International Monetary and Financial Committee

Twenty-Sixth Meeting
October 13, 2012

Statement by Mr. Guido Mantega
Minister of Finance, Brazil

On behalf of the Constituency comprising Brazil, Colombia, Dominican Republic, Ecuador, Guyana, Haiti, Panama, Suriname, Trinidad and Tobago

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World Economy

Since the Spring Meetings in April, the Fund has been revising downwards its short-term growth estimates. High-frequency indicators for several advanced economies have deteriorated substantially in recent months and risks to the outlook are mounting. Emerging market and developing countries (EMDCs) have also decelerated, largely due to lower external demand, an uncertain global environment and the lagged effects of policy tightening in some of the major countries.

In many advanced economies, fiscal and structural policies are severely hampered by political paralysis, i.e., by the absence of agreement on the way forward and, in the case of the euro area, even on the implementation or specification of already approved measures. As a result, major central banks are being led to take on a disproportionate share of the burden of crisis management.

Despite a succession of measures taken by advanced countries, growth remains weak, confidence low and unemployment high. In those countries going through strong fiscal adjustments, income inequality and unemployment are increasing, often with highly detrimental effects on social and political cohesion. Political extremism is on the rise.

We have been arguing for some time that single-minded and draconian fiscal policies may be counterproductive and have a tendency to backfire. The latest issue of the IMF *World Economic Outlook* has appropriately underscored the much larger than expected negative short-term effects of fiscal cutbacks in advanced economies.

No one denies the need for credible fiscal consolidation plans over the medium-term. In the short-term, however, fiscal measures should be taken to promote aggregate demand and job creation or at least mitigate the impact of consolidation on activity and employment. Of course, circumstances vary from country to country. In some important advanced economies, there is probably room for fiscal stimulus. In others, automatic stabilizers should be allowed to operate. In all cases, the composition of fiscal policy adjustments is critical. By that we mean fundamentally two things. First, one should preserve, and where possible augment, those components of spending that have a substantial impact on economic growth from the demand and supply sides, as is frequently the case with investments in infrastructure, for example. Second, fiscal adjustment should necessarily protect the poor and vulnerable; social safety nets should be exempted from cuts, and strengthened if possible.

We are fully aware of the acute dilemmas confronting policymakers in many advanced economies, including the United States, the euro area, the United Kingdom and Japan. The delayed reactions to the crisis, especially in the euro area, have led to the accumulation of intractable problems. At this stage, there are no – if there ever were – easy solutions.

Needless to say, countries under severe market pressure have little or no option but to proceed with fiscal consolidation. In these cases, external financial support can be instrumental in allowing fiscal adjustment to be spread over time. In a few extreme instances, sovereign debt restructuring may be unavoidable.

The euro area is at the epicenter of the crisis, as has been the case over the last two years. We take note of the recent steps towards further fiscal and banking integration, which may be essential to overcome the crisis. Broad and deep political consensus will be necessary to support these new steps and it remains to be seen whether consensus will be forthcoming.

Despite some progress since 2008 on the financial reform agenda, implementation remains slow and uneven. Financial systems in most advanced economies remain overly complex and leveraged, as highlighted in the IMF's latest *Global Financial Stability Report*. The authorities remain apparently incapable of responding to the ingrained tendency of financial markets to develop "innovative products" as a means of circumventing new regulations. Another round of financial turmoil may be festering while the world economy has yet to fully recover from the previous one. It seems that the harsh lessons of the financial crisis have gone unheeded.

Some major central banks are again resorting to quantitative easing. Recent experience suggests there are reasons to doubt the effectiveness of lax monetary policies in current circumstances. Real interest rates have been negative or close to zero for quite a long time without prompting a clear recovery in private consumption or investment. If the domestic transmission mechanisms are weak, monetary policy will operate mainly through its effects on exchange rate depreciation and the resulting increase in net exports.

Advanced countries cannot count on exporting their way out of the crisis at the expense of emerging market economies. I have been arguing that "currency wars" will only compound the world's economic difficulties. Trying to grasp larger shares of global demand through artificial means has many side effects. It is a selfish policy that weakens the efforts for concerted action. As mentioned above, advanced countries should rethink their macroeconomic strategies and avoid simultaneous fiscal contractions and the consequent overburdening of monetary policy. Emerging markets and developing economies cannot passively endure the spillovers of advanced countries' policies through large and volatile capital flows and currency movements. All forms of trade and currency manipulation must be avoided because they improve international competitiveness in a spurious manner.

Brazil, for one, will take whatever measures it deems necessary to avoid the detrimental effects of these spillovers. We cannot accept the attempt to unfairly label as "protectionist" legitimate measures of defense in the areas of foreign trade, exchange rate and capital account management. Experience has shown that the free flow of capital is not necessarily the preferable option in all circumstances. We reaffirm the need for a more balanced approach within the IMF on how to limit excessive short-term capital flows.

Implementation of the 2010 Quota and Governance Reform

Despite our efforts, the 2010 quota and governance reforms did not enter into force by the time of these Annual Meetings, as agreed by the membership in 2010 and reiterated many times by the G20 and the IMFC. The failure to implement even limited reforms, approved by an overwhelming majority of countries, sends a negative signal to the outside world about the Fund's governance structure and its willingness to change.

