



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)



DC2007-0026
October 16, 2007

**STATEMENT BY THE MANAGING DIRECTOR
OF THE INTERNATIONAL MONETARY FUND**

Attached for information for the Members of the Development Committee is a Statement from the Managing Director of the International Monetary Fund, Rodrigo de Rato, for the Committee's seventy-sixth meeting to be held in Washington, D.C., on Sunday, October 21, 2007.

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**DEVELOPMENT COMMITTEE: THE MANAGING DIRECTOR'S WRITTEN
STATEMENT**

I. INTRODUCTION

1. The global economy is expected to continue to perform well in the remainder of 2007 and in 2008, although risks to the downside have increased following the recent financial market turbulence and tightening of credit conditions.
2. Thus far, the direct impact on developing countries of the financial market turmoil has been muted. Some emerging economies with more integrated financial markets or with high external vulnerabilities have felt the ripple effects of the turbulence. But overall, developing countries as a group have so far held up well.
3. The recent events illustrate that many developing countries are reaping the benefits of the economic reforms and improved macroeconomic policies that they have pursued in the past years. Good policies have become even more important in light of the increased risks to economic growth, especially for low- and middle-income countries.
4. At the same time, the international community must step up its contribution to developing countries with good policies in their efforts to meet the Millennium Development Goals (MDGs). For its part, the Fund remains a full partner in the international effort to achieve the MDGs. To that end, we are in the process of making our engagement in low-income countries more flexible and focused on our core areas of expertise and comparative advantage, as called for in the Fund's Medium-Term Strategy. Donors must intensify their efforts to ensure that the commitments they made at Monterrey and Gleneagles to increased and more effective aid and greater policy coherence are met.
5. In this statement, after a brief overview of our assessment of the world economic outlook, I shall concentrate primarily on presenting the Fund's perspective on the implications of the recent financial market turbulence for the world economy, especially middle- and low-income countries. I will close with a brief progress report on various reforms underway at the Fund on surveillance, our role in low-income and emerging market economies and on quota and voice—all key elements of our Medium-Term Strategy.

II. GLOBAL ECONOMIC PROSPECTS ¹

6. The global economy grew strongly in the first half of 2007, although turbulence in financial markets has clouded the outlook. The baseline projections for global growth in 2008 have been revised down by almost ½ percentage point since the July 2007 World Economic

¹ For details, see *World Economic Outlook—Prospects and Policies*, International Monetary Fund, October 2007.

Outlook (WEO) update. This would still leave global growth at a buoyant 4¾ percent, supported by generally sound fundamentals and strong momentum in emerging market economies. Growth is expected to be more subdued in the advanced countries. The housing downturn in the U.S. continues to apply a significant drag to growth, while recent indicators have given mixed signals about growth prospects in the Euro area and Japan.

7. Emerging economies in all regions continued to record strong growth in 2007. Although the underlying driving forces and economic policy settings differ from country to country, the positive growth trends are broad-based, affecting all major regions. Growth performance in *emerging Asia* remains exceptionally strong, reflecting robust exports and investment. Emerging economies in the *Middle East* continue to benefit from high oil prices and strong domestic demand. Economic activity in the oil-exporting countries is particularly buoyant in the non-oil sectors, fueled by increasing investment in infrastructure, social spending, and consumer demand. Economic developments in *emerging Europe* are positively affected by the strong upswing in western Europe and further integration in the global economy. By historical standards, growth in emerging economies in *Latin America* remains robust as well, although performance remains somewhat weaker than in other regions, partly reflecting the slowdown in the United States and supply constraints in some countries.

