private sector creditors on the *Principles for Stable Capital Flows and Fair Debt Restructuring in Emerging Markets*.

IV. Supporting Low-Income Member Countries

A. The Role of the Fund in Low-Income Member Countries

18. The Fund's principal contribution to implementing the development agenda remains the promotion of macroeconomic and financial stability—a precondition for growth and poverty reduction—through its policy advice, capacity building, and financial assistance. We thus remain fully engaged in efforts to help low-income member countries achieve the MDGs. To maximize its contribution, the Fund has undertaken a reassessment of its role in low-income countries, focusing on adapting its instruments to the particular needs of the low-income membership, as well as on better defining its role on the ground, particularly in the interaction with the authorities, civil society, and other development partners. The importance of efforts in these directions is underlined in the strategic review, with its accent on increased focus and flexibility. Recent work has concentrated on strengthening the instruments for engaging with low-income members, and helping members achieve and maintain debt sustainability. In addition, the Fund is a strong advocate of more and effective development aid and plays a role in supporting its coordination.

B. Supporting Low-income Countries' Efforts to Achieve the MDGs

19. The Fund has been working, with other development partners, to ensure that the Poverty Reduction Strategy (PRS) approach provides an operational tool for implementing and coordinating efforts to foster growth, poverty reduction, and progress towards the MDGs. A recent joint review with the staff of the World Bank concluded that the PRS approach is a useful framework for balancing domestic and external accountabilities for development results and providing a platform for scaling up country efforts to achieve the MDGs.[5] It also noted that alternative scenarios could overcome possible tensions between an operationally realistic PRS framework and more ambitious development plans, and suggested that Fund staff should play an active role in the development of such scenarios as well as in assisting countries manage higher aid flows.

20. The Fund is working with low-income country members and the international community to put in place appropriate policies and build capacity. It continues to assist countries in building sound institutions, which strengthens the capacity of the public sector to mobilize domestic revenue and improve budgetary management, which are essential for

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[4] *Progress Report on Crisis Resolution* (SM/05/342, 9/2/05).

[5] *Joint World Bank and IMF Report on Poverty Reduction Strategy Papers—Progress in Implementation* (http://www.imf.org/external/np/pp/eng/2005/020205.pdf).

scaling up public services. The Fund also helps build institutions in the monetary and financial sectors. Moreover, in areas within its mandate and expertise, the Fund is helping member countries improve governance, including the legal and regulatory reforms which are important for a vibrant private sector. The Fund is also helping its members to observe best practices in fiscal transparency, including with respect to resource revenue management on which it issued a Guide, and supports the Extractive Industries Transparency Initiative.

C. Modalities for Financing the MDGs

21. Financing for the MDGs remains prominent on the international agenda in view of the reaffirmation by the UN World Summit that much more aid is needed and the decision made at the G-8 Summit to double aid to Sub-Saharan Africa by 2010. The Fund continues to advocate substantially higher aid flows, while recognizing that reforms are needed to ensure that absorptive capacity improves as aid is scaled up. Equally important is improving the quality of aid through firm implementation of the Paris Declaration on Aid Effectiveness. The Fund stands ready to help member countries adapt their macroeconomic policies to manage higher aid inflows.

22. While the most effective way to generate additional resources for the MDGs would be for donor countries and multilateral institutions to increase their ODA contributions, consideration is also being given to alternative mechanisms, including innovative modalities such as the International Finance Facility (IFF) and global taxes. Following up on a request from the Development Committee, Fund staff have contributed to a World Bank paper on development financing for the forthcoming Committee meeting.[6] A number of proposals have now been fleshed out, but some technical concerns still need to be addressed, and the challenge of mobilizing sufficient political consensus for implementation remains.

D. Refining the Fund's Policy Advice and Strengthening its Instruments

23. For some time now, the Fund has been considering how it could better serve its low-income members. While it is recognized that the Poverty Reduction and Growth Facility (PRGF) will remain the main instrument for assisting these members, its mission to support low-income members' efforts to secure and maintain macroeconomic stability and achieve sustainable growth and reduce poverty requires the institution to adapt as members' needs evolve.

