Statement by James Michael Flaherty
Minister of Finance, Canada
On behalf of Antigua and Barbuda, The Bahamas, Barbados, Belize, Canada, Dominica, Grenada, Ireland, Jamaica, St. Kitts and Nevis, St. Lucia, St. Vincent and the Grenadines
On behalf of Canada, Ireland, and the Caribbean countries I represent in this Committee, I would like to extend my heartfelt appreciation to Managing Director de Rato at this, his last Annual Meeting. Through his leadership, including development of the International Monetary Fund’s (IMF’s) Medium-Term Strategy, Mr. de Rato has strengthened the Fund’s capacity to fulfill its mandate of supporting a prosperous global economy.

I welcome the appointment of Mr. Dominique Strauss-Kahn as the new Managing Director. He brings to the IMF a wealth of experience and a strong vision for the Fund. I also welcome the appointment of Mr. Tommaso Padoa-Schioppa as the new Chairman of the International Monetary and Financial Committee (IMFC). I look forward to the new ideas and perspectives from both of these appointees, which will enable further progress to be made on the important challenges facing this institution.

We meet amidst reminders of these challenges, owing to the heightened uncertainty associated with the financial market turbulence that began this summer. Despite this increased uncertainty, I draw confidence that our institutions stand at the ready to support well-functioning markets. Central banks around the world are to be commended for their effective response to the sudden liquidity squeeze that hit short-term capital markets. Moreover, given the sound fundamentals supporting the global economy, I expect that the global economy will continue to register strong growth.

Nevertheless, the resilience of the global economy and financial system is clearly being put to the test by current developments. The challenge facing policy-makers is to carefully examine the root causes of the current financial volatility and draw the appropriate lessons for policy responses at the national and international levels. The rapid transmission of distress in the relatively small U.S. subprime mortgage market to global financial markets testifies to our global interdependence and our need for effective international institutions. In this regard, we must be doubly committed to reaching agreement on and implementing reforms to the IMF, including a realignment of quota that better reflects the evolving economic weights of members. Reform will strengthen the Fund, ensure its continued relevance, and allow it to effectively respond to new challenges in our global economic system.
Global Prospects

Since our last meeting, the global economy has been slightly weaker than anticipated, and the outlook has further clouded as a result of the turmoil in financial markets triggered by the collapse of the U.S. subprime mortgage market. The losses in that relatively small market quickly disseminated to global markets via the market for asset-backed securities, resulting in a global credit squeeze. Although quick action on the part of the Bank of Canada and other major central banks helped sustain market liquidity, certain market segments remain stressed, and the IMF anticipates a protracted period of adjustment. Nevertheless, the fundamentals of the global economy remain sound, and the IMF continues to project growth of around 5 per cent in 2007 and 2008.

To date, financial market turbulence has had the largest impact on the U.S. and Europe. Unlike past episodes of heightened uncertainty, the current adjustment in risk tolerance did not spark a wave of capital flight from emerging market economies. In part, this reflects the great strides made in Latin American and other emerging market economies in improving macroeconomic policies, which have increased investor confidence. Although the outlook for China and India has moderated owing to lower external demand, their domestic economies remain at risk of overheating due to strong investment and capital inflows. The emerging economies are increasingly shifting from being primary beneficiaries of global growth to its major drivers.

The slowing of the U.S. economy and the associated depreciation of the U.S. dollar should help moderate the U.S. current account deficit and help unwind global imbalances. However, global imbalances remain significant, and continued progress is needed on implementing the recommendations that emerged from the multilateral consultations. Finally, although global inflationary pressures have eased, we must remain vigilant and committed to inflation control.

Canadian Developments

Canada’s economy continues to operate at a high level of activity, owing to robust domestic demand. However, the tightening of credit conditions, the appreciation of the Canadian dollar to parity with its U.S. counterpart and the weakness in the U.S. housing market are expected to reduce Canadian exports and negatively affect growth. As a result, the IMF expects Canadian growth to ease to the 2.5-per-cent range in 2007 and 2008.

Final domestic demand remains strong and continues to be the main driver of growth. Canadian real gross domestic product (GDP) growth slowed moderately in 2006, given weaker U.S. demand, the past appreciation of the Canadian dollar and a cooling of the Canadian housing market. In 2006, real GDP increased 2.8 per cent—down slightly from a year earlier—while final domestic demand grew 4.7 per cent on solid support from non-residential investment and consumer spending. Solid personal income gains, very healthy job growth and still-low interest rates, coupled with Canada’s strong monetary and fiscal fundamentals, are supporting the Canadian economy. In each of the first two quarters of 2007, growth exceeded 3 per cent at an annual rate.
Total consumer price inflation has been volatile over the last year, largely due to energy prices. However, well-anchored expectations have helped keep core consumer price inflation relatively stable and near the Bank of Canada’s 2-per-cent inflation target.

