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Statement by Mr. Hans-Rudolf Merz
Minister of Finance, Switzerland

On behalf of Azerbaijan, Kyrgyz Republic, Poland, Serbia, Switzerland, Tajikistan, Turkmenistan, Uzbekistan

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I. Introduction

At this juncture, the IMF is facing a threefold challenge. It is called on to redefine its core mission, establish a sound resource base, and enhance its governance. Substantial work to address these challenges are ongoing, but their importance has been accentuated by recent events in the world economy. I sense a strong momentum to advance these key efforts. Successful institutional reforms are in the collective interest of the membership, since they enable the Fund to play its preeminent role in safeguarding international macroeconomic and financial stability.

With a marked slowdown in global growth and the ongoing financial market turmoil, the Fund has to effectively contribute to stabilize the international financial system and to strengthen the resilience of this system over the medium term. The Fund is rightly *re-directing its focus and adapting its instruments* in response to the more recent developments in the global economic environment. These changes must build on its well-established bilateral and multilateral surveillance instruments. But the Fund will also need to find new ways how to assess the linkages between the macroeconomy and financial markets. The close cooperation with the FSF, the BIS, standard setting bodies, and national authorities will help distill relevant knowledge and forge a consensus on the lessons for public policy.

In parallel to the thorough strategic review of tasks and activities, important strides are being made to *modernize the working of the IMF to make it more cost-effective*. I find these measures that will lead to efficiency gains, expenditure reductions, and a sizable downsizing within a short period remarkable for an international public institution. These efforts have my support and I commend the new Managing Director for his vision and determination. Furthermore, I am confident that it will be possible to make the Fund's income base sustainable, based on the recommendations by the Group of Eminent Persons.

I support Resolution on the reform of quota and voice in the IMF. I consider the increase in basic votes effective in enhancing the voice of the smaller members. I also agree with the specific measures to strengthen the representation of the two African constituencies. However, I retain strong reservations against other parts of this package, namely the design of the new quota formula which includes a large weight for GDP partially measured in purchasing power terms. I thus insist that any further quota adjustment should be based on a refined quota formula that better reflects the key role of financial globalization for the IMF's mandate.

II. Global Economic and Financial Environment

Uncertain Growth Outlook

The growth outlook for the world economy has significantly worsened, with considerable risks of a further deterioration. The financial market turbulence that started in a limited segment of the US mortgage market has over the past several months spread across the financial system. Financial institutions continue the process of re-pricing hard to value assets and their associated risks. While such an adjustment could be seen as long overdue, there is the potential that the former exuberance of markets could turn into excessive pessimism and risk adversity. The scenario of a downward circle of deteriorating credit quality causing asset deflation and possibly leading to a disorderly unwinding of global imbalances is indeed unsettling.

The risk of a recession in the *United States* – which is at the epicenter of the current financial turmoil – seems high and rising, although export growth and additional fiscal and monetary impulses should support the economy. The Federal Reserve has cut interest rates very aggressively, which could counteract the negative growth impact of decreasing house prices and stock market wealth. But there is the potential that this monetary easing fuels inflation in the medium-term. For *Europe*, the economic fallout from the slowdown in the United States and the credit market crisis is difficult to quantify. In fact, domestic demand in many countries, including Switzerland, continues to be strong, and a large share of exports goes to fast-growing Asian markets. The European economies also tend to benefit from increased investment spending in oil-exporting countries.

Emerging Markets have generally been resilient to the market disruptions, due to improved macroeconomic stability reflected in sounder fiscal and current account balances and higher reserve levels. However, risks to their outlook have also increased with inflationary pressures even more pronounced than in advanced countries. Increased international trade and financial linkages would suggest that significant effects of the current downturn may yet be felt in these countries. In some countries greater exchange rate flexibility would allow to better cope with such spillover effects. For some *emerging European countries*, on the other hand, credible Euro adoption agendas, along with responsible fiscal policies, may be decisive in anchoring business confidence and protecting these countries from a sudden reversal of capital inflows. They are well advised to combine effective financial sector supervision with macroeconomic policies that keep excessive credit growth in check.

Most countries in *Central Asia and the Caucasus* continue to experience rapid growth, supported by commodity exports and expansionary macroeconomic policies. A key challenge for these countries is rising inflation that also reflects substantial and worrisome increases in food prices.

Policy Response

Central banks have been at the forefront in responding quickly to the unfolding financial market turmoil by repeatedly providing liquidity to alleviate stress in interbank lending. Despite these coordinated efforts and a substantial monetary easing in the US, financial conditions remain tight. This could well indicate that in the current environment central banks' traditional tools are insufficient to address what – in its core – is a crisis of confidence among market participants. Exceptional measures to provide money markets with sufficient liquidity such as the swap lines between the Federal Reserve, the ECB, and the Swiss National Bank are thus appropriate. However, it is important that such credit lines do not counteract the monetary policy strategy.

