International Monetary and Financial Committee

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October 11, 2008

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

On behalf of Bahrain, Egypt, Iraq, Jordan, Kuwait, Lebanon, Libyan Arab Jamahiriya, Maldives, Oman, Qatar, Syrian Arab Republic, United Arab Emirates, Republic of Yemen

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

1. The financial market fallout has proved more severe and more protracted than initially assessed and, even now, considerable uncertainty shrouds the outlook. In the span of a few weeks, the financial landscape in the U.S. and Europe witnessed epic shifts, amid successive failures of major and longstanding financial institutions. Markets are bracing for further financial market weaknesses to unfold, and the specter of a recession in key advanced economies is now looming alongside inflationary risks from the surge in commodity prices. The risk of a more severe feedback loop between rising financial market stress and a global economic downturn is also increasing. Against this background, a rapid deceleration in **global growth** is projected, to 3.9 percent and 3.0 percent in 2008 and 2009 respectively. This in large part reflects marked downward revisions to the outlook in advanced economies, which are projected to skirt a recession in the second half of 2008. Despite continued robust momentum, growth in emerging market and developing countries is also projected to moderate from the torrid pace observed over the past several years, as the spillovers from the global financial crisis intensify.

2. **Risks to the economic outlook are clearly on the downside.** A prolonged process of deleveraging and balance sheet repair could precipitate further deterioration in global financial conditions and place a further drag on economic recovery. Despite rising financial losses predicted from market corrections in the U.S. and some European countries, the risk of a further deepening of the credit default cycle is likely to dent corporate and household balance sheets. Consumer confidence could be further weakened by the negative impact of asset price deflation on household wealth, at a time when fuel and food prices have risen and labor market conditions are softening. Prolonged liquidity pressures in advanced countries' financial markets run the risk of mutating into a solvency crisis, often requiring decisive and comprehensive government-supported interventions. Notwithstanding the uncertainty about the adequacy of national solutions to stem systemic risk, there is a further concern these might be inconsistent across countries. Uncertainty also surrounds the outlook for inflation. In advanced economies, rising slack and some stabilization in commodity prices are likely to curb inflationary pressures. By contrast, inflationary pressures are expected to remain strong in emerging and developing economies, as pass-through of recent price increases unfolds and domestic demand continues to be robust.

3. The unprecedented confluence of shocks from continued strains in global financial markets, receding growth and continued tightness in commodity markets constrain the policy

space for policymakers all over the world. In the **United States**, conditions remain difficult despite massive efforts to restore liquidity and confidence in financial markets. Monetary policy has been eased substantially. The recent cut in the policy rate in coordination with other advanced economies, should provide support to an economy facing financial stress and ongoing house price correction. The fiscal stimulus package has also provided a targeted and well-timed buffer to domestic demand. The recent intervention by the U.S. authorities on Freddie Mac and Fannie Mae is also appropriate given the need to prop market confidence and stem the potential domino effect of the financial crisis.

4. We have generally been supportive of measures using public sector balance sheets to contain systemic financial risks, particularly when prolonged liquidity stresses run the risk of precipitating broader solvency concerns. The recently approved rescue plan, aimed at the purchase of distressed assets from banks' balance sheets, could help improve liquidity and confidence in the financial system, although bank capital is likely to remain under considerable strain. The sheer magnitude of the recently approved rescue plan lends support to two important considerations: (1) the financial sector has become oversized and some consolidation is necessary to restore financial system health; and (2) implementation strategies will be key for the plan to be successful in shoring up the financial system without exacerbating moral hazard and jeopardizing longer-term fiscal solvency. In the period ahead, we expect the Fund to develop a clear assessment of the implications of this rescue plan to the broader membership in terms of both financial and macroeconomic stability.

