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INTERNATIONAL FINANCE CORPORATION
INTERNATIONAL DEVELOPMENT ASSOCIATION
INTERNATIONAL CENTRE FOR SETTLEMENT OF INVESTMENT DISPUTES
MULTILATERAL INVESTMENT GUARANTEE AGENCY

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Address by **MICHEL CAMDESSUS**,
Chairman of the Executive Board
and Managing Director of the International Monetary Fund,
to the Board of Governors of the Fund

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Washington, D.C., October 6, 1998

Mr. Chairman, Governors, ladies and gentlemen, let me extend a warm welcome to you all, particularly the Governor for the Republic of Palau, our 182nd member, and, among the observers, to Wim Duisenberg in his new capacity as President of the European Central Bank. Wim, in welcoming you, allow me to salute on behalf of the Fund, the extraordinary achievement of Europe in availing itself of a single currency, after many years of patient work and steady convergence. I wish also to express our deep gratitude to President Clinton and President Menem for their presence with us today, for the encouragement that they have given us, and for the inspiration that we can draw from their remarks.

Governors, you have come this year in the midst of a crisis. A crisis that has already cost hundreds of billions of dollars, millions of jobs, and the unquantifiable tragedy of lost opportunities and lost hope for so many people, particularly among the poorest.

This is a time then, for hard thinking, for recognizing errors, and for bold steps. So let us try together to find answers to four basic questions:

- Where do we stand?
- What has gone wrong?
- What should be the basis of a new financial architecture? And,
- How can we travel from today's crisis to a more secure, stronger international monetary system?

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I. Where do we stand?

The Fund's most recent assessment is that, in the absence of any further major shocks, world output will expand by about 2 percent in 1998, just one half of what we projected a year ago.

What has changed? Two key factors have aggravated the crisis that first emerged in Southeast Asia: One, a crisis at the heart of the crisis—the recession and financial system distress in Japan—intensified. Two, the abrupt deepening of crisis in Russia triggered a new wave of instability throughout the world. No country has been immune. Contagion has spread through the emerging markets, especially Latin America, and financial markets in Europe and North America have turned down. Finally, this turmoil has traveled full circle, creeping back into Asia to make its prospects for an early recovery more uncertain.

This virulent contagion was felt most keenly in those countries with weak policies and inadequate institutions, but even countries with well-managed economies have not been spared. We did not anticipate the strength of this virus, which has struck far and wide, for instance, attacking Latin America because Russia ran into trouble. What a powerful demonstration this has been of the real vulnerability of emerging markets to abrupt changes in confidence, and the risks that arise when relatively small economies become the recipients of very large short-term flows!

Now, in the aftermath of this second shock of the crisis, most developing countries face a sharply weaker environment, greatly diminished capital inflows, and declining commodity prices:

- In Africa, where many successful adjustment programs were producing positive per capita growth for the fifth year in succession;
- In Latin America, where many countries had greatly strengthened their macroeconomic and structural policies; and
- Among the economies in transition, many of which, after years of painful structural transformation, were preparing themselves for another year of significant growth.

All of these, and others in the Middle East and the rest of Asia, now face difficult challenges.

It would be perhaps too dramatic yet to talk of global recession, but the evidence of the risks calls for immediate action. Fortunately, in the industrial countries of North America and Europe the fundamentals remain sound. For some time, inflation has been subdued. Economic expansion continues in the United States, while in the economies of the euro area the recovery has continued to firm. But even North America and Europe are not immune, and effects of the crisis are beginning to be felt. It was therefore most appropriate that representatives of the industrial economies recently recognized the shift in the balance of risks from inflation to a slowdown in demand. Their pro-growth stance, together with prospects for a gradual turnaround of the Asian countries in crisis, if they continue strong policies, lead us to anticipate a modest upturn in world growth in 1999, from 2 percent to, say, 2 1/2 percent. But there are still many downside risks.

If we expect any upturn next year, it will be because of the impressive steps by many countries, some of which were already implementing Fund-supported programs, to shield themselves against contagion. An example at the onset of the crisis was the Philippines which was able to absorb the worst of the successive waves of contagion by prolonging and rapidly strengthening an existing successful Fund-supported program. The reaction of Latin American countries, so admirably illustrated by the remarks of President Menem, is also to be lauded. By jointly strengthening their defenses they have invited the markets to take greater account of the striking progress accomplished over the past decade and in particular since the Mexican crisis. They have created the conditions for the Fund to negotiate promptly its financial support, if necessary.

