International Monetary and Financial Committee

Seventeenth Meeting
April 12, 2008

Statement by Statement by His Excellency
Sultan N. Al-Suwaidi
Governor of the United Arab Emirates Central Bank

On behalf of Bahrain, Egypt, Iraq, Jordan, Kuwait, Lebanon, Libya, Maldives, Oman, Qatar, Syria, United Arab Emirates, and Yemen

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I. The Global Economy and Financial Markets—Outlook, Risks, and Policy Responses

1. Developments since our last meeting in October 2007 have confirmed that the problems that erupted in a limited segment of the U.S. financial sector have now spread and evolved into what is considered one of the largest financial shocks since World War II. While the events triggered by the subprime mortgage fallout and its impact on the real economy in the U.S. are still unfolding, many other advanced economies are reeling with the dislocations reverberating to their financial systems, and the likely spillover into the real sector. Amid considerable uncertainty surrounding the likely duration and cost of the financial crisis, **global growth** is now projected to moderate to 3.7 percent in 2008 and 2009. The outlook for major advanced economies is considerably weaker, reflecting the marked downward revision in U.S. growth forecasts, with a modest, albeit decelerating activity projected in the Euro area and Japan. Unprecedented is the resilience of emerging and developing countries to the current turmoil, with the growth momentum witnessed partly offsetting the drag on global activity induced by the slowdown in advanced economies. These latter developments reflect in large measure the reforms over the past decade or two that have increased the resilience of these countries to adverse shocks.

2. Risks to the **baseline outlook are clearly tilted to the downside**, with some probability of growth softening to the equivalent of a global recession at 3 percent or possibly lower, should the fallout from the financial crisis prove protracted or mutate into a full-fledged credit crunch. Conditions in the financial markets are expected to remain difficult for some time, as the twin engines of the financial system—the banking system and the securities market—appear to be subject to strain simultaneously. A further risk to the outlook emanates from the possible interaction between negative financial shocks and domestic demand, particularly in the U.S., with broader repercussions on global growth. Notwithstanding the economic slowdown, risks related to inflationary pressures and oil market developments have also increased, with the run up in oil and other commodity prices being partly driven by speculative factors in the face of the sharp depreciation of the U.S. dollar.

3. Policymakers all over the world face a policy dilemma and a complex problem to address. In the **United States**, policymakers need to strike a delicate balance to address the twin crises where both inflationary pressures and a slowing growth appear to be taking place

simultaneously. The housing crisis clearly shows that financial regulation and supervision have lagged the development of new and complex financial instruments, with the financial accelerator effect of increased use of homes as collateral amplifying the spillovers from the housing sector to the rest of the economy. Consumption is likely to be held back not only through the wealth effect due to declining housing prices, but also by the increased uncertainty clouding the economic environment as labor market conditions soften and energy prices continue to rise. Policymakers have appropriately opted to lean more toward addressing the growth issue. Monetary policy has been eased substantially, accompanied by sizable injections of liquidity to help alleviate the strains in credit markets and restore market confidence. The fiscal impulse of some $150 billion by the U.S. Treasury to help support demand is also appropriate given the circumstances. But with tightening credit conditions limiting the traction of monetary policy, along with uncertainty about the lags and effectiveness of the fiscal impulse, the policy stimulus may have come a little too late. If anything, there could perhaps be a risk of overstimulating the economy.

4. The unprecedented nature of the current crisis would arguably call for unorthodox policies, including the **potential use of public balance sheets to safeguard the financial system**. In this respect, the recent action by the Fed to support the bail out of a major U.S. financial institution may seem justified. However, such measures inevitably raise concerns of moral hazard and equity, and therefore must be resorted to sparingly. That said, policy measures taken so far, while appropriate and welcome, do not address the root problems underlying either the still declining housing prices or the credit crisis—both of which cloud the economic scene in the U.S. and possibly other developed economies. While recent Fed action may have alleviated some of the credit dislocations for major U.S. banks, the deeper underlying problem of insolvency remains unaddressed, and the resolution mechanisms for such insolvency risks are unclear. Moreover, other international financial institutions, especially in Europe, are deeply engaged with U.S. businesses and are therefore not immune from such risks, given the larger common components of financial shocks.

5. Policymakers in the **Euro area** face an equally difficult dilemma. Despite upside risks to inflation, downside risks to growth from currency appreciation and lingering uncertainty about the health of the financial sector have somewhat increased. Moreover, the run up in house prices in some countries remains a source of concern, despite a potentially more muted impact on consumer spending given the relatively limited spread of innovative mortgage financing. Given differences in macroeconomic frameworks compared to the U.S., the scope for monetary easing or a fiscal stimulus may be more limited.