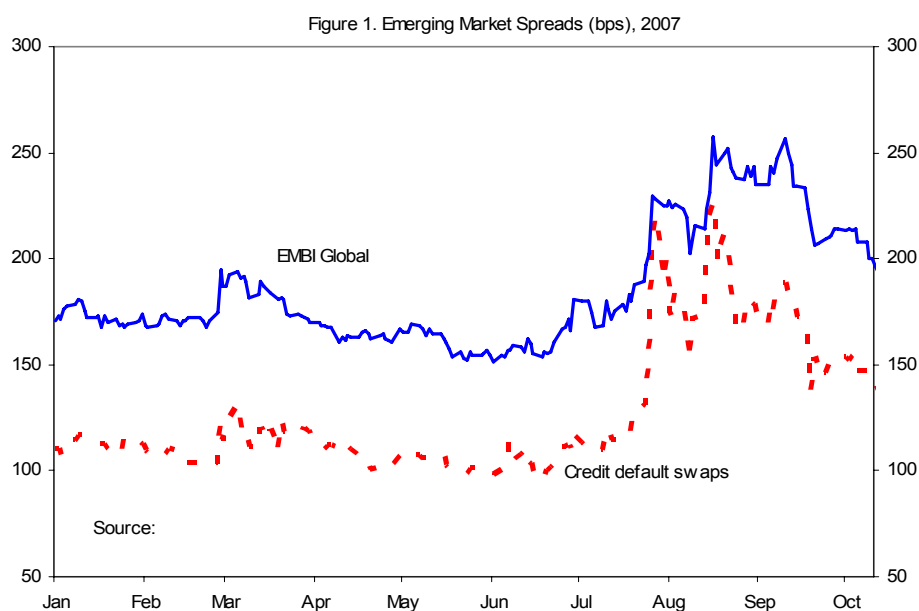
8. Low-income countries continue to benefit from strong demand for commodities in rapidly growing emerging markets and the favorable global environment. Although growth performance in *sub-Saharan Africa* is led by the expansion of oil production and the traditional non-fuel commodity exporters, many low-income countries in the region are experiencing positive spillovers in the non-commodity sectors, as evidenced by broad-based domestic demand growth. Also, in many of them, the manufacturing industry and services, although coming from a small base, are on a rising trend, leading to a gradual diversification of the production base and contributing to higher productivity growth. Although exports in low-income countries in *Asia* and the *CIS* are benefiting from high commodity prices and expansion of production capacity in traditional export sectors as well, achieving higher productivity growth and attracting investment in the nontraditional sectors remains a challenge.

9. Risks to the outlook are firmly on the downside, centered around the concern that financial market instability could deepen and trigger a more pronounced global downturn. The staff's baseline forecast is predicated on the assumption that market liquidity is gradually restored in the coming months and that the interbank market reverts to normal functioning, although wider credit spreads persist. A more extended period of tighter credit conditions, however, could have a significant dampening impact on growth, particularly if it puts additional pressure on housing markets in the U.S. and some European countries. Emerging market countries with large current account deficits and substantial external financing needs, particularly those in emerging Europe, could also be adversely affected if capital flows were to weaken. While downside risks to the outlook from inflation concerns have generally been somewhat reduced by recent developments, oil prices have risen to new highs and, with spare

production capacity remaining limited, a further spike in prices can not be ruled out. Risks related to persistent global imbalances still remain a concern.