24. The Fund recently completed its review of the design of PRGF-supported programs in "mature stabilizers."[7] While many low-income countries still need significant

[6] World Bank, *Aid Effectiveness and Aid Financing,* background paper for the Fall 2005 Development Committee meeting.

[7] *Review of PRGF Program Design* (SM/05/304, 8/09/05, http://www.imf.org/external/np/pp/eng/2005/080805r.htm)

macroeconomic adjustment, many others have achieved broad macroeconomic stability and sustained growth, often with the Fund's support. The review confirmed the importance of adequate policies—particularly those which would open the economy and avoid macroeconomic instability and exchange rate overvaluation—in initiating sustained growth even in countries with weak institutions. It also asked how fiscal space could be created for urgent spending needs, beyond what can be achieved through a better allocation of existing resources. Increases in grants clearly have the greatest potential in this regard, although even these must be managed carefully: the risk and consequences of real exchange rate appreciation must be recognized, but weighting these too highly can lead too quickly to an approach whereby aid is kept in international reserves and the additional external resources provided are not absorbed. The choice between the other means of financing higher public spending—taxation and borrowing—requires that attention be given to issues of crowding out and to implications for debt sustainability. As regards monetary policy, the study found support for targeting single-digit inflation rates, but also some room for looser monetary targets reflecting financial deepening.

25. *Shocks Facility*: The Executive Board has agreed in principle to the creation of a new window in the PRGF Trust for low-income members facing exogenous shocks.[8] This window would provide concessional support to low-income members without a PRGF arrangement, and act as a potential safety net for members that wish to exit continuous PRGF program engagement. It would thus complement the existing instruments available to assist low-income countries facing shocks, such as augmentations of PRGF access, the Compensatory Financing Facility, subsidized emergency assistance for natural disasters and post conflict cases, and the use of credit tranche resources.

26. *Signaling:* The Executive Board also recently agreed to establish a new non-financial mechanism, the Policy Support Instrument (PSI), which will be made operational shortly.[9] The PSI will be available to PRGF-eligible countries which do not need the Fund's financial assistance and which have a poverty reduction strategy in place and a policy framework appropriate for consolidating macroeconomic stability and debt sustainability, while deepening structural reforms in key areas that constrain growth and poverty reduction. A PSI will require country policies to meet the standard of upper credit tranche conditionality. Regular semiannual reviews by the Board of a PSI-endorsed program will provide a multidimensional assessment of policies in addition to a judgment on whether the program as a whole is on track. Publication of PSI-related documents will be voluntary but presumed. An on-track PSI would facilitate rapid access to concessional resources from the Fund in case of shocks, although quick access to Fund resources may not be possible for PSI users that choose not to undertake a safeguards assessment.

[8] *Strengthening the Fund's Ability to Assist Low-Income Countries Meet Balance of Payments Needs Arising from Sudden and Exogenous Shocks* (EBS/05/88, 6/10/05).

[9] *Policy Support and Signaling in Low-Income Countries* (EBS/05/87, 6/10/2005).

27. *PRGF Financing Needs:* In order to maintain adequate capacity of the PRGF instrument to meet future needs, work is underway on estimating the demand for PRGF financing over the medium term, incorporating the implications of potential debt relief and the introduction of the PSI and the shocks window. The Executive Board has emphasized the close linkages between the financing of the Fund's concessional lending operations and further debt relief, and agreed that the Fund needs to be adequately equipped to meet future financing demands associated with its role in supporting low-income countries. The Board has also underscored that additional financing for the proposed shocks window should be secured from donors, as needed.

E. Debt Relief and Debt Sustainability

28. There has been further progress in implementing the enhanced HIPC Initiative. In total, 18 countries have reached the completion point, and Burundi recently reached the decision point, bringing the total number of countries in the interim phase to 10. The Fund and World Bank Boards agreed last year to extend possible eligibility for the Initiative to 2006 to allow more countries to benefit from HIPC debt relief, while "ring-fencing" participation to avoid creating perverse incentives. The staffs have recently drawn up a preliminary list of 13 potentially eligible countries (including the additional countries that qualify based on end-2004 debt burden indicators) that have not yet reached the decision point. Grant resources are still needed to cover HIPC debt relief for the three protracted arrears cases, Liberia, Somalia, and Sudan, which are also potentially eligible countries.

