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Statement by the Hon. **THOR PEDERSEN**,
Governor of the Fund for **DENMARK**,
on behalf of the Member States of the European Union,
at the Joint Annual Discussion

ECONOMIC AND FINANCIAL COMMITTEE

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Statement by Mr. Thor Pedersen, in his capacity as Chairman of the EU Council of Economic and Finance Ministers, to the Annual Meetings of the IMF and the World Bank 2002

1. Introduction

1 - I submit this statement in my capacity as Chairman of the EU Council of Economic and Finance Ministers. It focuses on: recent economic developments and policies, in particular in the EU; corporate and financial sector issues raised by recent events; crisis prevention and resolution; poverty reduction and financing for development; and the fight against the abuses of the international financial system.

2 - These meetings are held at a time of major fluctuations in financial markets, which have increased downside risks to the world economic outlook. These episodes of increased financial volatility, following already significant corrections of financial asset price, and compounded by certain high profile cases, have highlighted the importance of improved corporate governance, accounting and auditing practices. It is important to restore confidence in the economic and financial system worldwide, and to ensure that financial volatility and its impact on the real economy are minimised.

3 - It is in this context important to pay particular attention to the possible impact of recent macroeconomic and financial shocks on developing countries. Action should follow the commitments taken in Monterrey and Johannesburg. This is especially necessary for the poorest countries in sub-Saharan Africa, where the Millenium Development Goals are most at risk of not being met. The IMF and World Bank should make special efforts to take this commitment forward. We reiterate the call made at Monterrey for a Global Development Compact between developed and developing countries based on mutual accountability for results.

4 - These meetings are also the last before the European Council concludes the enlargement negotiations with up to 10 new member countries next December in Copenhagen. A successful conclusion of these negotiations will mark another major step for the EU and will contribute to the creation of one whole and undivided Europe.

2. Economic developments and outlook

5 - The recovery of the global economy, which started at the beginning of this year, particularly in the US, the EU and Asian emerging market economies, is underpinned by a number of forces such as the reversal of inventory cycles and the substantial easing of macro-economic policies in the advanced economies over the past year. However, the outlook, while on balance positive, is clouded by uncertainty and significant downside risks.

Risks and uncertainties

6 - The global economic outlook is being clouded, first, by concerns related to financial stability. Most indicators suggest that the recent sharp series of falls in major stock markets are the result of the unwinding of past over-investment which built up during 1999-2000. Following recent high-profile cases, the level of uncertainty regarding companies' earnings expectations and stock market valuations has also increased. Weaknesses in corporate governance and in accounting and auditing practices have been revealed which have further lowered investors' confidence in equity investments in general and have compounded the already significant correction in stock prices. A further weakening of the real economy could lower investors' confidence even more.

7 - Second, imbalances between and within the major economic areas of the world have not been corrected, although the current level of the euro, following its strengthening, better reflects the economic fundamentals of the euro area. Recent trade disputes raise the risks of a new cycle of protectionist measures and counter-measures, which could endanger growth prospects worldwide.

8 - Third, the current high levels of oil prices could also weigh on the prospects of recovery. Furthermore, the high volatility of the market remains a source of risk for the confidence of both households and corporations.

The EU and the euro area

9 - **The EU economy** was in 2001 marked by a sharp and unexpected slowdown in economic activity. However, since the beginning of the year, the economy has stabilised and is gradually picking up. The response of economic policy, sound and stable fundamentals, and an improvement in external demand have provided the platform for the recovery to consolidate during the next months. The available information on economic activity suggests that the EU economy will remain modest in the second half of 2002 and gather strength in 2003. Headline inflation declined from an exceptional peak in the first months of the year stemming from temporary factors. As a whole, the decreasing impact of past price shocks and the recent appreciation of the euro should enable HICP inflation to stabilize at levels around 2% in the course of 2002, though monetary and wage developments will continue to be closely monitored.

10 - Macro-economic policies in **the EU and the euro area** are designed to meet the challenge of restoring non-inflationary economic growth in a context of less supportive global economic conditions. The progress made in former years on fiscal consolidation in the framework of the Stability and Growth Pact has allowed the EU and the euro area economy to be in a better shape to deal with cyclical fluctuations. Budgetary policies will be geared to maintaining or achieving public finances close to balance or in surplus in the medium run, while supporting growth by letting the automatic stabilisers work symmetrically, as envisaged in the SGP. Besides providing leeway for the free and symmetric play of automatic stabilisers, medium-term budgetary positions that are close to balance or in surplus also allow for a steady decline in government debt and enhance the capacity to address budgetary challenges stemming from ageing populations. Over the last few years, substantial progress has been made in implementing structural reforms.

