



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)



**DC2008-0011**  
October 10, 2008

**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, Dominique Strauss-Kahn, for the Committee's seventy-eighth meeting to be held in Washington, D.C., on Sunday, October 12, 2008.

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

### **I. INTRODUCTION**

1. The recent World Economic Outlook (WEO) notes that the global economy continues to face strains from a deepening and broadening financial crisis, with many advanced economies bordering on recession. Growth in emerging and developing economies is still close to trend, but the more severe and protracted the financial crisis becomes, the more they are likely to be affected. Many countries are also still grappling with the macroeconomic fall-out and poverty effects of the food and fuel price shock.
2. In this context, the challenges for policymakers differ across countries. The priority in advanced economies is to support activity and contain risks to financial stability in a period of rapidly slowing growth. In emerging and developing economies, policymakers must balance growth and inflation risks while fostering adjustment to higher food and fuel prices. At the multilateral level, policymakers should intensify their collaboration to underpin stability and confidence by broad-based actions to address the financial market crisis. For developing countries in need of increased financial assistance to address the food and fuel price shock, donors must follow up on commitments made at Gleneagles and, more recently, Accra to increase aid and improve aid effectiveness.
3. The Fund stands ready to cooperate closely with its members and development partners to help countries deal with these pressing challenges. In this statement, I will give a brief overview of our assessment of the world economic outlook, including the financial market turmoil and the impact of the commodity price shocks, followed by a discussion of macroeconomic policy priorities for developing countries. I will also provide a brief progress report on our efforts to refocus the Fund.

### **II. RECENT DEVELOPMENTS AND THE GLOBAL OUTLOOK**

#### ***Economic growth is rapidly slowing, especially in advanced economies***

4. Global economic growth is expected to moderate from 5.0 percent in 2007 to 3.9 percent in 2008, and 3 percent in 2009. The advanced economies will be close to recession in the second half of 2008, as the negative feedback loop between strained financial systems and the macro economy has intensified. In the U.S., tightened credit conditions as a result of housing and financial market corrections continue to retard growth, despite aggressive monetary and fiscal policy easing. Similar conditions, together with the U.S. slowdown and euro appreciation, have dampened growth in Western Europe, while Japan has been recently affected by slowing exports and weakening domestic demand.

5. Economic activity in emerging and developing economies is also expected to lose steam, although by less than in advanced economies, with growth rates projected to ease from 8 percent in 2007 to 6.9 percent in 2008 and 6.1 percent in 2009. Emerging economies have to date not experienced the drastic reductions in access to external financing experienced in previous episodes of financial turmoil. But vulnerabilities are increasing and some countries with large current account deficits have had more difficulty financing them. Looking forward, export growth in emerging and developing economies is expected to decelerate, while the strong productivity gains of recent years are projected to sustain domestic demand. Commodity exporting countries will continue to expand, while economies dependent on food and fuel imports will tend to decelerate more sharply.