III. THE IMPACT OF RECENT FINANCIAL MARKET TURBULENCE

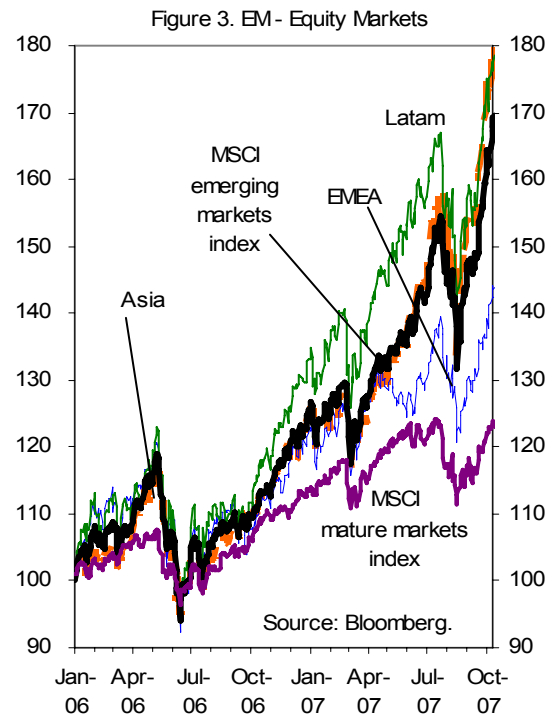
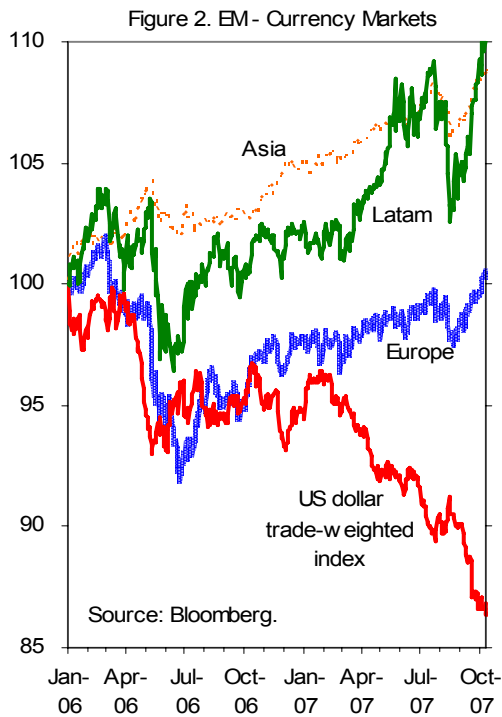
10. Mature financial markets have been experiencing significant turbulence in recent weeks. Problems in the U.S. subprime mortgage and leveraged loan markets have prompted a retrenchment from risky assets and a process of deleveraging, causing disruptions in some money markets, funding difficulties in a number of financial institutions, a widening of credit spreads in riskier asset classes, and more volatile bond and equity markets. These developments, in turn, have required extraordinary liquidity injections by a number of central banks. However, given the nature of the problem, the adjustment process may be protracted and credit conditions may not normalize for some time.²



11. The ripple effect of the mature market turbulence on middle- and low-income countries so far has been muted and uneven. Some emerging markets with more integrated financial markets, or with high external vulnerabilities, have been more affected. But as a group, middle- and low-income countries have held up well and they generally did not experience the liquidity problems that were seen in mature money markets. At the peak of the turbulence, interest rate spreads and the price for default insurance for emerging market debt instruments had risen by about 1 percentage point, thus increasing funding costs. However, spreads have since come down and have generally remained at low levels by historical standards. Currencies have also come under pressure, although depreciations were mostly

² A detailed account of the recent turbulence is given in the September 2007 Global Financial Stability Report.

contained, and a rebound took place once the strongest turbulence subsided. Equity markets in middle- and low-income countries retreated at the height of the turbulence, but the corrections—in contrast to earlier episodes of turbulence—were generally not much larger than those in advanced countries, and markets mostly remained up for the year as whole. In addition, in line with the pattern in mature equity markets, the corrections were short-lived, and the losses have since been recovered.



12. Several factors help explain why middle- and low-income countries have been less affected by this bout of financial turbulence, relative to earlier episodes. The recent turbulence in mature markets is related to innovative financial instruments that so far are less prevalent in less-developed markets. And many of these latter countries are more resilient than before because of stronger fundamentals and improved policies. Current account positions are stronger than in the past, with middle- and low-income countries as a group showing significant surpluses. Also, several countries have large foreign exchange reserves, and are thus less vulnerable to short-term funding disruptions.

13. These generally favorable conditions notwithstanding, there are several pockets of vulnerability, and we are still in the midst of unfolding events. While effects on middle- and low-income countries have been relatively modest so far, and even though as a group these countries appear well placed to weather adverse conditions, a further and deeper impact may yet become apparent, in particular if problems in mature markets were to persist.

14. There is a risk that investors and banks in middle- and low-income countries may be directly exposed to U.S. subprime mortgage losses through their holdings of asset-backed securities or other structured products. To date, though, such exposures do not appear to be widespread and, overall, the scope for substantial losses through this channel would seem limited. However, we believe that indirect effects are likely to be more significant and may be transmitted through two main channels.

15. The prime potential transmission channel is the effect of market turbulence on global output growth, and possible second-round effects on commodity prices.