6. The current conjuncture of events has brought to the fore the evolving role of **emerging market and developing countries** (EMDCs), particularly as a powerful engine of growth that could well prevent the global economy from sliding into recession. Many of the emerging and developing economies have so far largely escaped the adverse effects of the current turbulence in the international financial markets, reflecting much strengthened economic fundamentals that increased their resilience to adverse shocks, as well as higher commodity prices. For most EMDCs, the multiple challenge from overheating, growing imported inflationary pressures, and dealing with shifts in foreign exchange inflows remains a pressing concern. The latter could be even accentuated by the prospective easing of interest rates in key advanced economies, as well as by the ongoing process of repricing of risk away

from advanced countries' markets. Alternatively, a reversal of capital inflows could increase vulnerabilities in countries that rely on external financing sources.

7. Given their growing trade and financial global integration, EMDCs will not remain entirely immune to the impact of a more pronounced slowdown in advanced economies. Improved fundamentals in many EMDCs have certainly expanded the scope for countercyclical policies. **We believe, however, that the challenges and policy responses confronting emerging market economies are not adequately assessed or discussed**, particularly since the timing and extent of the impact of a global downturn is likely to vary given the divergences in country circumstances. An excessive tightening of financial policies may risk undercutting the only source of growth momentum to sustain global activity in the period ahead. The priority, therefore, is to adopt the appropriate policy mix to sustain domestic demand, through both consumption and investment, while safeguarding macroeconomic stability and reducing vulnerabilities from the financial turmoil in advanced economies.

8. **Role of the Fund.** The Fund had signaled as early as April 2007 the risks of a hard landing in the U.S. and other financial markets. The fact that these warnings were largely disregarded or downplayed by many analysts is a cause for concern. It is therefore important to avoid complacency regarding the potential risks from tail events, related to the possibility of overstimulating the economy in the U.S., or the conjunction of financial and macroeconomic risks precipitating a self-reinforcing contraction of global economic activity. These are significant contingent risks with different implications for policy responses. Against this background, we see a major role for the Fund in the following three areas.

9. First, given its global membership, multilateral perspective and technical expertise, the Fund is uniquely placed to facilitate the **dissemination of lessons learned** from the financial turmoil. We welcome the Report to the IMFC on the policy lessons and implications for Fund surveillance from the financial turmoil, while recognizing the evolving character of these lessons as events in financial markets continue to unfold. Going forward, we see scope for meaningful Fund engagement with member countries to try to address the short-term problems without losing sight of the need to focus on the medium-term challenges related to the crisis. The immediate focus on diminishing uncertainty and strengthening confidence in mature market financial systems, by injecting liquidity, enhancing disclosure and reinforcing banks' capital, is well founded. Over the medium term, more fundamental reforms, including the regulation of the mortgage market, the role of rating agencies, broadening the risk perimeter, strengthening supervisory cooperation and improving crisis resolution mechanisms, should be pursued. The Fund should also **develop a view on the extent to which government should be involved in stabilizing financial markets** while balancing concerns of moral hazard and equity.

10. Second, in view of the widespread and far-reaching implications of the current financial turmoil, we see a central role for the Fund as a forum for discussion and agreement on a **set of coordinated and consistent policy responses**, not only among industrial countries but encompassing emerging and developing countries as well. The Fund is uniquely placed in adding a multilateral perspective to policy responses in the current crisis, notably through the WEO and the GFSR; for providing a forum for ongoing discussion and

exchange of views especially with regard to possible contingency actions; and for promoting consistency of national policies and assessing their spillovers in an increasingly integrated global economy. In this connection, we would call for a more proactive role for the Fund in safeguarding the stability of the international financial system by **moving rapidly on a new liquidity instrument for emerging market economies**.

11. Third, through its **bilateral surveillance and FSAP assessments**, the Fund is well placed to assess the **linkages between financial and real sectors**, and provide valuable input to standard setters and other international bodies that could lead to further improvements in supervisory and regulatory frameworks. We see scope for better integration of some of the policy lessons in bilateral surveillance. We would also support strengthening the Fund's analysis of financial market developments and risks, especially in advanced economies, and developing new applications for stress testing to help identify financial vulnerabilities.