The international environment

11 - Following last year's recession **in the US** evidence of recovery emerged in the first half of this year. However, recent developments suggest that the future course of this recovery might be more muted than initially expected and is subject to a high degree of uncertainty. High-profile cases in the corporate sector have revealed possible structural weaknesses, which in turn have impacted on investors' confidence in equity investments. Consumption has remained relatively

robust during the slowdown and continues to be the key variable to the US short-term economic outlook, but may not be able to continue to fuel the recovery. On the corporate side, the reduction of inventories and its negative effects on production and employment seem to have come to an end, but business expectations of large firms have been deteriorating over the last few months, capacity utilization is relatively low and the cost of capital has increased. The utmost priority is to restore investor confidence, and to address shortcomings in corporate governance and financial reporting. The recent legislative initiative adopted by the US authorities that penalises corporate mismanagement provides a first step in this direction, although compatibility of new legislation and reforms with other worldwide regimes needs to be checked. Macroeconomic policy should continue to support the recovery. However, on the fiscal side, it is essential that public finances are brought back on a prudent medium-term course once the recovery is established in the light of the desirability of reducing the external and internal imbalances. Finally, we call on the US administration to remain committed to free trade principles and practices, as well as to the rules of the WTO.

12 - **In Japan**, despite a modest recovery fuelled by strong exports, domestic demand remains weak and deflationary pressures persist. This situation is aggravated by long-term structural difficulties, historically high unemployment, decreasing real incomes, and the constant decline of financial assets and real estate prices. The functioning of monetary policy transmission mechanisms remains deficient. Depressed stock prices have a negative impact on banks' and insurance companies' balance sheets and on the fund-raising ability of corporations. Finally, the sharp increase of public debt over the last decade, particularly given the effects of a fast ageing society, is also a matter of concern. Therefore, we encourage the Japanese authorities to press forward and implement a clear and coherent framework of structural reforms in the financial and corporate sectors. Action should focus on the removal of bad loans from balance sheets without further delay. The macro-economic policy stance should remain as supportive as possible to domestic demand, taking account of the need for medium-term fiscal consolidation. On the medium run, the general strategy of the Government to achieve a fiscal primary surplus while improving the efficiency of the public sector is welcome.

13 - Several **emerging market and transition economies** have been confronted with additional challenges stemming from recent macro-economic and financial shocks.

EU **accession countries** have on balance continued to perform well and should continue to do so despite the recent natural catastrophes in Central and Eastern Europe. The EU also expresses its support for the **Turkish** efforts to reform the economy and to ensure macroeconomic stability under the IMF program.

Macro-economic developments **in Russia** have been favourable, and growth prospects for this year remain stable. The EU welcomes the progress in the reform agenda and encourages the government to proceed further.

In **emerging Asia**, after the economic deceleration triggered by the sharp drop in exports, particularly in the technology sector, signs point to a progressive recovery. Significant progress in reducing vulnerabilities needs to be pursued.

The economic situation in **Latin America** has become increasingly fragile on the back of global uncertainties, but also specific factors related to local political contexts and debt dynamics. We welcome the efforts of the IMF to help the affected countries in the region, including the USD 30 bn package for Brazil. This assistance should help those countries to re-establish a sustainable economic and financial situation as a way to restore market confidence by implementing prudent fiscal and monetary programs and accelerate structural reforms that lay the basis for strong economic growth. The EU strongly encourages the Argentine authorities to finalise the negotiations with the IMF on a new program to build a credible and sustainable economic recovery.

3. Addressing the corporate and financial issues raised by recent corporate failures.

14 - While the recent turbulence on financial markets is a response to past imbalances in asset prices, recent events have emphasized the need for consolidating corporate and financial rules and practices. Beyond self-correction by the market, public authorities, including at the international level, should address the underlying structural deficiencies and establish where necessary new standards. In order to restore investor confidence and strengthen financial markets progress is especially needed in priority areas such as accounting, auditing, corporate governance and disclosure standards:

- first, the focus on transparency and accurate information needs to be stepped up, to enable investors and financial markets to access to fair company accounts. Those accounts should provide accurate information on the wealth and health of companies, to enable investors to make appropriate short and medium term investment decisions;
- second, strict standards should be developed and implemented, to guarantee the independence of auditors and financial and legal advisors. This means that inter alia auditing and consulting functions should be clearly separated, and that revenues stemming from auditing should be made more transparent;
- third, achieving transparent and healthy corporate governance has implications for the design of incentives for managers, to more closely align their interests with those of shareholders. In particular, managers' remuneration packages, including stock-options, and their responsibility in the preparation of financial information need to be reviewed.