- The current problems in mature financial markets may result in a general tightening of credit conditions, which is likely to have some negative impact on industrial countries' and global growth. It currently seems that this impact will be relatively limited.
- However, risks remain firmly to the downside. If financial market strains continue longer than currently assumed, and credit conditions remain tight, this might undermine consumer and business confidence and lead to a sharper slowdown. For instance, a consumption-driven slowdown in the U.S. would negatively affect Chinese exports and production, which would spill-over to other Asian countries. In turn, especially in combination with a tightening of financial conditions, this could trigger a decline in various commodities prices. As the spectacular boom in commodities prices has been one of the key factors underpinning the strong performance in many middle- and low-income commodity exporters (think of Brazil, Nigeria, or Zambia), a sustained decline in commodity prices would likely have significant adverse effects on economic performance and balance of payments positions.
- For low-income commodities exporters, particularly those less diversified, the direct effects of falling commodities prices on economic growth may be particularly strong. For emerging markets, however, a sharp worsening of the external environment could trigger lower growth, weaker fundamentals, higher risk premia, and faltering asset price booms. Commodity importers, however, may experience beneficial effects from lower commodity prices.

16. A second key transmission channel could be financial (increasing risk aversion and tighter credit conditions). In the short run, continued illiquidity in mature markets may cause further rounds of asset sell-offs, including middle- and low-income countries' assets, thereby increasing their funding risks. This effect is likely to be strongest in middle-income countries, since foreign investor participation tends to be more significant in these markets. Impact on low-income countries may be more muted and lagged because these markets are relatively illiquid and unlikely candidates for rapid sell-offs. But low-income countries would likely be affected if liquidity problems persist. Thus, the duration of the mature market

turbulence could prove a significant factor. More generally, a sustained broad increase in risk aversion and tighter credit conditions could limit access and raise the funding costs of middle- and low-income countries, possibly triggering large reallocations of investor capital.

- For emerging markets that depend on private foreign capital flows, a slower inflow pace, or a withdrawal of such flows, could have an immediate impact and pose challenges, in particular, for countries that have large current account deficits. And countries depending on bank flows (such as several countries in Eastern Europe and Turkey) could be adversely affected by a slowdown in cross-border bank lending resulting from either tighter underwriting standards or pressures on banks' capital that could force a moderation of lending even to good quality borrowers. In countries with large direct and indirect foreign participation in fixed income and equity markets, a pull-out of foreign investors could also have a significant impact on valuations. This, in turn, could potentially affect the balance sheets of local financial institutions, in particular banks, and reduce the availability of capital to the corporate sector, thereby weakening investment and growth.
- For low-income countries which have no access to international capital markets, the importance of this channel may be very limited. However, for those low-income countries that have been trying to gain access to international markets but are not yet robust participants, there is a risk that continued turbulence and risk-reassessment could delay access to private market financing. So far, however, we have not seen this risk materialize. Indeed, in September, Ghana became the first sub-Saharan country (other than South Africa) to issue external bonds, and the issue was several times oversubscribed.
- Low-income countries, however, may also be affected by a reduced capacity of their banking sectors, which are often key buyers of government securities, to raise funds abroad for these investments. In the longer term, if sustained, the combination of reduced market access and lower growth could also lead to a decrease in south-south FDI flows, which have increased strongly in recent years, and a slowdown in privatization activity.

17. Increased risk aversion and deleveraging may also trigger the unwinding of carry trades, thereby further reducing global liquidity. Moreover, in recent periods, carry trades have had a marked direct effect on some specific middle-income economies—including e.g., Brazil and Turkey—whose high-yielding currencies served as destination currencies for these trades. In such cases, changes in risk aversion can cause sharp downward adjustments in the exchange rate.

18. Finally, there might also be effects on emerging mortgage and housing markets. Several emerging markets in Central and Eastern Europe have experienced sharp increases in house prices in recent years, typically in combination with credit booms, sometimes fuelled

with substantial foreign currency lending. In an environment of a general reassessment of risk, and where doubts about lending standards and valuations fuel uncertainty, the confidence of domestic and foreign lenders and borrowers may yet be affected.