12. Allow me now to highlight some of the major developments in the **Middle East** region. Countries in the Middle East have been staging an impressive growth performance that remained relatively unscathed by the global financial turmoil, although policymaking in some countries is being complicated by the depreciation of the U.S. dollar. Growth in oil exporting countries has been strong, with trade and financial spillovers spurring even higher growth in many non-oil exporting countries in the region. Not surprisingly, the vibrancy of domestic demand, coupled with rising food and energy prices in many Middle Eastern countries, along with emerging supply-side bottlenecks in several Gulf Cooperation Countries, have stoked inflationary pressures. A somewhat uncomfortably high inflation could be expected in the near term until macroeconomic policies that have already been implemented take hold. That said, macroeconomic policies would be appositely adjusted to put inflation on a firmly downward trajectory before it becomes entrenched. For the specific case of oil-exporting countries, the exchange rate peg to the dollar will continue to pose a challenge to monetary policy, particularly given the different cyclical positions with the U.S. As such, government spending would be calibrated to reflect the cyclical positions of these economies, with the composition adjusted to target the supply constraints that gave rise to inflationary pressures.

II. IMF Reforms and Policy Agenda

A. Quota and Voice Reform

13. We attach great importance to governance reform of the Fund as a means of enhancing its legitimacy and credibility with the membership. Understandably, the proposed package cannot meet the preferences or priorities of any single member; progress toward agreement on a package will therefore require difficult compromises on the part of all members. Nonetheless, we underscore that reaching a compromise on a package of reforms should not come at the detriment of the reform objectives. We acknowledge and welcome the progress that has been realized since we embarked on our discussions on the subject, particularly the inclusion of GDP PPP blend and a compression factors, the proposal for tripling of basic votes, and the appointment of an additional alternate executive director for each of the African chairs.

14. Nonetheless, **the proposed package falls short of the key objectives set out in the Singapore Resolution.** At 1.1 percent, the increase in quota shares of emerging market and developing countries from the pre-Singapore level is entirely due to the first round, and is far from being significant in realigning the share of EMDCs with their evolving weight in the global economy. That said, we consider the agreement on the proposed package to be a first step in a dynamic process with the objective of realigning the Fund's governance structure with the evolving realities of the global economy. In this connection, we underscore the importance of periodic reviews of quotas to rebalance quota shares toward the most dynamic economies and raise the shares of underrepresented members. Specifically, an outcome of future quota realignments should be a further increase in the voting share of emerging market and developing countries as a whole.

B. A Sustainable Model for Fund Finances

15. Securing a predictable, flexible, and equitable source of income is critical in supporting the Fund's mandate. Equally important, agreement on a new income model has become an integral component underpinning the credibility of the ongoing downsizing and refocusing exercise, and should therefore proceed with utmost urgency. The Fund has delivered on a range of expenditure reducing measures amounting to almost 14 percent in real terms over the medium-term (FY2009-2011), to be achieved through staff cuts of about 400 positions, as well as other non-staff cuts. A new income model for the Fund is thus necessary to underpin the proposed integration of income and expenditure in a unified framework. We welcome the progress achieved to date and the agreement reached on several key proposals recommended by the Committee of Eminent Persons. In particular, we strongly support the proposed amendments to the Articles of Agreement to expand the Fund's investment mandate and the sale of a limited amount (post-Second Amendment) of Fund gold. We urge colleagues and major shareholders to remain actively engaged with their authorities to ensure a favorable outcome to these proposals.

C. Strategic Directions in the Medium-Term Budget

16. We welcome the proposals outlined in the Managing Directors statement on the Strategic Directions in the Medium-Term Budget. We agree with its guiding principle that the Fund's work should be refocused to its core mandate and prioritized according to comparative advantage. **Surveillance** remains central to the Fund's responsibilities in the international monetary system. We fully support enhancing the framework for surveillance as the central focus of our work going forward, and further improving the integration of financial sector analysis into our surveillance activities, albeit with two main reservations:

- First, we attach particular importance to Article IV consultations which underlie **bilateral surveillance**, and are therefore disconcerted by the proposed significant cuts in area department activities devoted to bilateral surveillance, as envisaged in the medium-term budget. In our view, the Fund is the one organization that provides this public good. Every effort should be made to safeguard the quality and credibility of bilateral surveillance, which is also the foundation of regional and multilateral surveillance.

- Second, we reiterate our misgivings regarding the Fund's involvement in **setting best practices for Sovereign Wealth Funds** (SWFs). The Fund does not have the requisite expertise in the areas of governance and transparency to take the lead in producing a set of best practices for SWFs. We are also concerned that the treatment of SWFs, to the exclusion of other types of institutional investors with proven track record of excessive risk taking and destabilizing behavior, would introduce a severe element of bias and lack evenhandedness in financial surveillance. Finally, the timing of this exercise and its political dimensions could inadvertently disrupt the flow of much-needed long-term capital from SWFs to institutions in the U.S. and elsewhere that face both liquidity and capital shortage issues.