15 - The EU has been working for several years to improve the integration, efficiency and resilience of its financial markets in the context of the Financial Services Action Plan (FSAP). Many measures in the FSAP already tackle the problems raised above, but recent experience has also led the EU to focus more heavily on some specific issues:

- the mandate of the EU High-Level group of company law experts has been expanded to include specific issues raised in the recent months, including issues related to best practices in corporate governance and auditing, in particular concerning the role of non-executive directors and supervisory boards, management remuneration, management responsibility for financial information, and auditing practices;
- listed EU companies will be required to use International Accounting Standards by 2005. We invite other countries to follow suit, and in particular call for full convergence between US GAAP and IAS;
- we have adopted also a principles-based approach to auditor independence, by targeting potential conflict of interest.

At the international level, the EU supports the efforts of the Financial Stability Forum (FSF) towards a coordination of the work already done by international standard setters.

4. The reform of the international financial architecture

4.1. Surveillance and crisis prevention

16 - We welcome the improvements in the IMF's work on crisis prevention and we take note of the completion of the recent Biennial Review of the Implementation of Fund's Surveillance. Crisis prevention, primarily through multilateral and bilateral surveillance, remains at the heart of the IMF's mission. We welcome the opportunity to continue discussions over the coming year on further measures to strengthen surveillance, including consideration of its institutional framework.

17 - Experience shows that most crises arise from vulnerabilities that have not been detected or corrected in time. Increased attention should thus be paid to potential vulnerabilities in the monetary, fiscal, exchange rate, and financial policy areas, notably in article IV consultations

and in the context of further refinements in early warning systems. To be fully effective in bringing about early and pre-emptive policy action, IMF surveillance needs to be transparent, objective, accountable and independent from judgements concerning IMF lending programs. In particular, we would like to see more countries move towards publication of Article IV reports. We call on IMF management to pursue, in a close dialogue with the Board, its current efforts to enhance IMF surveillance in line with these key objectives.

4.2. Crisis resolution and private sector involvement

18 - We welcome the Fund's work program to strengthen the Prague framework for crisis resolution. We agree that more work needs to be done in several areas, including on : (i) access policy, and (ii) the contractual and statutory approaches – that we consider complementary - to sovereign debt restructuring.

IMF access policy

19 - The overall policy framework for access policy is by and large appropriate as regards the access limits associated with the SBA and the EFF. However, its implementation remains unsatisfactory. In particular, there are insufficient safeguards to ensure that access above statutory limits is only granted in genuinely exceptional cases.

20 - Access decisions should be based on a robust external debt sustainability analysis. The Fund's analysis should start with a forward-looking assessment of countries' external financial positions under different scenarios (including stress-tests), and should be based on transparent and realistic macro-economic and financial assumptions. Access to Fund credits should in any case be subject to clear, country-specific access limits in order to provide the right incentives to markets and to help maintain good relations between the debtor country and private creditors.

21 - Access limits could be made more credible and transparent, through:
- reviewing whether current limits remain economically significant under the changed global economy;
- considering whether access beyond a particular level should be permitted under well-defined circumstances and new procedural rules;
- specifying strict rules and procedures for the combination of several facilities to finance individual programmes. There should be in particular a need for close scrutiny of the use of the SRF in order to avoid circumvention of access limits.

22 - If exceptional access is granted, which is only possible in cases where external debt appears to be sustainable given an appropriate policy response and realistic medium-term macro-economic and financial assumptions, more extensive justification by staff and more stringent conditionality are required. In particular there needs to be a higher burden of proof that (i) truly exceptional circumstances exist, and (ii) the debtor country has undertaken its best efforts to secure PSI (which implies in turn an exhaustive monitoring of PSI). Whenever a decision to grant exceptional access is taken, the burden of proof should be put on the IMF, which should provide specific detailed documents to the Board including: debt sustainability analyses, including stress-tests; an explicit assessment of the timing and probability of a return to market access; and a clear and transparent description of risks of contagion and potential systemic threats. The procedural rules for decisions on exceptional access could be strengthened through requiring: a formal assessment of whether the criteria for exceptional access have been met; a special Board meeting and a separate Board decision, as well as an ex post evaluation of their impact and effectiveness. We welcome the Agreement in the IMFC to define more clearly criteria to justify exceptional access, and strengthened procedures for early consultation and decision making.