Canada’s fiscal situation remains solid. On a total government basis, Canada was the only Group of Seven (G7) country in surplus in 2006 and will likely be the only G7 country in surplus in 2007 and 2008. Total government net debt, as a percentage of GDP, has also declined steadily from a peak of nearly 71 per cent in 1995 to about 27 per cent in 2006. Canada has had the lowest total government net debt to GDP of any G7 country since 2004, and we expect this to remain the case. To strengthen Canada’s ability to deal with economic shocks and challenges such as population aging, the Government aims—and is on track—to eliminate Canada’s total government net debt by 2021, at the latest. By doing so, Canada will be able to count itself among the very few industrialized countries that are in a net asset position.

Irish and Caribbean Developments

Now let me turn to developments and policy directions in Ireland and the Caribbean countries.

The performance of the Irish economy remains very strong, although the pace of expansion is likely to decelerate significantly over the period ahead. Real GDP grew by 5.7 per cent in 2006, with growth this year likely to be around 4.5 per cent and dipping to 3 per cent in 2008. While slowing, growth will remain strong by international standards. Apart from somewhat moderated international investment, the easing of growth reflects a fall-off in activity in the construction sector, which has been particularly buoyant in recent years. The less buoyant economy should contribute to an easing in inflation, which has tended to be somewhat faster than in partner monetary union countries.

The fiscal position remains strong. Exceptional revenue buoyancy in 2006 pushed the surplus close to 3 per cent of GDP, but a more normal pattern of a small surplus is in prospect for this year. On a net basis, the government debt ratio has fallen to only 12 per cent of GDP. With the economy slowing, employment growth will ease and migration flows will moderate, but there should be little change in the unemployment rate. While there are some downside risks, the overall prospect is for a fairly smooth transition from a period of exceptionally high growth to a still-strong but sustainable growth pattern.

The Caribbean countries that I represent continued to record robust economic activity in 2007, led by a strong recovery in tourism. Regional economic growth, which had fallen sharply with the decline in tourism in the wake of September 11, 2001, has rebounded strongly and inflation is moderate, despite high oil prices. Several countries took advantage of the favourable economic conditions to strengthen fiscal balances which, in combination with debt restructurings in some countries, has led to a modest decline in debt ratios. The region nonetheless remains vulnerable to exogenous shocks due to the still-high public debt levels and large current account deficits.
Regional integration continues to be an integral part of our Caribbean members’ economic strategy, with implementation of the Caribbean Single Market and Economy scheduled for next year. The authorities of these small, open countries view the regional integration process as critical to helping them overcome some of the limitations imposed by size and compete more effectively in the global economy. While the timetable for the establishment of the Regional Development Fund has slipped, work continues apace on its full implementation.

The region is vulnerable to natural disasters, particularly hurricanes. The World Bank Caribbean Catastrophe Risk Insurance Facility (CCRIF) was established earlier this year as the first multi-country catastrophic insurance to help reduce the fiscal costs of hurricanes. The recent experience with Hurricane Dean has demonstrated, however, that the facility is far from a panacea. In fact, it underscores the need for continued self-insurance via continuing investment in disaster preparedness and mitigation efforts. There is also a need to build awareness and deepen understanding of the CCRIF.

**IMF Reform**

Significant progress has been made on the Medium-Term Strategy since our meetings in the spring. In particular, the adoption of the 2007 Decision on Bilateral Surveillance will improve the way surveillance is conducted, including assessing the potential for domestic policies to have spillover effects. I also note that the Executive Board agreed that a triennial Statement of Surveillance Priorities will help identify a focused, forward-looking set of priorities for surveillance. These are very promising developments, but our task is not yet finished. It is important that the Statement of Surveillance Priorities be accompanied by a strong accountability framework.

**Quota and Voice Reforms**

Agreement on a package of reforms to the structure of IMF quota and voting power is a key priority for Canada, Ireland, and the Caribbean members of my constituency. Progress in this area, aimed at better aligning IMF governance arrangements with developments in a rapidly changing global economy, is essential to strengthening the legitimacy of the IMF as a cooperative international monetary institution, and is the foundation for progress on the wide range of initiatives that comprise the IMF’s Medium-Term Strategy.