***The financial market crisis has reached unprecedented levels***

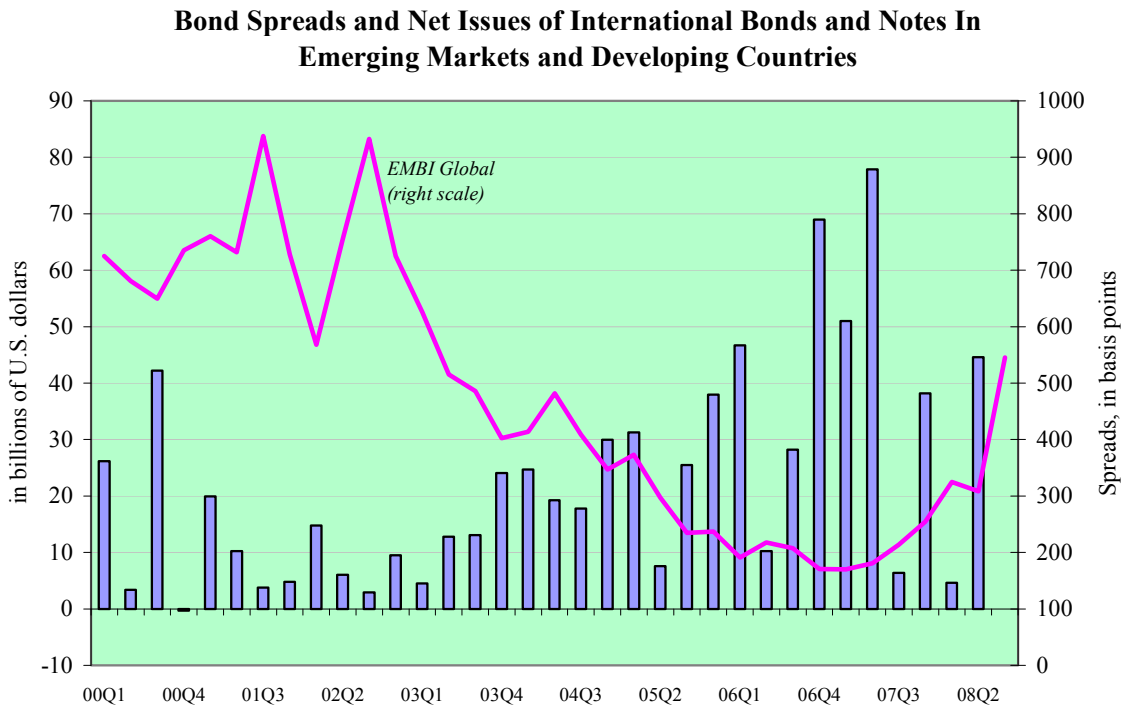
6. The historic events of the past few weeks could hardly have been imagined as the subprime crisis began to unfold a little over a year ago. Core financial institutions—major U.S. investment banks, the government-sponsored enterprises (GSEs), commercial banks in both U.S. and Europe, and the largest U.S. insurance company—faced losses from the subprime crisis that eroded their capital positions. This in turn led to funding shortages and ratings downgrades that compounded the collapse of confidence in these institutions and impeded the functioning of credit markets. So far, this has resulted in the collapse of one large investment bank, the restructuring of all the remaining U.S. investment banks, and failures of some major commercial banks in both Europe and the U.S.

7. The scale of policy intervention has been similarly historic. Central banks around the world have injected large amounts of liquidity into the interbank markets on a coordinated basis. Policy interest rates were lowered in the U.S., the U.K., and some other advanced economies. There were government-funded and sponsored bailouts of the GSEs and commercial banks in the U.S. and Europe. Funding and liquidity strains nevertheless remain high, as evidenced by persistently wide interbank spreads, swap bases and liquidity premia.

8. Reflecting tightening lending standards, credit to households in the US (and to some extent also in Europe) has slowed, and growth in corporate borrowing is expected to abate once existing loan commitments to enterprises have matured or been drawn down. These constrained credit conditions are likely to persist at least through much of 2009, putting a damper on economic growth prospects in advanced economies.

9. Although emerging markets and developing countries have so far remained resilient to the financial market crisis, the deleveraging process in advanced economies and decreased investor risk appetite have reduced the availability of external financing, especially for corporates, and raised interest rate spreads on emerging market debt. Leveraged investors in advanced economies—such as hedge funds—that depend on funding from other financial institutions, have been forced to scale back emerging market investments; other market

participants such as mutual and pension funds have reduced their emerging market exposure as well.



Sources: Bank of International Settlements; Bloomberg.

