International Monetary and Financial Committee

Ninth Meeting
April 24, 2004

Statement by the Hon. Peter Costello, MP, Australian Treasurer on behalf of the constituency comprising Australia, Kiribati, Korea (Republic of), Marshall Islands (Republic of the), Micronesia (Federated States of), Mongolia, New Zealand, Palau (Republic of), Papua New Guinea, Philippines, Samoa, Seychelles, Solomon Islands and Vanuatu

Statement by The Hon. Peter Costello, M.P.
Treasurer of Australia[1]
to the International Monetary and Financial Committee
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The International Monetary Fund is about to enter a new era in its leadership. Many challenges await, although the new Managing Director will inherit a sound institution that has been well served by Mr Horst Köhler over the past four years. The members of this constituency would like to record their appreciation to Horst Köhler for his commitment to advancing the objectives of the Fund and the interests of all its members.

As we move forward to appoint a new Managing Director, it is important that this be through an open and transparent process with the objective of selecting the best possible candidate for the position regardless of nationality. To do otherwise would undermine the credibility of the Fund as an inclusive organisation and the impact of its advice will be eroded. We welcome the efforts of the IMFC Chairman to enhance consultation throughout the membership on the process of selecting the new Managing Director.

A strengthening global economic outlook

Since 2003, global economic activity has strengthened and broadened, led by a rapid upturn in the United States and emerging Asia, along with a firming of the recovery in Japan. Industrial production and global trade have picked up, and business and consumer confidence are strengthening. Geopolitical tensions remain, although other shocks such as SARS and Avian Bird Flu have receded. Despite the pick-up in growth and rising oil and commodity prices, inflationary pressures remain low, reflecting excess capacity and competitive pricing in domestic and global markets.

The strengthening in the world economy is welcome. Nevertheless, significant medium-term risks remain which could threaten the prospects of an enduring period of global economic growth. Moreover, while activity is picking up in most regions, its pace and composition vary and many economies continue to under perform, particularly low-income countries. The challenge is to ensure that there is a broadening and deepening in the global recovery and that vulnerabilities that have been on the radar for some time are managed to ensure that the recovery is not cut short. Chief among these is the need for an orderly unwinding of global current account imbalances, countering growing protectionist pressures and managing the adverse impact of sustained high oil prices. There is also the need to address the medium-term challenges many countries face from demographic changes. In addition, we live in uncertain times and a new shock may be just around the corner. Hence, policy flexibility needs to be restored as an insurance against the unexpected. There is also the

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pressing need to lift the performance of the poorest performing developing countries and make further inroads into reducing poverty.

We are at a juncture where the strengthening in economic activity could lead to policy complacency and, even worse, policy reversals. Hard won economic gains can be easily lost through policy inconsistency. Economic growth provides the best time to push ahead with needed fiscal and structural reforms.

The policy messages are not new. The fiscal expansion in the US provided a timely stimulus to growth during a period of substantial economic shocks. However, with growth consolidating, it is now important to establish a credible path towards medium-term fiscal consolidation.

In addition to US fiscal consolidation, a reduction in the United States current account deficit that is benign for the global economy will require continued domestic demand growth in Japan and stronger domestic demand growth in Europe. The recovery in the Euro area has so far relied primarily on exports with domestic demand remaining subdued. Sustaining higher growth will require faster and deeper structural reforms. The recovery in Japan exceeded expectations in 2003, and is very welcome. While growth was driven primarily by net exports and investment, there are signs of increasing consumer demand and rising consumer and business confidence. However, to ensure that the recovery is sustained, efforts must continue at ending deflationary pressures, restoring the medium-term fiscal accounts, and reforming the corporate and banking sectors.

China's rapid growth has been beneficial not only for the people of China, but for the world economy and it is in everyone's interests that this growth momentum be maintained. China serves as an excellent example of a country that is using trade reform to drive far-reaching reforms across its economy. The prospect of continued rapid economic growth in China is providing both challenges and opportunities for other countries. Those that respond with defensive policies are likely to miss out on growth opportunities and risk being left with distorted economic structures that will be difficult and costly to reverse. In contrast, countries that create maximum flexibility in their economies stand to maximize the gains from China's emergence. Other East Asian economies' strong linkages with China have, along with a pick up in domestic demand, assisted in achieving their recent strong economic growth.