5. In the **euro area**, financial sector stresses are intensifying, with recent indicators suggesting that the pernicious feedback loops between the financial sector and the real economy may be increasing. In a coordinated response across several European countries, the ECB has appropriately eased monetary policy in the face of deepening financial dislocations and prospects of a sharp deceleration in growth. The spate of government interventions in major financial institutions suggests that problems unfolding in the U.S. may be hitting Europe with a lag, with the possibility for more widespread failures. The authorities' responses so far have been swift and decisive, although still based on a case-by-case approach. A more comprehensive and coordinated approach, akin to the U.S. plan, may be warranted to avert the fallout from a systemic crisis.

6. **Emerging market and developing economies (EMDC)** have so far been relatively resilient in the face of the ongoing financial turmoil, underpinned by solid fundamentals, sound policies, and strengthened financial buffers. Nonetheless, financial contagion appears to be spreading to several EMDC in the form of reversals in capital inflows, increased funding costs, and heightened investor jitters unrelated to fundamentals. Against this backdrop, and despite continuing the robust momentum, growth in EMDC is projected to moderate largely on account of weaker external demand, while domestic demand is expected to remain resilient, further adding to inflationary pressures from strong international commodity prices. Vigilance and policy flexibility are therefore required in the period ahead to guard against macroeconomic volatility from financial spillovers, while appropriately balancing the objectives of price stability and domestic growth.

7. Allow me to highlight some of the major developments in the **Middle East region**. Countries in the region have continued to stage an impressive growth performance. In both oil and non-oil exporting countries, growth is expected to remain brisk in 2008 and 2009,

supported by robust domestic demand and activity in non-oil sectors. Notwithstanding soaring investment costs, output of oil and natural gas is expected to expand in 2008-2009, reflecting heavy investments in production and distribution capacity by oil-producing countries. Growth momentum in non-oil exporting economies is driven to a large extent by remarkable reforms and past efforts to modernize their economies and strengthen the business environment, benefiting from sizable FDI flows. Modest downside risks to the outlook relate to a sharper deceleration in global growth and, for some countries, intensifying spillovers from the financial crisis.

8. This said, increases in oil and food prices are expected to continue to pose important challenges to macroeconomic policy management in both oil and non-oil exporting countries in the region. With headline inflation levels persisting beyond the comfort zone for many central banks, the issue for policymakers is to strike the right balance between sustaining economic momentum without losing control over inflation, while fending off heightened macroeconomic volatility from financial spillovers. In **non-oil economies**, the challenge is to bring down inflation while providing adequate assistance to mitigate its impact on the poor without jeopardizing longer-term fiscal and debt sustainability considerations. The call for raising interest rates needs to be balanced against the risk of fueling speculative flows, in a context where the traction from monetary transmission may be fairly limited. In the same vein, the broader call for greater exchange rate flexibility should be appropriately qualified to account for country-specific circumstances. A more supportive fiscal policy may be more effective in this context, although due regard should be accorded to political economy considerations that may impose short-term policies that could temporarily deviate from medium-term consolidation paths.

9. In **oil exporting economies** of the **Gulf Cooperation Council (GCC)**, vibrancy of domestic demand, along with supply-side bottlenecks, have further stoked inflationary pressures. Despite limited pass-through of higher food and fuel prices, indications are growing of possible second round effects. Managing inflationary pressures is especially complicated by the currency peg to the U.S. dollar in the context of divergent cyclical positions. To this end, the authorities have increased reserve requirements in several instances, while tightening measures and controls over credit growth. An important role is also accorded to fiscal policy in moderating inflationary pressures. While mindful of the need for higher spending in support of diversification plans, the authorities have adjusted the composition of their spending toward reducing supply bottlenecks and expanding absorptive capacity. More generally, inflation in GCC countries is believed to be temporary, which is expected to ease as food and oil prices stabilize and supply-side shortages relieved with the coming on stream of large construction and services projects. Progress toward the monetary union has also been achieved. The charter for a monetary council, a precursor to a regional Central Bank, has been approved in September by GCC central bank governors.