Resistance to reform undermines the efforts to transform the IMF into a truly multilateral and representative organization. If the Fund's legitimacy deficit remains unaddressed, the institution could be thrown back on the path of diminishing relevance it experienced prior to the 2008 crisis.

At the stage we are in, the United States' acceptance of the reform is a necessary and almost sufficient condition for the entry into force of the 2010 quotas. We urge the United States' authorities to stand by their commitments and use their best efforts to complete the required domestic steps as soon as possible. The US played a crucial role in the negotiation of the 2010 agreement and continues to exert a positive influence in the ongoing comprehensive review of the IMF quota formula.

To achieve greater representation of EMDCs, the 2010 reforms included as one of its elements the reduction by two of the number of chairs held by advanced European countries in the IMF's Executive Board. The modest reshuffling announced so far indicates that this reduction will be effected mostly by cosmetic changes, namely by upgrading "emerging markets" of the European Union. This of course fails to correct the overrepresentation of Europe in the Board, sending yet another negative signal to the outside world.

Review of the Quota Formula

The realignment of quota shares is the centerpiece of IMF reform. The 2010 quota and governance agreement includes two fundamental forward-looking elements: the comprehensive review of the quota formula, to be completed by January 2013, and the decision to bring forward the timetable for completion of the next general review of quotas to January 2014. The agreement establishes that any realignment in quota shares is expected to result in quota increases for dynamic economies in line with their relative positions in the world economy, and hence likely in the quota share of emerging market and developing countries as a whole.

It was only because of the inclusion of these forward-looking elements, and the expectation that the membership would enter the new round of negotiations in good-faith, that Brazil and other emerging market economies supported the 2010 reform, with its limited gains in terms of overall shift in voting power to EMDCs.

G-20 Leaders have, in their Los Cabos summit in June this year, reiterated once again "(…) that the distribution of quotas based on the formula should better reflect the relative weights of IMF members in the world economy, which have changed substantially in view of strong GDP growth in dynamic emerging markets and developing countries". Unfortunately, we are witnessing since then attempts by some G-20 countries to backtrack on this and other commitments. We find this deeply disturbing and do not take it lightly. Everyone should realize that any attempt to go back on or "reinterpret" commitments, especially those made at the Leaders level, risks damaging irreversibly the credibility of the countries that renege on their pledges, as well as that of the G-20 and the IMF.

We favor a quota formula based essentially on GDP, an indicator that is a clear and widely used measure of economic weight, and available on a timely basis for almost all IMF members.

We reiterate our view that the openness variable is fundamentally flawed and that its presence in the quota formula generates irreparable distortions. As currently defined in the formula, openness is the relative share of each country in the gross sum of all current account flows (debits and credits). This measure has no economic meaning. It is not used anywhere else outside the IMF quota formula and should not be confused with the usual definitions of economic openness.

One of the many problems of openness, as defined in the formula, is the fact that it is based on gross rather than value-added flows, resulting in double or multiple counting. Why should the IMF quota formula include a variable inflated by multiple counting? GDP, as we know, is a value-added measure, avoiding multiple counting of the different stages of production. Those that defend the current measure of openness should, for the sake of consistency, propose that GDP also be measured on a gross basis.

Independently of the anomalies of the openness variable, it is well known that larger countries and countries with more diversified economies tend to be relatively more closed. In other words, the current measure of openness provides a premium for smallness and specialization. Why should the IMF quota formula reward the latter and penalize large and diversified economies?

Whatever the combination of variables, and the ways they are defined, we should ensure that the representation of EMDCs in the Fund is enhanced. The outcomes of the ongoing quota formula review should be checked against overall shifts in calculated quotas to EMDCs and low-income countries. We reaffirm our commitment to protect the representation of the poorest members, as well as that of small middle-income countries.

Small States

At the beginning of this year, a working group of IMF Executive Directors was formed to address the concerns of small middle-income states. This working group, coordinated by our chair, has been promoting joint action on several policy and country items coming before the Executive Board, including issues such as surveillance, eligibility to concessional financing and the provision of technical assistance and training.

This small state initiative has resonated with Management and staff of the Fund. Greater attention is being directed towards small states, including more research on their peculiar challenges. In September, one of the countries of our chair, Trinidad and Tobago, co-hosted with the Fund the first *High Level Caribbean Forum on Small States*. We are pleased to see that the concerns of small states are finally on the radar of the Fund. The Caribbean countries in our constituency appreciate this initiative, which in fact originated from a call by the Governors of Guyana, Suriname and Trinidad and Tobago.

Reserve Pooling among BRICS Countries

In June 2012, on the sidelines of the Los Cabos G-20 Summit, BRICS Leaders discussed bilateral swap arrangements in national currencies as well as reserve pooling and asked their Finance Ministers and Central Bank Governors to work on these issues and report back to them at the 2013 BRICS Summit.

Since then, a working group on reserve pooling and bilateral swap arrangements has been undertaking technical work on the feasibility of setting up a contingent reserve arrangement between the BRICS. There seems to be a consensus between the five countries that a self-managed reserve pooling scheme could have a positive precautionary effect, help forestall short-term liquidity pressures and provide mutual support. It would also contribute to strengthen the global financial safety net and complement existing international arrangements.

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Finally, let me welcome the countries that are joining our constituency as of November 1st. The presence of new members strengthens our role as a multi-country constituency and expands our outreach to different regions.