All of this means that we are not in 1928. Recession on a global scale can be avoided. If we keep a steady nerve, if all countries pursue stability, structural adjustment, and orderly liberalization of their economies, this crisis can be overcome. Countries at the heart of the turmoil can emerge stronger and better prepared for the challenges of the next decade. But for this to happen and for us to respond properly, we must understand clearly what went wrong.

II. What has gone wrong?

Let us be clear: we are speaking not just of countries in crisis, but of a system in crisis, a system not yet sufficiently adapted to the opportunities and risks of globalization.

Let us turn to countries and first to Russia, the most recent crisis. What did go wrong in Russia? Not the country's overall strategy for reform. Under this strategy, which was supported by the international community for over seven years, a fundamental transformation had begun in the economy, the society, and the political system. The economy had been opened and decidedly oriented toward the market, and inflation had been tamed. An upturn in economic output had finally started in 1997, and the prospects for further growth were fair, if only reform efforts could be maintained.

But an appropriate strategy was not enough. In spite of the government's good intentions, too much was left undone, and support for reform was insufficient. In early 1998 the situation turned for the worse. Russia suffered a major terms of trade shock mainly from falling energy prices. This compounded the prevailing structural and macroeconomic weaknesses—a severe fiscal imbalance, pervasive problems of corporate and public governance, growing financial sector fragility, and deficiencies in market institutions. Abruptly, this summer, the markets delivered their harsh verdict. Now in our dialogue with the new government, we see that Russia will need to re-establish a sound path to recovery and to restore confidence greatly weakened by its unilateral debt restructuring. If Russia can begin again to help itself, and do so convincingly, assembling broad support for reform, the Fund will, of course, stand ready to help.

But earlier, in Asia, what went wrong after decades of remarkable performance? As in Russia, the crises were three-dimensional. The first dimension involved macroeconomic imbalances, reflected in short-term capital outflows. A second took the form of acute financial

sector problems reflecting the absence of robust banking institutions and practices. And the third was embedded in the economic culture, allowing unduly close links among the state, the banks, and the corporate sector. This approach of “managed development” was simply out of tune with the demands of a globalized economy.

To the three-dimensional problem we had to consider a triple response. In the first and second dimensions—the macroeconomy and the financial sector—we were on more or less familiar ground. In the third, together with other agencies, we faced newer challenges: lack of transparency, misgovernance, and corruption. Nonetheless, reforms are now being implemented, some are having immediate positive effect; others addressing deep-rooted problems will need more time to take hold.

In brief, to an unprecedented crisis, we had to bring unprecedented responses, and at times to enter stormy, uncharted waters. These were comprehensive programs put together in emergency situations. When needed they have been adapted. And they are working.

Consider what has been achieved. On a narrow definition of stabilization, the task is well advanced. In Korea and Thailand, and even in Indonesia, exchange rates and interest rates have stabilized and are moving toward more appropriate levels. Inflation is in check. External positions have strengthened remarkably, as current accounts have swung from deficit to large surplus. And Governors, we should all commend your colleagues from the countries in crisis who had the vision and courage to achieve that. But we know only too well about the sharp loss of output and heavy social costs that have accompanied these gains. Capital accounts have yet to turn around convincingly. So even if some necessary conditions for renewed growth have been fulfilled, the task is far from complete.

These countries need to press ahead resolutely with their full adjustment and reform programs, making sure that the poorest will benefit. The social costs have been high, too high, even if in Asia, as elsewhere, we have encouraged the authorities to make room for adequate social expenditure, relaxing fiscal targets as needed. And let me tell you that we applaud the initiative, spearheaded by the World Bank, to sharply increase the funding for social safety nets in countries undertaking painful reform.