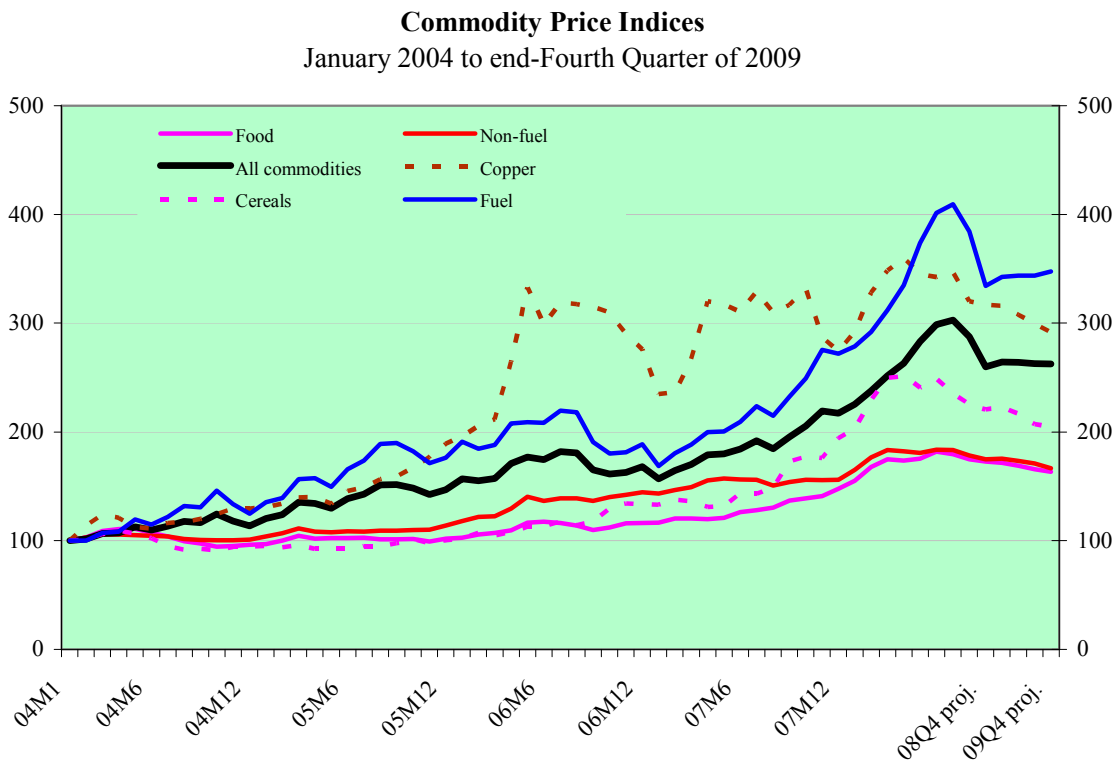
10. With little or no direct exposure to the mortgage-related structured products underlying the turbulence in advanced economies, the fallout for most banking systems in emerging and developing economies has been limited so far. But signs of stress are growing. Banking systems that rely heavily on external borrowing are clearly the most vulnerable. In some emerging markets, portfolio outflows are contributing to stock market declines and domestic funding stresses. Vulnerabilities are particularly elevated in Eastern Europe, where domestic banks have built up large negative net foreign positions vis-à-vis foreign parent banks, which are vulnerable to market sentiment as they obtain a large part of their funding in wholesale markets. Also, banks have become increasingly exposed to the real estate sector in recent years. They have not experienced a significant increase in loan losses so far, but have increased provisions for bad loans and may be forced to reduce credit growth if asset quality deteriorates sharply. The risk of such a scenario has risen, for instance, in the Baltics, where house prices and real credit growth have fallen.

11. Looking forward, a combination of global credit tightening, rising domestic interest rates, and the global growth slowdown could spread credit squeezes and rising defaults to a larger number of emerging markets and some developing countries, although the still favorable growth prospects in many of these countries will serve as a buffer to the effects of external financial shocks.

12. In collaboration with other international bodies, the Fund has begun distilling lessons from the financial crisis and encouraging early action by member countries. We are advocating a broad range of recommendations to strengthen financial supervision and regulation, improve frameworks for liquidity provision, and reinforce crisis management arrangements. We have also strengthened our own contingency planning and crisis preparedness, and stepped up our monitoring of highly vulnerable countries.

***Food and fuel prices have eased in recent months, but remain high***

13. In our preoccupation with the global financial crisis, we must not overlook the “other crisis” facing developing countries—the surge in fuel and food prices. While these prices have eased from recent peaks, they remain well above their levels at the onset of the recent run-ups. As of end-September, oil prices have declined around 45 percent with respect to their mid-July peaks, but are still almost double the levels recorded at end-2006. A sharper-than-anticipated weakening of oil demand and higher OPEC production has contributed to this decline. Nevertheless, underlying market balances remain tight, with demand from emerging and developing economies remaining robust.



Source: WEO.

14. Similarly, food prices have decreased by 8 percent from their June peak but are still well above end-2006 levels. A bumper wheat crop this year, together with reductions of rice and wheat export restrictions, has led to substantial increases in world market supply in these two grains since May 2008. Nonetheless, other factors will keep exerting upward pressure on

food prices over the medium term. Demand, particularly from emerging and developing economies, is likely to remain robust, while continued strong demand for corn for ethanol use and high fuel and fertilizer costs will also bolster price pressures.