Sovereign debt restructuring

23 - We reiterate our support for the parallel consideration of both statutory and contractual approaches to improve the process of sovereign debt restructuring, which are complementary. The assessment of a Sovereign Debt Restructuring Mechanism (SDRM) should be considered as part of a coherent and wide-ranging strategy for dealing with financial crises, and should therefore be developed in parallel with the operational improvement and further implementation of the PSI approach established in Prague, and welcome the agreement in the IMFC to consider a concrete proposal next spring.

24 - We call on the IMF to work further on statutory approaches to sovereign debt restructuring that may require new international treaties, changes in national legislation, or amendments of its Articles of Agreement. As regards the contractual approach, steps should be taken to promote the inclusion of CACs in international bond contracts. It will be important that all member countries, both advanced and developing ones, play their part in helping to promote the establishment of appropriate tools to facilitate the inclusion of CACs in international bonds. This means inter alia designing standard model contractual provisions to be used, CACs-friendly legislation, and incentives to promote the actual inclusion of CACs. In this respect the EU member states will coordinate effectively in order to lead by example in including majority action clauses and collective representation clauses in government bonds issued under a foreign jurisdiction. We call on others to follow this lead, with a view to establishing new market practices and procedures.

25 - Since both the contractual and the statutory approaches will take time to be assessed and implemented, work should continue in order to implement expeditiously the Prague framework on other main issues at stake including standstills and the IMF's policy of lending into arrears (LIA). Specifically, we urge the IMF to further clarify rules and modalities for implementing the LIA strategy in the context of contractually or statutorily-based approaches.

4.3. Conditionality

26 - We welcome the work under way to streamline conditionality and are looking forward to the discussion on the revised Guidelines. A major issue in this context is the improvement of cooperation between the IMF and the World Bank.

27 - With respect to low-income countries, cooperation is already intense, but can be further enhanced within the existing PRSP framework. In all countries, including in particular middle-income ones, IFIs' programs should be based on a truly country-owned reform strategy. A common unified framework for the two institutions aimed at identifying underlying problems and subsequent proposals for reforms could also help in middle-income countries to build a more effective and consistent cooperation between the two institutions. Strengthening collaboration requires consultation and information sharing, especially during the design phase of the program. Early and continuous consultation is absolutely indispensable for those countries where both institutions provide medium term support.

28 - A number of possible practical ways to reinforce necessary information sharing and consultation, in addition to the existing cooperation at various levels, includes the following avenues:

- First, common participation in PRSP-processes "on the ground", staff attendance in one another's Board meetings, and cross-participation in one another's country missions and joint missions – including participation of resident staff - could be increased.

- Second, a structural policy matrix could provide a comprehensive overview of structural reforms, their purpose, timing, and the institution primarily responsible for their monitoring. This instrument could inter alia operationalise the lead agency-concept, and help to streamline and manage the totality of conditionality.
- Finally, the IMF and the World Bank could consider new ways of further enhancing their cooperation in areas of common interest, including through new institutional arrangements where necessary, drawing on the experience with the Financial Sector Liaison Committee and the Joint Committee on HIPC/PRSPs.

4.4. IMF quotas

29 - The IMF has launched the 12th general review of quotas. In this context, we look forward to the work of the Fund to assess the need for an overall increase of quotas considering developments in the world economy. Work on IMF quota formulas should continue to be conducted in line with the three main guiding principles supporting the central role of the IMF in the international financial system, i.e. legitimacy, cooperation and transparency. In addition, quota shares should reflect a country's relative position in the world economy and in the international financial system. A position in which a country's quota is substantially below its calculated quota should be avoided. We also call on the Fund to continue to assess the usefulness, in the light of recent discussions, of an increase in basic votes of IMF members countries.

5. The role of the IMF in poor countries

30 - The EU reaffirms that the Monterrey Consensus and the financial commitments made in connection with the Monterrey Conference provide the broad framework towards achieving the Millenium Development Goals, and welcomes the recent confirmation of this approach in Johannesburg.

31 - The IMF is the key institution to promote macro-economic and financial stability, and fulfils in this respect a fundamental role in its low-income country member states.

32 - The IMF should, in close collaboration with the World Bank : (i) continue to streamline PRGF structural conditionality, concentrating on areas critical to the success of PRGF programs; (ii) consider alternative policy choices and the related trade-offs in programs; (iii) and build on the progress already made to promote pro-poor spending and pro-growth policy undertakings in PRGF programs.