Overall, these programs are beginning to work, but they will not suffice. For these countries, for any country, to enter the new century with sounder long-term prospects than before, more is needed: a cooperative effort by the entire world community to repair the major shortcomings in the global system that this crisis has brought to light:

1. the weak culture of transparency throughout the world—public sector and private sector, at national and at international levels—that severely hampers sound policy, stable markets, and the efficiency of our surveillance;
2. the weakness of financial systems;

3. a piecemeal opening of capital accounts, that involved a largely unrestricted easing of potentially volatile, short-term flows while non-debt inflows were submitted to legislative or bureaucratic restrictions, exactly the opposite of what should have happened;
4. hesitation in defining modalities for involving private institutions in preventing and resolving crisis; and
5. lastly, while sophisticated global forms of financial intermediation were developing rapidly, we were slow in establishing practices and regulations at the level of world markets based on experience and on credible institutions to enforce them.

Mr. Chairman, if we wish—as we must—to achieve sustainable high-quality growth and stability, we need a global trade and financial system that is open and well regulated, that ensures access to the information necessary to differentiate risks, and that can count on the international community to undertake firm surveillance ensuring the credibility and predictability of countries' policies. This means that we must correct the five shortcomings I have just listed.

In short, to extend the enormous progress of the last 50 years into the next half century, we need a new architecture for the international monetary system.

III. What should be the key features of a new financial architecture?

This new architecture must rest on five underlying principles: transparency, soundness of financial systems, involvement of the private sector, orderly liberalization of capital flows, and modernization of international markets harnessed with standards of best practices and means for enforcing them. I do not need to elaborate on many of these principles as the Interim Committee communiqué has done that well.

- **Transparency.** This is the golden rule. High-quality information and analysis are essential for sound policy formulation and for participation in the markets: there is a task for all. The Fund's new data dissemination standards are already in place—an essential first step—and we are working to strengthen and broaden our surveillance. Governments' policymaking will be enhanced by adopting the new code of good practice in fiscal transparency, and the code for transparency in monetary and financial policies that is being prepared. Market participants must also expect to offer greater transparency—including through additional regulatory and disclosure requirements—to ensure better functioning markets. Ultimately, the effectiveness of this reform will hinge on how ready members and market participants are to adopt the standards for transparency and how well the Fund uses them in surveillance.
- **Strengthened banking and financial systems.** This is a keystone. You have been very clear about the objective, no matter how complex it will be in execution. Strong

frameworks for regulation and supervision must be put in place, supported by the worldwide adoption of consistent standards for accounting, auditing, insurance, securities, payments systems, and banking supervision. The Fund is strengthening its capability in this area by refocusing its bilateral and multilateral surveillance as well as its technical assistance and training. Together with the World Bank, other international organizations, and national agencies, it will be essential for us to move forward rapidly with disseminating and applying principles and good practices in the context of a framework for financial stability.

- **Involvement of the private sector.** This is essential as it is the primary source of finance for many countries. You have made it clear that as a minimum, the private sector should be involved, in a voluntary and cooperative fashion, in forestalling and resolving financial crises. Looking to the future, and drawing valuable lessons from the experience in providing relief in the Asian crisis countries, two objectives come to mind: first, to establish the proper incentives to foster sustained private sector participation in global capital markets, minimizing the risk of sudden withdrawals; and second, in realizing it, to avoid moral hazard. We must work more on these issues, and the private sector's participation in this process will be essential.
- **Liberalization.** The crisis has revived here or there the temptation to revert to outmoded patterns of controls. But on that you have avoided a theological dispute. Your response has been a continued commitment to free trade and payments systems and a clear invitation to press ahead with the mandate you gave us in Hong Kong. The aim should be to progress cautiously and in an orderly fashion on our path towards a liberal system of capital movements set in the context of properly sequenced financial reform and of strong macroeconomic balances. At the same time, we urge the remaining 40 members who have not yet accepted the obligations of Article VIII, to do so expeditiously.
- **Modernizing the international markets by harnessing them with international standards of best practices.** The objective is straightforward and worth repeating: to establish for all international financial operations the same types of practices and discipline that have been established progressively and today prevail in the best working financial centers. For that we need consistent world standards not only in the monetary and financial areas of core concern to the Fund, but also in accounting, auditing, bankruptcy, and corporate governance which are the concern of other agencies. Of course it will not be enough simply to disseminate standards. Compliance by all sectors will be required: the actual practices of public and private sector entities will need to be changed; the public sector may have a role in strengthening incentives to adopt and comply with standards; and the Fund's surveillance will need to be modified to assure the world that the changes are being well implemented.