19. In terms of policy implications, the potential consequences of the current market turmoil should not be underestimated. The adjustment process in mature markets could be protracted and credit conditions might take some time to return to normal. Also, downward risks to the global economy have increased materially. More broadly, uncertainty on the location and size of losses has revealed the potential for rapid shifts in market sentiment that can affect seemingly unrelated markets. This has changed the nature of systemic risk.

20. Against this background:

- In the period ahead a rethinking of practices in areas such as transparency, the role of credit rating agencies, and the boundaries of regulated institutions is likely to take place. Middle- and low-income countries, too, may consider stepping up surveillance against risks of credit indiscipline and related vulnerabilities. In particular, financial sector supervision needs to ensure that innovative risk transfer instruments do not weaken incentives of lending institutions and credit standards.
- Strong macroeconomic policies matter to reduce risk. Middle- and low-income countries need to ensure that their policies continue to support resilience. In particular, high dependence on foreign financing and highly leveraged balance sheets remain key risk factors, and comfortable reserve levels, relative to short-term debt, help absorb liquidity shocks. And improved debt management (longer maturities, less foreign currency borrowing) fosters resilience in periods of tighter credit, reducing rollover risks.

IV. RECENT DEVELOPMENTS IN SURVEILLANCE

21. Recent events in global financial markets have underscored the importance of the Fund's role in bilateral and multilateral surveillance in promoting financial and economic stability. Significant progress has been made since the Spring Meetings in refining and modernizing the framework for our surveillance activities, and strengthening its implementation.

22. In June, the Fund Board approved a new Decision on Bilateral Surveillance over Members' Policies, to foster greater clarity, candor, evenhandedness, and accountability. The new framework emphasizes external stability as the focal point of surveillance, while also clarifying what exchange rate policies countries should avoid and when the Fund should express concern. The focus of efforts has now shifted to implementing this new Decision effectively in developed as well as developing countries. Separately, the positive experience with the first Multilateral Consultation on Global Imbalances confirmed the value of this approach as an instrument for enhancing the Fund's multilateral surveillance activities.

23. Further improvements in the quality of surveillance are also being pursued by continuing the refining of our methodologies for exchange rate assessments of individual member countries, including for low-income countries and producers of exhaustible resources; more systematically integrating financial sector assessments into surveillance; and better assessing how developments and emerging trends and risks in the global economy affect individual countries.

V. THE ROLE OF THE FUND IN LOW-INCOME COUNTRIES

24. The Fund remains fully committed to providing support to its low-income members and helping them achieve the MDGs as soon as possible. Aside from providing debt relief under the Enhanced Heavily Indebted Poor Countries (HIPC) Initiative and the Multilateral Debt Relief Initiative (MDRI), considerable effort has been made under the Fund's Medium Term Strategy to clarify our role and responsibilities in helping countries attain the macroeconomic stability and sustainable strong growth critical for achieving the MDGs. Recent efforts include refining the Fund's advice on managing scaled-up aid inflows; and clarifying the parameters of the Fund's involvement in the Poverty Reduction Strategy (PRS) process and its collaboration with donors in low-income countries. In addition we are in the process of reviewing the Fund's engagement with fragile states.

25. Our debt relief operations under the HIPC Initiative and the MDRI are moving ahead.³ A total of 22 countries have reached their HIPC Initiative completion point, and 24 countries have now received debt relief from the Fund under the MDRI. An additional 10 countries are between HIPC Initiative decision point and completion point, and nine are potentially eligible for HIPC initiative assistance. Nevertheless, the delivery of relief from some commercial and non-Paris Club official bilateral creditors remains low. The Fund strongly encourages all creditors to deliver their expected share of relief, as this is a key requirement for the effectiveness of such international initiatives. The need to mobilize additional resources to allow the protracted arrears cases to benefit from debt relief has also become more pressing with the positive developments in one of these countries.