While it is essential to effectively and rapidly counter the symptoms of the current financial market downturn, it is equally important to subsequently assess and sort out its underlying causes and remedy evident systemic weaknesses. In doing so, the private sector should feel compelled to make significant adjustments to its practices in order to strengthen the resilience and functioning of global capital markets. On the official side, a pragmatic strengthening of the regulatory framework for financial markets that builds on the joint work already in progress on the international level, targets asymmetric incentive structures, and substantially enhances disclosure appears most promising. We expect that many of these improvements can be effected within the Basel II framework and encourage its broad implementation and further refinement. Also, the cooperation between supervisors over large global financial institutions should be intensified further.

The Swiss supervisors are at the forefront in improving oversight over large banks and the financial system, as confirmed in the recent Article IV consultations that focused on financial risks and related policy measures. The international initiatives pursued as a result of the current crisis will involve different public and private sector bodies. These multiple work streams will therefore need to be very well coordinated, prioritized, and sequenced. Overreaction and inconsistencies should be avoided in favor of a predictable reform path. The optimal role of the Fund in this process still has to be fully defined.

III. Reforming the IMF

Strategic Directions

I welcome the Managing Director's ambitious agenda of re-orienting the Fund's activities towards its *comparative advantages*. This approach promises to make the IMF's work more relevant to members and enhance its effectiveness and impact. It allows, and requires, the Fund to focus on those responsibilities that contribute most in the international context. This not only implies the targeted use of limited resources, but also coherence and a clear division of labor with international institutions whose strengths are complementary, particularly with the World Bank. The Fund is faced with heightened expectations regarding its impact through surveillance, low income country work, and capacity-building.

The Fund's *surveillance mandate* is a core competence and is crucial to its multilateral and bilateral roles. It is an area where no compromises can be made on output quality. This function should be appropriately adapted and I support the envisaged emphasis on the linkages between the real economy and financial markets, and cross-border spillovers. The operational implementation of this enhanced macro-finance and multilateral focus should be mainstreamed throughout the Fund, rather than implemented in one particular department. Also, further research efforts on the macro-finance nexus will be needed, so that policy recommendations can be made with sufficient confidence.

I look forward to the first Statement on Surveillance Priorities in the context of the Triennial Surveillance Review, which will provide the means to direct surveillance towards key issues of common concern. While I note that these changes will give the *multilateral perspective of surveillance* more weight, the regular dialogue with authorities as part of its *bilateral surveillance process* remains key. This dialogue is the bedrock of the IMF's technical expertise and credibility. As affirmed in the 20007 Surveillance Decision, the Fund is called on to follow the principles of evenhandedness, candor, and focus in annual Article IV consultations. The quality of its monitoring, analysis, and policy discussions must remain a priority. I want to emphasize that the analytical content of Article IV reports needs to be preserved, even as streamlining is pursued.

The *Fund's role in low-income countries* first and foremost is to help these members secure and maintain macroeconomic stability and sustainable debt levels. I expect the Fund to make candid macroeconomic assessments and to offer pertinent policy advice to member authorities, taking into account the specific circumstances of each country, in its area of competence. Also, it is very desirable to draw more extensively on the experience from emerging markets, as well as cross-country work more generally, in order to help low-income countries graduate into an environment of higher growth and financial deepening. I favor a clearer delineation of the Fund's role in low-income countries relative to other institutions, such as development banks, in order to optimize the Fund's value added while enhancing its own operational effectiveness. On engagement with donors, the sharing of information by the Fund is key, all within the confines of the role as a trusted advisor. At the same time communication with, and the coordination among, donors remains the responsibility of the recipient authorities. With regard to Fund arrangements with low-income countries, the Executive Board has a critical fiduciary duty in reviewing program implementation and the use of Fund resources. I thus welcome the intention to maintain the respective reviews cycles. I also positively note that independent ex-post assessment that evaluate prolonged Fund resource use will be maintained.

Although demand from the membership for *technical assistance and training* has steadily increased, the Fund remains a niche player in the provision of such capacity-building services in the international context. Tighter resource constraints now require a concentration on a more limited range of areas, in keeping with the principle of comparative advantage. A main challenge also is the modernizing and harmonizing of technical assistance administration with a view to establish an accurate and transparent costing that reflects international best practice. This can then be the basis for external fundraising and increased bilateral contributions, for example to thematic and geographic trust funds. At the same time, the Fund should maintain some capacity to conduct TA within its own budget constraints, including for areas where this has benefits for the membership as a whole, e.g., anti-money laundering, and for members that might not be on the screen of many bilateral donors, e.g., post-conflict countries and fragile states. Overall, charges for capacity-building services, uniform, graduated or otherwise, would clearly be the best way to address the need to efficiently channel and respond to members' requests. The delivery of technical assistance and training via regional centers seems to be particularly cost-effective in building local capacity and should be extended. The same applies to training courses. Generally, there should be more information for the membership and more visibility of the Fund's technical assistance output and I support amending the transparency policy in this regard.