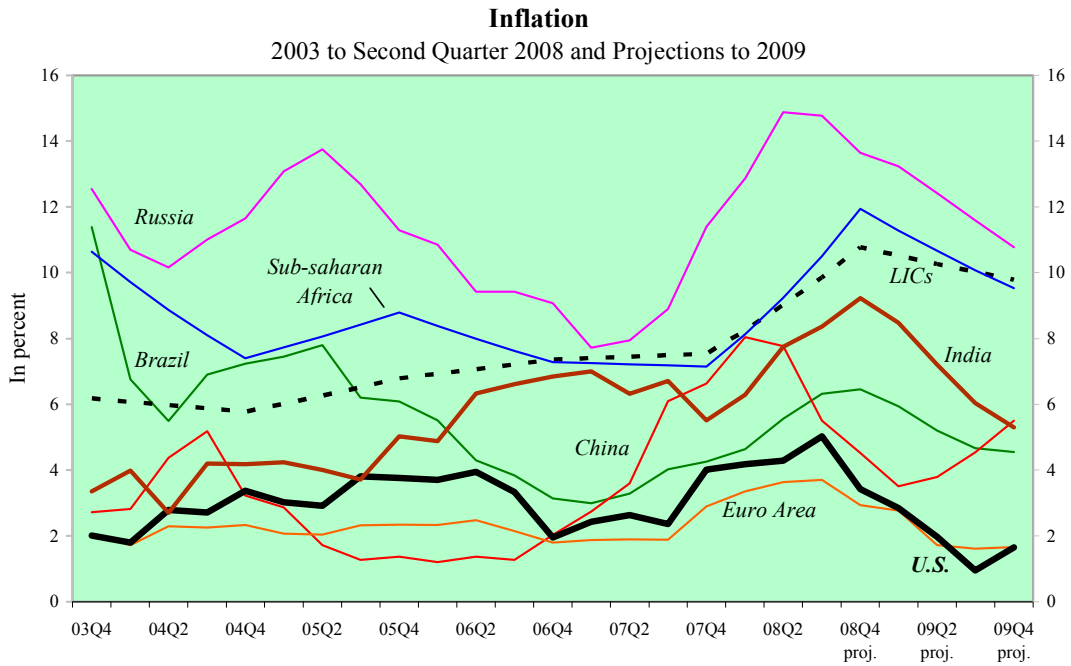
15. The sharp increases in food and oil prices have weakened the external positions of many emerging and developing economies. Excluding large surplus countries (such as China and Russia), the current account deficits of 44 emerging markets are projected to rise to US\$337 billion (3.2 percent of GDP) in 2008, from US\$160 billion (1.7 percent of GDP) in 2007. Many low-income countries are facing similar effects, especially those countries that are highly dependent on fuel imports: 58 net fuel-importing low-income countries face a rise in their fuel bill of US\$60 billion (3.2 percent of GDP) in 2008. The balance of payments effects of higher food prices will be less pervasive in low-income countries, most of which have substantial domestic production. For 43 net food importers with available data, however, the rise in their food bill in 2008 is estimated at about US\$7 billion (0.8 percent of GDP).

16. The commodity price increases have also contributed to increased global inflationary pressures. Inflation expectations in advanced economies remain well anchored and headline inflation in emerging and developing countries is projected to fall in 2009 as commodity prices level off. But some countries—notably in sub-Saharan Africa—are facing second-round inflation effects and strong wage pressures. Overall, headline inflation in emerging and developing countries is projected to rise from 6.4 percent in 2007 to 9.4 percent in 2008, before falling to 7.8 percent in 2009.