26. The Fund is working with low-income members to help them use the debt sustainability framework to design their medium-term borrowing strategies. Technical assistance in this area will be stepped up, in close coordination with the Bank and other institutions. The Fund and the Bank are jointly reaching out to lenders to raise their

³ *Initiative for Heavily Indebted Poor Countries (HIPC) and Multilateral Debt Relief Initiative (MDRI)—Status of Implementation* (SM/07/310, 8/30/07), *Enhanced Heavily Indebted Poor Countries Initiative—Status of Non-Paris Club Official Bilateral Creditor Participation* (SM/07/323, 9/11/07), *Update on the Financing of the Fund's Concessional Assistance and Debt Relief to Low-Income Member Countries* (SM/07/324, 9/13/07), and *The Acting Chair's Summing Up* (BUFF/07/135).

awareness of debt sustainability risks. In this regard, efforts made by some creditor groups, including the OECD's export credit group, to foster sustainable lending practices are welcome developments.

27. The Fund has refined its advice on appropriate macroeconomic policies in the context of the planned scaling up of aid to low-income countries.⁴ Baseline aid projections in Fund-supported programs should represent the staff's best estimate of the amount of aid that is expected to materialize, but staff will also assist the authorities in preparing sustainable scaling-up scenarios. Fund-supported programs encourage a full and effective spending of all aid, while the decision on how much to spend should take a medium-term perspective and be based on country-specific circumstances, including macroeconomic stability, absorptive capacity constraints, and debt sustainability. In the face of volatile aid disbursements, there is merit in smoothing expenditures over time so that key spending programs are adequately financed, provided that international reserves are adequate and macroeconomic stability is preserved. Wage bill ceilings under Fund-supported programs should be used only in exceptional cases when warranted by macroeconomic considerations.

28. Similarly, the parameters of the role of the Fund in the Poverty Reduction Strategy process have also been clarified, based on the principle of re-focusing the Fund's activities on our areas of core competency and comparative advantage; and a consistent institutional approach to collaborating with donors and other stakeholders has been established. Fund-supported programs should continue to be closely aligned with the Poverty Reduction Strategy Papers and the staff should report on the use of resources for poverty reduction.⁵ Fund staff will signal to donors when more aid could be used effectively and without endangering macroeconomic stability, or conversely, when existing or planned aid exceeds a country's capacity to do so.

29. Fund staff will continue to collaborate closely with the Bank in assisting countries in assessing the fiscal and debt sustainability of scaled-up aid flows, and in the design of medium-term debt management strategies that would help them avoid the re-accumulation of unsustainable levels of debt. We are helping our low-income members develop effective public financial management systems, including by better formulating budgets and controlling spending, and building institutional capacity. The Fund also engages in frequent and extensive information exchange with donors on areas of Fund's core expertise.

⁴ *Aid Inflows—The Role of the Fund and Operational Issues for Program Design* (SM/07/210 and Sup.1, 6/14/07), *Fiscal Policy Responses to Scaled-Up Aid* (SM/07/199, Sup.1, and Sup.2, 6/7/07), and *The Acting Chair's Summing Up* (BUFF/07/102, 7/12/07).

⁵ *The Role of the Fund in the PRS Process and Its Collaboration with Donors* (SM/07/334, 9/21/07) and *The Chairmans's Summing Up* (BUFF/07/139, 10/12/07).

30. Together with the Bank, we are reviewing the arrangements for Joint Staff Advisory Notes (JSANs) to enhance their effectiveness and usefulness. We plan to launch external consultations before submitting a report to the Boards by the end of the year.

31. Developing countries, particularly in sub-Saharan Africa, have made great strides in strengthening the economic environment for high and sustained growth. Notwithstanding these efforts, however, achieving the MDGs will require more aid and better aid. I am concerned that actual aid flows are falling well short of meeting the commitments made at Gleneagles, particularly for Africa. Fulfillment of these promises would help create space for the higher social and infrastructure spending necessary to accelerate growth and fight poverty. Enhancing aid effectiveness will also require further work on the part of donors and recipient countries to align and harmonize aid. This also underlines the urgency of making rapid progress in reaching agreement on the 15th IDA replenishment.

VI. BANK-FUND COLLABORATION

32. The External Review Committee on Bank-Fund collaboration made a number of specific recommendations, including some that are particularly relevant to the work of the Bank and the Fund in low-income countries.⁶ The main message of the Committee's report is that improved collaboration will enhance service delivery to member countries, and that the institutions should seek to foster a culture of collaboration at all levels. The Spring Development Committee and IMFC welcomed the Report's messages.