29. The G-8 recently put forward a proposal for further debt relief for Heavily Indebted Poor Countries. The proposal envisages the cancellation of 100 percent of the claims of the IMF, International Development Association, and African Development Fund on the countries that have reached, or will reach, the completion point under the enhanced HIPC Initiative. According to the proposal, the cost to the Fund would be met from its own resources, drawing *inter alia* on existing funds earmarked to finance HIPC debt relief and PRGF operations.

30. The Executive Board has discussed the G-8 proposal on various occasions, and considered ways to implement it, focusing primarily on questions of uniformity of treatment, conditionality, and financing. There is a consensus that the proposal could go a long way toward eliminating the external debt burden of a number of the world's poorest countries, thereby freeing resources for achieving faster progress towards the MDGs. The Board has also emphasized the importance of not impairing the Fund's lending capacity for low-income members. In this regard, it has welcomed the G-8's commitments to provide additional resources to meet several needs: the resources necessary for the three protracted arrears cases; possible costs of debt relief to countries that may become eligible for HIPC assistance under the extended sunset clause; and up to US$350–500 million to meet other difficult to foresee costs.

31. However, to preserve the potential benefits of debt relief in the longer term, especially in light of many low-income countries' ongoing financing needs, it will be critical

to help countries avoid excessive borrowing. The purpose of the new debt sustainability framework (DSF) for low-income countries that the Executive Boards of the Fund and the Bank adopted earlier this year is to help low-income countries avoid excessive build-up of debt in their pursuit of the MDGs.

V. Doha Negotiations and Aid for Trade

32. An ambitious and timely conclusion to the Doha Round remains one of the most vital contributions that could be made to bolstering global growth, including for low-income members, over the medium term. It is important that countries use the December 2005 WTO Ministerial Conference meeting in Hong Kong to agree on a specific trade liberalization framework. Otherwise, when coupled with the tensions created by global imbalances, a failure of the Doha Round could exacerbate protectionism.

33. Fund and World Bank staff have formulated ways to provide stronger "aid for trade" as described in a joint report.[10] The intention is to help low-income countries achieve the full benefits of trade liberalization and alleviate the supply constraints to exploiting trade opportunities. An important component of such efforts would be scaling up and expanding the activities of the Integrated Framework (IF)—an inter-agency initiative to coordinate trade-related technical assistance and mainstream trade into national strategies—which also entails increased assistance in the form of grants and loans from an IF-supported trust fund. Staffs also propose to report to the Development Committee and IMFC at the 2006 Spring Meetings on the adequacy of existing mechanisms to address regional or cross-country trade needs and explore new mechanisms as appropriate. To address adjustment costs arising from trade liberalization, staffs propose a strengthened framework for assessing adjustment needs so that existing assistance mechanisms can be better utilized. The Fund's Trade Integration Mechanism (TIM) is already available to help countries address the pressures that may emerge from multilateral trade liberalization undertaken by other countries. Floating tranches under Fund arrangements could also be used to mitigate the balance of payments impact of trade reforms when the timing of those reforms is uncertain.

VI. Voice of Developing Countries and Countries in Transition

34. The Fund's legitimacy and effectiveness depend crucially on members' perceived stake in the IMF as an institution. Our governance structure needs to continue to evolve to reflect the changing realities of the global economy, to ensure that all members have an adequate voice in the institution—including Asian and other emerging economies whose growing economic weight is not reflected in the Fund's governance structure, and African countries, where the Fund is heavily engaged.

35. The Executive Board explored in a seminar the options for moving forward in this area. The staff paper for this discussion notes that progress will require broad consensus

[10] IMF and World Bank, *Trade Progress Report: Doha Development agenda and Aid for Trade,* paper for the Fall 2005 Development Committee meeting.

among shareholders and examines the scope for change, including in the absence of a general quota increase. Among the measures discussed are *ad hoc* increases for selected countries whose quotas are most out of line; voluntary adjustments in quotas among country groups or individual members, to better reflect members' relative positions in the world economy; and an increase in basic votes, to correct the erosion of voting power of the African countries and other countries with relatively small quotas. The future work program on this issue, including in the period leading to the 2006 Annual Meetings, will take careful account of the suggestions that emerged during the seminar.