***The global recovery will be slow and risks are tilted to the downside***

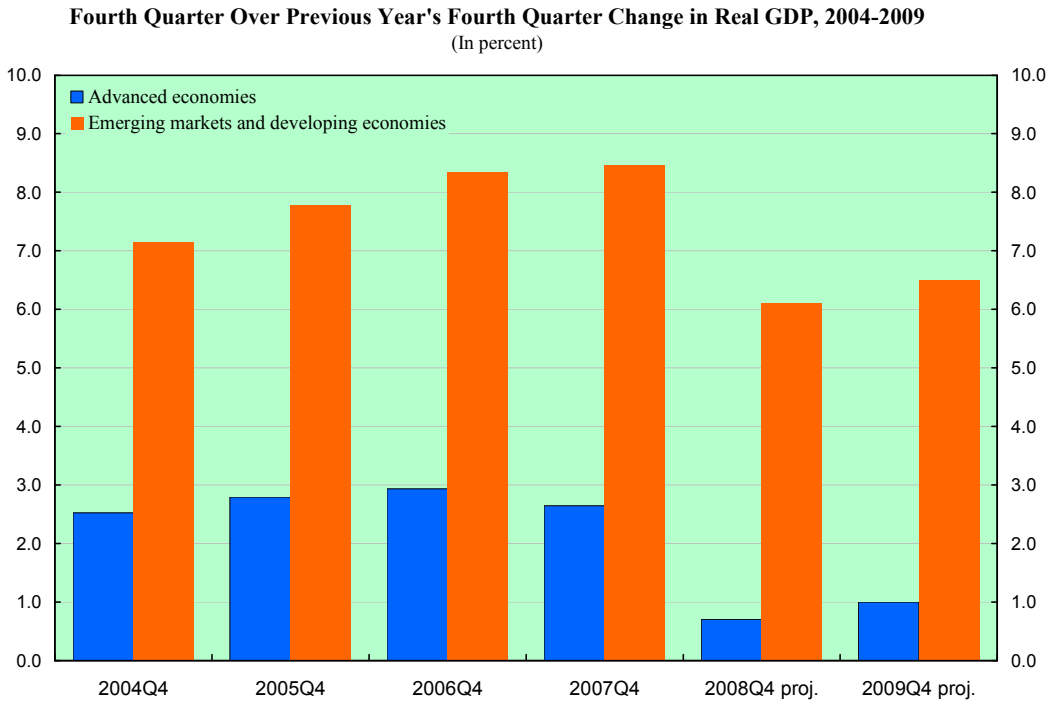
17. A gradual recovery of global economic activity should take hold in 2009. The pace of growth will be slower than in previous periods, as tight credit conditions continue to affect the corporate sector and households in advanced economies. Nonetheless, several factors should lay the ground for a recovery, including more stable conditions in the U.S. housing sector in 2009; relatively strong nonfinancial corporate balance sheets in the U.S. and Western Europe; and continued demand growth in emerging economies.

18. The situation is exceptionally uncertain, however, with risks tilted to the downside. Financial risks remain elevated, as rising losses in the context of a global slowdown could add to strains on financial institutions and further reduce credit availability. In addition, the U.S. housing market could deteriorate for longer than expected, and European housing markets could weaken more broadly. On the positive side, commodity prices are expected to stabilize, while demand, especially in emerging economies, could prove more resilient than projected to recent commodity price and financial market shocks, as was the case in the first half of 2008.



Source: WEO.

Inflation rates for low-income countries (LICs) and Sub-saharan Africa are on annual bases.



Source: WEO.

*Policy challenges differ across countries*

19. Under these circumstances, policymakers are faced with diverse challenges. In advanced economies, signs of moderating inflationary pressures may provide scope for monetary easing to support activity and stabilize financial conditions. In some emerging and developing countries where second-round inflation effects have been limited, the balance of risks is also shifting towards slowing activity. In these countries, an easing of the macroeconomic policy stance could be justified. Elsewhere, however, firmer action may still be needed to prevent a wage-price spiral, and thereby avoid a hard landing at a later stage. In this regard, more flexible exchange rate regimes could help to make monetary policies more effective.

20. Governments in emerging and developing economies are also faced with difficult choices when addressing the social effects of higher food and oil prices. Countries have responded in different ways: reductions in fuel and food taxes and tariffs, increases in universal subsidies, expansions in transfer programs, and public-sector wage increases. Several countries have resorted to export restrictions and export taxes focused on key food commodities. Many have allowed the pass-through of the first-round effects of food and fuel price increases, but others are still delaying this process.

21. Many of the measures adopted, however, are not cost effective and may even be counterproductive over the medium term. About one-third of developing countries have increased or are planning to increase fuel price subsidies in 2008. These subsidies are undermining the necessary adjustment of their economies to higher world market prices, may create unsustainable fiscal positions, and are inconsistent with longer-term objectives to mitigate climate change. Likewise, the untargeted food subsidies that exist in many developing countries are ineffective and costly. Well-targeted measures, such as direct income support and food-for-work programs, that help the poorest while keeping a cap on government spending are highly preferable to measures that extend to those who do not need government support.