Will this be enough? Some may say that these proposals are not bold enough, that standards and codes of good practice rest too much on consensus, mutual trust, and an exceptionally high sense of responsibility of all actors. They may argue for the imposition of global rules or taxation, but I do not see a consensus materializing on such a basis. Instead I suggest that our five elements provide the basis for a broad agreement to be assembled in a spirit of subsidiarity; acting at world level is appropriate only when action at the national or regional level cannot suffice. This means, of course, in the light of recent developments, that national regulators must adopt all appropriate measures to reinforce their financial systems, not the least addressing decisively the serious problem created by the lack of transparency and poor monitoring of hedge funds and of transactions in many off-shore centers.

I am convinced that, taken together, and cemented by your shared sense of commitment, these five elements can be constructed into the sound, stable system that we all desire. But, new challenges, even new crises, will emerge. To face them, we need to move to a higher level of international cooperation particularly now as we face simultaneously the difficult tasks of renovating the system while managing crisis. This brings us to the single most important task that now confronts us—that of charting the path out of the crisis.

IV. The path out of crisis

Yes, the tasks we confront are complex, but it is essential that we make an immediate start. Even so, we can only expect gradual results, probably over a period of years. So then, for the period immediately ahead, what could be the elements of a new consensus on how to progress from the present situation to a sounder world economy based on the new architecture? Everyone has a role.

First, for the more robust economies: at present, the industrial countries clearly have a role as engines of global growth. The recent commitment by the G-7 finance ministers and governors to preserving or creating conditions for sustainable domestic growth and financial stability was a welcome signal, but action and continued vigilance will be needed. Action is particularly urgent in Japan. As the second largest industrial economy, Japan plays a pivotal role in the world economy, especially in Asia. But at present, its economy is wracked with financial and corporate sector problems. Decisive moves by the authorities to promptly and resolutely repair the financial system, while pushing the agenda for deregulation, openness, and structural reform and, simultaneously, continuing fiscal stimulus until the recovery is self-sustaining, will deserve the highest international encouragement and praise.

Second, the international community must provide effective support to the countries rebuilding themselves, provided they continue implementing the agreed programs with utmost determination. Each constituency must seriously consider if there is not something more to be done to assure their success:

- Bankers and other private creditors, by speeding up private or public sector debt restructuring and, where needed, debt reduction; and by maintaining credit lines and commercial credit arrangements;
- Official bilateral creditors and donors, by extending support, where needed, particularly when pledged under second-line-of-defense arrangements or, more generally, by recognizing that bilateral support is vital for the Fund to be able to play its catalytic role; let me tell you that I particularly welcome here the initiative announced by Japan in favor of Asian countries, and the readiness expressed by Spain, with the support of others in the EU, to assist in the financing of Fund-supported programs in Latin America.

Third, countries fighting contagion, above all should resist the temptation to undertake unilateral debt action, to adopt protectionist measures, or to force economic expansion by inflationary financing. Instead, they need to develop their capacity to anticipate difficulties and to respond quickly. They should persevere with programs based on sound money, budget discipline, structural adjustment, strengthening of financial systems, transparency, and promotion of good corporate and public sector governance.

Such countries must be able to count on support from the Fund and the international community, as already is the case with some 75 countries that have Fund-supported programs, or are negotiating them at present. A remark here in passing. Seventy-five countries in such programs! How much this tells us about crises avoided and growth preserved. Yet, the task of a number of them is so hard that the Fund may be called upon to broaden its present support to them. In saying that, I have particularly in mind countries in Africa, in the Caucasus or Central Asia, and in Latin America. We will not shy away from our responsibility and, if needed, take new initiatives to this end.

This leads us to the **fourth** task: financing the IMF itself. More authoritative voices than mine have made this point. In a world of rapid change, in a world where sudden market developments can destabilize even well-performing economies, the Fund needs adequate financing to perform its mandate fully.

Several items now need action as soon as possible: the quota increase is most urgent and should be finalized as soon as possible, together with the New Arrangements to Borrow, and the ratification of the SDR allocation you approved last year.