Responding to the Ongoing Financial Market Turmoil

10. The risks to global stability posed by the ongoing crisis place it squarely within the Fund's mandate, and this institution is the one best positioned as the lead international agency for macrofinancial analysis and capacity to prevent and resolve international financial crises. The Fund must be fully prepared to provide timely and effective support to the membership—whether analytical, policy, or financial support. Modernizing the Fund's

financing model and toolkit, particularly through the establishment of a new liquidity instrument for emerging market economies, and refocusing the priorities of its surveillance agenda are important steps in this regard. The Fund also has a key role to play in rebuilding the global financial architecture in the aftermath of the crisis.

11. Over the past few years, the Fund has been honing staff skills and its focus on global financial stability and macrofinancial linkages, analysis of vulnerabilities, and dissemination of best practice. The depth and quality of analysis contained in the Fund's flagship publications and surveillance reports all attest to successful efforts to deepen expertise in our core policy areas. These reports highlighted vulnerabilities related to excessive risk-taking and regulatory gaps. More importantly, the Fund has been directly engaged with authorities of systemically important advanced economies in proposing and debating measures to preserve and restore financial stability. The Fund is also responding to calls to reinforce its early warning capabilities, with greater focus on advanced economies, and to develop further tools for analyzing cross-country spillover risks. There is therefore scope for the Fund, in collaboration with others, to guide the medium-term financial system reforms.

12. The priorities for the Fund's financial surveillance agenda in the period ahead are well founded. The planned preparation of operational guidelines for strengthening the existing frameworks for monitoring risk profiles of individual institutions and for coordinated oversight and response to group-wide risk is important. Central bank liquidity management is another important area for further work, together with a review of crisis management and resolution frameworks. Challenges posed to emerging economies will likely command greater focus in the period ahead, and Fund staff should be prepared to respond with innovative approaches than those contained in the traditional FSAP assessments. Some aspects of MCM's work may need to proceed at a faster pace than others, in response to shifting priorities as the crisis unfolds.

13. The Fund's collaboration with the FSF has been built on the premise of natural complementarities between their respective roles. The Fund should continue to provide input to the FSF in identifying global risks and best practice drawing on lessons from members' experiences with crisis resolution. Close collaboration will be needed with the relevant bodies entrusted with defining standards, codes, best practice, and regulation, especially with regard to transitioning to Basel II and the procyclicality of regulatory and accounting frameworks. The Fund's value added will necessarily stem from its capacity to bring the broader macrofinancial perspective and wider membership experience.

Responding to the Challenges Posed by Higher Food and Fuel Prices

14. The Fund has responded appropriately to crises arising from the surge in food and fuel prices that afflict the global economy. The rapid agreement to modify the Fund's concessional lending instruments, including through augmentations to PRGF programs and reform of the ESF, is most welcome. The ongoing program of research is also helpful in providing a useful set of policy prescriptions to help countries adapt to these shocks while shielding its most vulnerable population groups. In particular, it notes that pass-through of commodity price increases may need to be gradual, taking into account political economy considerations and capacity constraints. It also recognizes that the strategy and pace of phasing out subsidies would need to be developed on a case-by-case basis.

II. IMF Reforms and Policy Agenda

Reviewing the IMF Lending Role

15. The ongoing financial turmoil underscores the importance for the Fund's lending approach to remain relevant to its members' evolving needs. While reflecting favorable global and country specific developments, the sharp decline in the demand for Fund resources is also indicative of several problems with its traditional financing model, including stigma, slow response, and excessive conditionality. This renders Fund financing less relevant for many countries in mitigating capital account-induced balance of payments pressures. A bolder rethink is therefore needed to fill existing gaps for emerging market economies in the Fund's lending apparatus.

16. The ongoing financial turbulence is likely to impact emerging market economies in different and unanticipated ways, and it is important that an appropriately designed instrument be in place should the need for it arise. **Developing a new liquidity or crisis prevention instrument is, therefore, a priority**. The facility should ensure that access to financing is large, automatic, and frontloaded. Additionally, conditionality should be streamlined, tailored to the country's specific circumstances, and focused on the objective of the facility. In this connection, **there is merit in increasing overall access limits**, given the divergence between members' quotas and the size of their capital flows. The upcoming review of charges and maturities should also help in further honing the cost structure for such facility. We can broadly support the roadmap proposed by the Managing Director along the five areas in his draft statement. We believe, however, that a more ambitious timeline is warranted for the establishment of a new liquidity instrument, and look forward to a discussion after the Annual Meetings.