22. Measures that distort international trade and deter investment in agriculture, such as export restrictions and domestic price controls, should be progressively removed. At end-August 2008, 35 countries had some form of export restriction on food items in place. Such restrictions have aggravated the upward pressure on world market food prices. Export restrictions and price controls also damage incentives for investment in agriculture, which is essential to meet the rapidly rising world demand for food products in the coming years. The food crisis reinforces the case for rapid and substantial progress in opening agricultural markets at the multilateral level. All parties involved should therefore make strong efforts to reinvigorate the Doha Round.

23. The IMF stands ready to assist its members in dealing with these policy challenges with macroeconomic policy advice, technical assistance, and financing. In response to the

food and fuel price shocks, we have already provided fifteen countries with additional assistance under lending programs supported by the Poverty Reduction and Growth Facility (PRGF), equivalent to about US\$260 million. We have also recently reformed our Exogenous Shocks Facility (ESF), opening the way for more rapid and higher access for the affected members. The Fund continues to collaborate closely with other international institutions in the UN High-Level Task Force on the Global Food Security Crisis.

### **III. THE FUND'S POLICY RESPONSE TO NEW CHALLENGES**

24. The challenges facing the global economy impart greater urgency to the refocusing efforts underway at the Fund. I would like to highlight recent initiatives in three key areas: our surveillance activities, our lending facilities, and our role in low-income countries.

#### **A. Strengthening Surveillance**

25. Surveillance is at the core of the Fund's mandate. The recently completed triennial surveillance review found that Fund surveillance is highly valued by its audiences. Nonetheless, our surveillance activities need to be continually strengthened and adapted to the rapidly changing global financial environment and evolving needs of our members. A recent analysis of how future financial crises may affect emerging market countries found that higher capital flows have yielded important benefits, but also increased volatility and risk of asset price bubbles. In light of this, we are placing priority on four key areas: (i) strengthening our work on assessing risks (including to provide early warning to members), (ii) further deepening our analysis of macro-financial linkages, (iii) better incorporating multilateral perspectives with respect to cross-border spillovers and lessons from countries' experiences, and (iv) strengthening exchange rate analysis and stability risks, including further progress in refining assessment methodologies.

26. We are also promoting better data collection and transparency, tailoring technical assistance to bolstering resilience to shocks, strengthening policy advice on crisis prevention and management, and improving communication and coordination with members and international bodies. In a successful example of the latter, the Fund helped facilitate a series of meetings of Sovereign Wealth Funds (SWFs), where there was an agreement on a preliminary set of 24 voluntary generally accepted practices and principles (Santiago Principles) for SWFs. These principles will help underpin the SWFs potential positive role in promoting financial stability and maintain an open global investment climate.

#### **B. Review of the Fund's Financing Instruments**

27. The global financial system and members' financing needs have changed enormously since the Fund was created. The current crisis has brought into sharp relief the need to reassess our array of lending instruments and adapt them as necessary to suit the diverse and evolving needs of the membership. We have therefore launched a comprehensive review of

our lending framework. This work will re-examine the analytical foundations for Fund lending and the role of conditionality; consider ideas for streamlining existing facilities and creating new ones, such as a liquidity instrument; review borrowing limits and financing terms; and reassess our lending role and facilities for low-income countries. The aim is to complete this review and decide on reforms before the 2009 Annual Meetings.

### **C. The Fund's Evolving Role in Low-Income Countries**

28. We are committed to maintaining our close engagement with low-income countries, while focusing on our core areas of expertise. Our role in these countries is to help them secure macroeconomic and financial stability as the basis for sustained growth and poverty reduction.<sup>1</sup> The precise nature and scope of our work must be tailored to country circumstances. In some, achieving macroeconomic stability remains a priority. Others have overcome this initial challenge, and the emphasis in these countries will be on how to engrain stability in stronger macroeconomic and financial institutions, so as to boost confidence and encourage private investment; how to support financial sector development while ensuring its soundness; and how to scale up spending for investment and social priorities without jeopardizing debt sustainability. In this regard, the Bank-Fund Debt Sustainability Framework has become an effective instrument for designing medium-term fiscal policy frameworks and defining sustainable lending principles for donors and creditors. In program design, we will continue to build on progress already made in focusing conditionality on measures critical for macroeconomic stability and incorporating greater flexibility in fiscal targets.