33. Against this background, a joint Management Action Plan (JMAP)⁷ has been prepared, aimed at translating existing good-practice in collaboration into standard practices. The agreed actions in the JMAP are designed to (i) improve coordination on country issues; (ii) enhance communications between the staff of the two institutions working on common thematic issues; and (iii) improve incentives and central supports for collaboration on policies, reviews, and other institutional issues. The relevant departments and units in the two institutions will prepare periodic progress reports, highlighting emerging examples of good practice as well as problem areas that need further attention.

34. Actions agreed between Bank and Fund managements in the JMAP were presented in separate informal seminars to the Boards of the two institutions in early October. The JMAP will be launched immediately after the Annual Meetings, and the goal is for most new systems to be operational in time for the preparation of the respective FY09 budgets.

⁶ *Report of the External Review Committee on Bank-Fund Collaboration, Final Report*, February 2007.

⁷ *Enhancing Collaboration: Joint Management Action Plan* (Draft report prepared by Fund and Bank staffs, September 11, 2007)

VII. FUND SUPPORT OF EMERGING MARKET ECONOMIES

35. The strong economic fundamentals in several major emerging markets have helped reduce their vulnerabilities to financial market strains, and led to robust economic performance in recent years. Accordingly, many of these countries have moved from a program to a surveillance-only relationship with the Fund. However, macroeconomic fundamentals still vary widely among emerging market countries and some vulnerabilities remain. It is therefore prudent for these countries to prepare for times when market access is more constrained and the risk of spillovers is higher.

36. In these circumstances, the Fund has been focusing on strengthening its crisis-prevention role in emerging market economies. Besides surveillance, recent Fund efforts have focused on strengthening the diagnosis of underlying vulnerabilities, and on developing a new liquidity instrument for market access countries. The new instrument would help reduce the risk of crises by: (i) providing a way for well-performing countries with remaining vulnerabilities to signal strong policies; and (ii) by making substantial disbursements available rapidly in the event of a crisis. There has been some encouraging support on key elements of a design, including by those members who might use the instrument. We are ready to come back to the Board on this issue once there is a clearer expression of interest for a new instrument among the membership.

VIII. QUOTA AND VOICE ISSUES

37. We have made progress on the agenda for quota and voice reform approved by the Fund's Board of Governors at the 2006 Annual Meetings in Singapore. These reforms aim to enhance the effectiveness and credibility of the Fund by making significant progress in realigning quota shares with members' relative weight and role in the global economy and, equally important, by enhancing the participation and voice of low-income countries. Since the Spring Meetings, the Fund Board has held further discussions on key issues related to the new quota formula, the modalities for the second stage quota increases, and the increase in basic votes. The Board will also consider an amendment to the Articles of Agreement enabling Executive Directors elected by a large number of members to appoint more than one Alternate Executive Director. The Executive Board will provide a detailed report to the Fund's Board of Governors on progress to date on these reforms.

IX. THE FUND'S WORK ON CLIMATE CHANGE ISSUES

38. The Global Monitoring Report for Spring 2008, which is being jointly prepared by Bank and Fund staffs, will have environmental sustainability and climate change as thematic area for monitoring. The selection of this topic is an acknowledgment of the threat climate change poses to developed and developing countries and its importance for sustainable economic growth and poverty reduction. Progress towards environmental sustainability, which constitutes one of the MDGs, presents major challenges for developing countries in several key areas of government policy. Although the Bank will take the lead on this, in

collaboration with donors and specialized UN agencies, the Fund will need to be ready to assist its members in analyzing macroeconomic effects and making the right fiscal policy choices when dealing with environmental issues. As part of this effort, it is our intention to present around the end of this year a Board paper discussing the fiscal implications of climate change and alternative adaptation mechanisms to deal with the effects of climate change. An appendix on the macroeconomic implications of climate change is continued in the Fall 2007 World Economic Outlook (WEO), and a more extensive chapter on this topic will follow in the Spring 2008 WEO.