17. With respect to low-income countries, the Fund has moved expeditiously on shock financing. The Exogenous Socks Facility (ESF) fills an important gap in our low-income financing toolkit, and the agreed reforms strike a good balance between facilitating greater speed of response to shocks and appropriate safeguards. The modified ESF introduces a number of positive elements, including a rapid access component, which allows more rapid response to more members. Appropriate policies are expected with rapid access, with policy commitments varying depending on the members' circumstances.

Advancing the IMF Surveillance Agenda

18. We fully support enhancing the framework for surveillance which remains central for the Fund to fulfill its responsibilities in the international monetary system. The Triennial Surveillance Review revealed several shortcomings which should be addressed in the period ahead. In particular, there is a need for greater candor in our assessment of risks to global stability emanating from advanced economies. In several cases, there has been a disconnect between grave technical findings and more upbeat headline messages that obscure the degree of concern, particularly for advanced systemic economies. Accordingly, we support the broad thrust of the four priority areas identified by the Managing Director, namely, improving the Fund's early warning capabilities, strengthening understanding of macro-financial linkages, better integration of multilateral perspectives in bilateral surveillance, and a focus on external

stability. **There should be a shift away from the focus on global rebalancing and toward global financial stability and the related immediate concerns of navigating the global economy through the unfolding financial crisis**. The publication of the first Statement on Surveillance Priorities (SSP), as a standalone document, should be helpful in identifying to the public the intended focus of the Fund's surveillance priorities.

Generally Acceptable Principles and Practices for Sovereign Wealth Funds

19. We commend the members of the International Working Group (IWG) for the Sovereign Wealth Funds for the development of a set of Generally Accepted Principles and Practices (GAPP). We also thank the Fund for its role in facilitating the compilation of these Principles, which represents a consensus view of the IWG members on issues that have been contentious and controversial. Developments in the ongoing financial turmoil have further emphasized the stabilizing role of SWFs in global financial markets. The work on finalizing these Principles in the span of only four months is testimony of the commitment by SWFs to uphold this role and to dispel protectionist concerns. We certainly hope that this effort will be met with an equally strong commitment on the part of the recipient countries to advance on guidelines to safeguard the free flow of global capital.

20. **We welcome the recognition in the preamble to the Santiago Principles the voluntary nature of this exercise, and the emphasis that each of these Principles is subject to home country laws, regulations, and obligations**. We have reservations regarding extending disclosure and transparency requirements to areas where the competitive position of SWFs relative to other types of investors would be compromised and a double-standard created. In view of the voluntary and consensus-based character of the initiative, we are not convinced of proposals to monitor the implementation of the Principles. We have previously cautioned against 'voluntary' initiatives by the Fund from developing into 'mandatory' practices, which would detract from the ownership of these Principles by the SWFs. In addition, given the tight budgetary constraints that the Fund is operating under and the competing priorities in light of the ongoing financial turmoil, we would not be in favor of further Fund involvement beyond this stage.

Other Items

21. **Income Model.** We welcome the progress made in preparing for implementation of the new income model. We underscore, however, the importance of advancing on two key elements of the model: (1) an Executive Board decision authorizing the sale of a limited amount of gold; and (2) amendment of the Articles of Agreement to expand the Fund's investment authority.

22. **Governance Reforms.** The IEO report on aspects of the Fund's corporate governance has produced some useful recommendations to strengthen the decision-making framework. The agenda proposed by the Working Group of Executive Directors to organize the follow-up to the evaluation report is particularly broad and ambitious; we therefore see the need for identifying and agreeing on a list of priority actions to guide the work ahead. We welcome the proposal by the Managing Director to establish a joint task force of Management and Executive Directors to take forward the roadmap suggested by the Working Group and coordinate progress with the Manuel Committee report.