I must also reiterate the need for the Fund to receive, without further delay, sufficient resources to replenish the Enhanced Structural Adjustment Facility (ESAF). It is the sine qua non for our contribution to the HIPC Initiative, to post-conflict situations, and to adjustment and reform programs in the poorest countries—particularly in Africa—to be commensurate with the task. Governors, I say that with special emphasis, as we must make the maintenance

and, I would suggest, the strengthening of our efforts in these poor countries an integral part of our new consensus.

And **fifth**, in this search for a consensus on a path out of the crisis, our institutions must be adapted to this new world. This applies to the IMF itself. It has been said that you should not reform the fire brigade while fire is raging. Well, I believe that at least we must start. In fact, I would say that it is a most valuable part of the culture of the Fund to be able to pursue internal reform even while continuing with our emergency work in all parts of the world. Of course, we will pursue our efforts continuously to improve our role in preventing and managing crises. We shall explore means to strengthen our capacity to provide support more efficiently—including in a precautionary way—to countries pursuing sound policies that face difficult global financial conditions. But we must go several steps further.

Let me tell you what I see as feasible now to make the Fund more attuned to this new world.

- You all agree, I think, that the Fund must be no exception in observing the golden rule of transparency. Let us, then, make further progress in opening many more of our operations for publication and for external evaluation. Already evaluation of the ESAF is complete, and surveillance, our central activity, is being reviewed. But a key remaining issue in attaining greater transparency lies, as you know, in the degree of confidentiality required for maintaining a totally open dialogue with each of you. As soon as a consensus about these limits is reached among yourselves, we will be ready to publish documents you still ask us to keep confidential. Let us work together in reconciling these two requirements.
- Our legal instruments also need to be reappraised. I see two areas where the question of amending the Articles of Agreement arises. One is an amendment to make orderly capital account liberalization one of the purposes of the Fund and to extend the Fund's jurisdiction, as needed. On that we have already started our work. But the question of another amendment is raised by a more specific aspect of the architecture—still a controversial one: the need to facilitate the orderly restructuring of distressed debt. I welcome the Executive Board's decision to come back to this issue.
- We must pay close attention also to the frequently raised issue of political accountability. Whenever Fund-supported programs have an impact that goes beyond the strictly economic sphere, the legitimacy of our actions as a technical institution is questioned. But the issues go beyond accountability to the need for the authority to discharge adequately the responsibilities you entrust to us. Therefore, I wish to reiterate here my full support for the French suggestion to consider now transforming the Interim Committee into a "Council" with decision-making, rather than consultative, powers. This transformation, long anticipated in Article XII, Section I of the Articles of Agreement, could crown our efforts to

- establish a credible new architecture, by creating a body whose members are collectively responsible for key developments in the international monetary and financial system. It would significantly contribute to the new dimension of cooperation which is needed, by providing your representatives to the Council with a central forum from which to speak with full legitimacy, with full authority, and with a single voice.
- Lastly, two major developments suggest the need to revisit the modalities of the Fund's multilateral surveillance. The first, unveiled by the Asian crisis, is the extent of destabilizing movements in exchange markets. The second, as the euro develops into a key international currency, is the potential for cooperation among the monetary authorities of the multipolar system that is likely to develop in the years ahead. No doubt a new international monetary equilibrium is emerging, the surveillance of which will be a core task for which the Fund must prepare itself.

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Mr. Chairman, Governors, I have had to touch this morning on issues of paramount importance for the future of the world economy and to tell you that I am confident that—narrow as it may be—there is a way out of the crisis. You can count on the Fund and on its competent and valiant staff to be steadfast in implementing your fundamental objectives of sound money, high-quality growth, protection of the poorest, and human development. You can count on the Fund to be prompt in adapting itself and ambitious for reforming itself. You can count on the Fund to stand by all its members in whatever difficult situation they may be.

But, Governors, the Fund can only help those of its members who strive to save themselves. And we cannot do that alone. Working together with the World Bank and the regional development banks, we also need your support. We need you as our partners, as our shareholders, as those with whom the final decisions, the final responsibilities, lie.

Let us join forces in completing the work we have just reviewed. With your support, under your guidance, the Fund you have placed at the center of the financial system will proudly continue to play its part of service.