33 - Of the 42 countries classified as HIPCs four are currently expected to have a sustainable burden of debt after traditional debt relief and one has so far not opted to apply for debt relief. Hence, 37 HIPCs are expected to eventually benefit from debt reduction under the Initiative. However, there are factors that may prevent some HIPCs from receiving sufficient debt reduction to achieve a sustainable debt position at completion point: (i) first, not all creditors have agreed to provide debt reduction; (ii) second, the financing needs of the Initiative as estimated at Cologne in 1999 have not been fully met; (iii) finally, growth could be weaker and export commodity prices could be lower than assumed under the Initiative. Genuine debt sustainability should be ensured for all eligible HIPCs. It will therefore be necessary to take action in a number of areas, such as assessing those cases where a fundamental change in a country's economic circumstances due to an exogenous development leads to an unsustainable debt at completion point, and paying renewed attention to the implementation of sound policies in HIPC during and following the interim period, including strict avoidance by the countries concerned of new borrowing on non-concessional terms. The IMF should also work with other stakeholders to: (i) secure the compliance of all creditors, official and private, and take the necessary actions to tackle non-compliance, including through

reporting in Article IV surveillance; (ii) ensure full financing of the HIPC Initiative through appropriate bilateral debt relief and donors' contribution to the World Bank HIPC and the IMF PRGF-HIPC Trust Funds, in line with reasonable burden-sharing. Going forward, the IMF and World Bank need to ensure that forecasts of debt sustainability are made on the basis of prudent and cautious assumptions about growth and exports.

34 - Good public expenditure management (PEM) and effective Poverty and Social Impact Assessments (PSIA) are essential for effective poverty reduction. These are areas where the World Bank is the lead agency but collaboration between IMF and World Bank needs to be strengthened.

6. Combating abuses of the international financial system

35 - The EU reiterates its commitment to fight against the abuses of the financial system, including money laundering, terrorism financing, harmful tax practices and insufficient regulatory frameworks and practices in the financial area.

The fight against money-laundering

36 - Money laundering distorts markets and economic decisions, can lead to financial instability and is one of the tools for terrorism financing. We reaffirm our strong support to the Financial Action Task Force (FATF) whose Forty Recommendations constitute the anti-money laundering international financial standards. We welcome the fact that a great number of countries worldwide have chosen to endorse the FATF special recommendations and join the self-assessment process. This includes the participating states of the OSCE, the ASEM countries and several others. We call on countries and territories listed by the FATF as non-cooperative to make all necessary effort to implement these recommendations. We will continue to implement the coordinated countermeasures recommended by the FATF against the jurisdictions in which no progress has been made. We also welcome the ongoing process launched by the FATF to revise and upgrade its standard in the fight against money laundering.

The fight against terrorism financing

37 - In the fight against terrorism financing, the EU is committed to implementing rapid and coordinated initiatives. We strongly support the special recommendations laid down by the FATF at its extraordinary plenary session in October 2001 related to the fight against the financing of terrorism and are taking the necessary steps to comply with the special recommendations. We call on all countries to follow suit. To encourage the broadest possible participation in this fight, we call on the FATF to identify countries for follow-up assessment and technical assistance, by the IMF, the World Bank, and the United Nations within their respective mandate.

38 - The IMF and the World Bank have a key role to play in ensuring the integrity of financial markets, in particular by fostering compliance with the international standard in the fight against money laundering and terrorism financing. We welcome in this respect the progress in the joint effort by the Bretton-Woods institutions and the FATF to finalise a comprehensive AML/CTF methodology. We support an integrated and comprehensive ROSC module, incorporating all aspects of 40+8 FATF Recommendations. We therefore welcome the decision of the IMF and World Bank to start a 12-month pilot program of AML/CFT assessments and accompanying Reports on the Observance of Standards and Codes (ROSCs) that would involve participation of the Financial Action Task Force, and FATF-Style Regional Bodies (FSRBs). We look forward to a comprehensive review of the experiences at the time of the next Annual Meetings. We also urge the Fund and World Bank, in cooperation with other international organisations and donor countries, to identify and respond to needs for technical assistance.

Other issues

39 - Administration and enforcement of tax laws depend increasingly on transparency and effective international cooperation. Exchange of information in relation to taxation of savings, on as wide a basis as possible, is to be the ultimate objective of the European Union in line with international developments. We invite OECD countries to lead by example.

40 - We continue to support the work of the FSF, in particular on recent corporate failures, reinsurance, offshore centres, credit derivatives and highly-leveraged institutions.