29. We are also reviewing key instruments used in support of low-income countries to enhance our effectiveness and efficiency. In addition to the recent reform of the ESF, we will review the Policy Support Instrument (PSI) to ensure it meets the needs of LICs that seek intensive policy engagement rather than long-term financing. In collaboration with the Bank, we are streamlining the procedures for Joint Staff Advisory Notes (JSANs). Further, a new framework will be developed that refines earlier proposals to strengthen the Fund's engagement in fragile and post-conflict states, taking into account views expressed in outreach with potential recipients and donors.

30. The Fund continues providing debt relief to low-income members. A total of 23 countries have reached their HIPC Initiative completion point, 25 countries have received debt relief under the MDRI, and 8 countries are potentially eligible for HIPC initiative assistance. The delivery of debt relief by private creditors has increased, but coordinated action remains necessary to encourage participation from these and non-Paris Club official bilateral creditors and guard against litigation. Additional financial resources will be needed

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<sup>1</sup> Statement by the Managing Director on the Role of the Fund in Low-Income Countries, see <http://www.imf.org/external/np/omd/2008/eng/pdf/100208.pdf>.

for the Fund to provide debt relief to all HIPC. Long-term debt sustainability remains a concern for many post-completion-point HIPCs, stressing the need for sound borrowing policies and strengthening debt management capacities.

31. We are also taking steps to improve the effectiveness of capacity building assistance in low-income countries. Technical assistance will be better integrated with surveillance and lending operations and better aligned with the strategic objectives of the recipient countries and the Fund. Four new regional technical assistance centers will be opened soon. The new centers—one in Central America, one in Central Asia, and two more in Africa—are a response to country demand and to positive experiences to date with regionally-based assistance.

32. The achievement of the MDGs will depend in part on increasing aid and aid effectiveness by the development partners. Excluding debt relief, trends in commitments of aid are falling short of what is necessary to meet the Gleneagles targets, especially in Africa. Therefore, donors must step up efforts to increase both the volume and the quality of aid. The Fund recently participated in the High Level Forum on Aid Effectiveness in Accra, where the international community reached a consensus on steps to enhance predictability of aid flows and increase the use of country systems by donors. The Fund will continue to be an active partner in the common endeavor to implement these principles. We will also take an active part in the Conference on Financing for Development to Review the Implementation of the Monterrey Consensus in Doha later in the year.

#### **IV. OTHER ISSUES**

##### **A. The Fund's Work on Climate Change**

33. Consistent with its current mandate, the Fund will continue to explore the macroeconomic and fiscal consequences of climate change. It will provide policy advice on macroeconomic and fiscal aspects of adaptation and mitigation to climate change in bilateral discussions with countries that are likely to be affected earlier and more severely than others, and stand ready to assist its members with technical advice on fiscal policy aspects of mitigation. Also, the Fund stands ready to provide financial support to its members facing exceptional balance of payments needs that might arise in cases of extreme climate events.

##### **B. Bank-Fund Collaboration**

34. Fund and Bank staff have continued to work together to implement the Joint Management Action Plan (JMAP) to enhance collaboration.<sup>2</sup> Teams have initiated the

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<sup>2</sup> See: <http://www.imf.org/external/np/pp/2007/eng/092007.pdf>

country-level work program discussions that are a central component of the JMAP. In addition, we have also piloted web-based mechanisms—“country portals”—to improve information flows between country-teams.

### **C. Quota and Voice Reform**

35. On April 28, the Board of Governors approved far-reaching reforms of the Fund’s governance structure that will provide a significant increase in the quotas of emerging markets and give low-income countries a greater voice in the institution. To complete the reforms, an amendment of the Fund’s Articles of Agreement will need to be accepted by at least three-fifths of IMF members representing 85 percent of the total voting power. The proposed quota increases also require consent and payment by the 54 eligible members. The deadline for consent is October 31, 2008. Recognizing that additional time might be needed, the Resolution approving the reforms stipulated that the Executive Board may extend this period as it may determine, taking into account, in particular, the need of members to obtain domestic legislative approval. The Board will have the opportunity to consider the need for such an extension prior to the October 31 deadline. In addition, a committee of eminent persons has been appointed to assess the adequacy of the Fund's current framework for decision-making and advise on any modifications that might enable the institution to fulfill its global mandate more effectively.