The Income-Expenditure Framework

The clarification of the strategic direction is a necessary underpinning for determining the appropriate resource envelope over the medium-term. Priority setting and financial sustainability must go hand in hand. I support the objectives that the Managing Director has set in terms of expenditure savings and increasing income. I am pleased that the envisaged significant financial restructuring process is well under way. By combining measures on the expenditure and income sides, it should be possible to achieve a sustainable financing of the Fund.

On the *expenditure side*, I have taken note of the thorough examination of current tasks by internal working groups. This has yielded valuable proposals to achieve efficiencies and cut costs, including through the modernization of structures, operations, and business processes. I endorse the budget envelope for the medium-term, and the envisaged reduction in expenditures by 100 million US Dollars in real terms by 2011. I am aware that this target entails a significant reduction in staffing levels. The challenge is to make the expected voluntary and involuntary separation as acceptable as possible, while avoiding the exit of high performing staff.

The Fund's *income situation* is projected to deteriorate further in coming years, implying a continued drawdown of reserves. It remains urgent to address the Fund's financial situation in a comprehensive way. I thus support the Resolution to broaden the investment mandate of the Fund. Overall, however, I would have preferred to adopt all elements originally proposed by the Committee of Eminent Persons. This would have given the Fund a rational income model. The exclusion of the possibility to invest members' quota resources from this package deprives the Fund of a discretionary income instrument. Looking ahead, reaching a formal consent by all members for gold sales will be key. Such sales should be well coordinated with central banks and included in the existing agreement for official gold sales. I do not expect such sales to disrupt the gold market, an experience that is borne out by past gold sales by the Swiss National Bank both directly on-market as well as through the BIS as an agent. Further, I am in favor of introducing a dividend policy as an instrument to redistribute income in excess of what is necessary to cover the Fund's running costs and the accumulation of appropriate reserves. Given broader tasks and responsibilities, there is a need to enhance the Fund's governance and capacities in investment and risk management.

Quota and Voice Reform

The agreement reached among members that concludes the second stage of the quota and voice reform is in many respects unsatisfactory. It is a product of realism and compromise. While I continue to subscribe to the overall objective and also support the measures that will enhance the voice of low-income countries, my main concerns relate to the new quota formula. I continue to have strong reservations in this regard. However, I also clearly recognize the importance of this reform for the Fund and its entire membership. It is in this spirit of collective interest that I am willing to support the second Resolution on quota and voice reform.

The *new quota formula* does not sufficiently anchor the functions of quotas, nor does it reflect the responsibilities of the Fund and its members. These responsibilities are derived from its mandate as a monetary institution with global financial stability as its core mission. GDP at market rates, not in PPP terms, is the sole measure to accurately reflect members' economic position in the context of the Fund's mandate. As the formula is geared to political ends, it does not establish an economically sound and lasting basis. In particular, it does not sufficiently mirror financial globalization even as the Fund refocuses its strategy in this direction. I believe that even a 30 percent weight for openness is too low in a globally integrating world. Any further increase in quotas will thus need to be effected based on a revised formula.

I welcome the inclusion of a *compression factor* in the formula. It is a transparent redistribution mechanism for avoiding excessive divergence between the quota shares of large and small countries, and for enhancing the share of developing countries. Since the compression factor addresses the undesired divergence in quota shares, and this divergence is not time dependent, it should be permanent.

Also, I agree on the *other elements of the package* that have helped make this compromise possible. The tripling of basic votes is an effective way of enhancing the representation of smaller members, and I welcome the fact that the higher overall share of basic votes will be maintained in the future. Better representation will also be possible through the attribution of a second Alternate Executive Director for the two African Chairs.

IV. Outlook

I welcome the decisiveness by which the Managing Director has addressed the institutional and policy challenges that the Fund is facing today. I am reassured that he will turn the need for financial adjustment into an advantage by allowing the Fund to become a more efficient and more focused institution. Implementing the decisions that the IMFC is asked to endorse will require substantial further work and stamina. The forthcoming evaluation of the Fund's corporate governance by the Independent Evaluation Office (IEO) is to be seen as part of the efforts to modernize the institution. However, institutional change cannot be an end in itself. The reforms should enable the Fund to more effectively contribute to the stability of the global monetary and financial system as it develops.