Important progress has indeed been made in recent months. We all agree on the overall objectives of quota reform, which is to increase the voting share of developing countries (particularly dynamic economies) and to increase the voting share of Poverty Reduction and Growth Facility countries. We also agree on some elements of the quota formula, and there have been some innovative proposals aimed at reconciling the broad spectrum of interests across the Fund’s membership. However, divisions remain on key issues, and we will need to redouble our efforts if an agreement is to be reached by the spring meetings.
Progress will require flexibility on the part of all members of the IMF. We ask all members to look beyond their short-term interests and work together toward agreement on a package of reforms that will keep the IMF as the institution at the centre of the international monetary system of the 21st century.

**Surveillance Reforms**

Surveillance over member exchange rate and economic policies is fundamental to the IMF’s mandate and central to reforms under the Medium-Term Strategy. I welcome the progress since our last meeting in ensuring that the Fund has the tools and the appropriate governance structure to carry out candid, targeted and even-handed surveillance that is capable of identifying threats to external stability. This progress has been realized in two ways.

First, this June, the Executive Board adopted the 2007 Decision on Bilateral Surveillance, replacing the 30-year old 1977 Decision. The 2007 Decision puts more emphasis on members’ domestic policies, as well as giving the Fund the ability to better identify domestic macroeconomic and exchange rate policies that lead to external instability. It also reinforces the principle that surveillance should be applied to all members in a uniform and even-handed fashion that promotes open, two-way dialogue. Despite some inevitable teething pains related to its implementation, the benefits of the new Decision are already apparent.

It is also important to note that, in the spirit of consensus, this reform was agreed to without introducing new obligations for members or changing the Fund’s emphasis on constructive dialogue and persuasion. I look forward to the continued integration of the 2007 Decision into the Fund’s daily work, as well as the regular review of progress in Fund efforts to focus on those priorities in an effective and even-handed manner.

The second area of progress took place in August, when the Executive Board came to consensus on the desirability of a triennial Statement of Surveillance Priorities. The Statement of Surveillance Priorities will work in conjunction with the Fund’s triennial surveillance reviews to ensure that the right issues are focused on in a frank, fair and flexible manner in support of global economic and financial stability.

I am also pleased that many on the Executive Board supported the idea that the effectiveness of the Statement of Surveillance Priorities would be enhanced if it were endorsed by the IMFC. In my view, endorsement of surveillance priorities by the IMFC and ultimately by all Governors is key to ensuring widespread political buy-in and effective accountability for targeted, balanced and effective Fund surveillance, as well as support for the tough policy actions that are often needed to promote international monetary stability and orderly adjustment of imbalances.

**Securing a Stable Source of Financing for the IMF**

As we know, the Fund’s traditional means of financing its operations has become increasingly unsustainable. In January, the Committee of Eminent Persons on the sustainable financing of the Fund (the Crockett Committee) released its report containing
a range of possible financing options. Staff have begun to elaborate on these options, and I look forward to further analysis. At this time, I would encourage members to continue to keep all options on the table, as a package of measures will likely be required to successfully address the current situation.

I also commend Staff and Management for their ongoing efforts to identify efficiency-enhancing measures, improve the link between inputs and outputs in the budgeting process, and slow the growth in nominal administrative expenses. These efforts are timely, as they provide a basis to build on going forward. New income streams for the Fund should be advanced in parallel with substantial reductions in expenditure, including not only the search for further efficiencies, but also larger questions about how the Fund’s outputs and priorities could be refocused in line with its comparative advantages and the evolving needs of its members.

**The IMF’s Role in Low-Income Countries**

The Fund’s low-income members face particular challenges in establishing macroeconomic stability, building efficient financial sectors, developing sound legal and business frameworks and investing in infrastructure. Those that have been the recipients of the Enhanced Heavily Indebted Poor Countries (HIPC) Initiative and Multilateral Debt Relief Initiative debt relief should use the fiscal space created by debt relief to accelerate economic growth and reduce poverty. This requires a commitment to restrain excessive external borrowing to avoid another run-up of unsustainable debt.

In their efforts, these authorities will require the well-coordinated assistance of the Fund, the Bank and the rest of the international community. I therefore welcome the recently approved Joint Management Action Plan to improve coordination and communication between the Staffs of the Fund and the Bank and the more focused role for the Fund in the Poverty Reduction Strategy process and low-income countries more generally. I also encourage all borrowers and lenders to participate fully in the HIPC debt relief process, and to respect the Low-Income Country Debt Sustainability Framework.

The authorities of our constituency extend their appreciation to the Caribbean Regional Technical Assistance Centre (CARTAC) for its help in improving macro policy analysis, public expenditure management, and tax and customs policy and administration. CARTAC has proven to be an efficient multi-donor program and a fine example of Paris Declaration principles in action; I would welcome other donors to join Canada, Ireland, the United Kingdom and the European Union in this effort.