Emerging markets have benefited from the benign financing environment. However, a sharper-than-anticipated rise in interest rates in industrial countries could see rising spreads and lower capital flows to emerging markets and increased market volatility. On the part of emerging markets, it is important that the current favourable financing environment does not lead to complacency and they continue to pursue sound macroeconomic polices and structural reform.

The Fund's contribution in meeting policy challenges

All countries – developed, emerging markets and developing – face significant policy challenges if growth is to be sustained. Ultimately, it is the decisions taken by individual countries that will determine whether these challenges are successfully embraced, although there is a pressing need for greater international cooperation and support, particularly in the area of multilateral trade liberalisation.

A successful conclusion to the Doha Development Round is perhaps the largest single positive factor that could both enhance the prospects of developed economies as well as assist in the development of low-income countries. The Fund must continue to work towards the advancement of an open international trading system through identifying the costs of protectionism and the benefits of trade liberalisation in its surveillance activities as well as providing appropriate technical assistance. We particularly welcome the recent decision to introduce a Trade Integration Mechanism which will help mitigate concerns low-income countries might have over temporary balance of payments adjustments resulting from multilateral trade liberalisation, particularly through the loss of tariff preferences.

Strengthening Fund surveillance

Surveillance goes to the heart of the contribution that the Fund can make in helping members address their policy challenges. The forthcoming biennial review of surveillance provides an important opportunity to take stock of the Fund's performance and to identify how surveillance can be made more focused. However, this is not a topic that should only be considered at discrete two yearly intervals. Fund staff, management and the Executive Board face a daily challenge of ensuring that Fund surveillance is as effective as possible.

Much of the focus on improving surveillance concentrates on technical and procedural issues, such as data provision, balance sheet assessments, debt sustainability exercises and financial sector analysis. These are important in helping to identify vulnerabilities facing members as well as improving the quality of Fund advice. Much progress has been made in these areas over recent years. However, such efforts are only a means to an end, and the ultimate test of the effectiveness of surveillance is whether the Fund makes a positive contribution in assisting countries to implement appropriate policies. It is difficult to measure the success of Fund surveillance, although it is apparent when Fund policy advice is not being pursued.

The influence of the Fund over a country's policy choices is clearly greater if a country is implementing a Fund-supported program. As such, it is particularly important to ensure that program design is sound and conditions appropriately targeted. These are issues that should be pursued in the 2004 review of conditionality. It is noteworthy, however, that developed countries no longer use Fund resources and their relationship with the Fund is largely through surveillance. This has led to understandable concerns that Fund policy 'scrutiny' is biased towards developing countries and emerging markets, notwithstanding that the policies of the major developed countries have the greatest global economic and financial consequences. A key challenge facing the Fund is to increase the effectiveness of surveillance over developed economies.

It is essential that surveillance be tailored to meet the circumstances facing each country. The coverage of surveillance has broadened in recognition that economic stability depends on a range of macro and micro factors. Nevertheless, for Fund surveillance to be effective it must be appropriately targeted. Priorities will vary from country to country and the Fund's policy message, and its contribution to the public policy debate in a country, must not be diluted through attempts to cover too many issues at one time.

As noted previously, the risks to the global economic outlook have been on the radar screen for some time. The task of surveillance is often not simply one of telling authorities what they should do, for this may be well known. Rather, surveillance has to contribute to the more difficult task of helping a country's authorities convince a sceptical legislature and public that proposed reforms are warranted. The Fund has to be alert to the political realities facing a country's policy makers, who in turn should be seeking to see how best they can use the Fund's surveillance processes to advance needed reforms. An area where the Fund should have a comparative advantage and where it should be of major assistance is through relevant cross-country comparisons. While there has been some progress on this front, much more needs to be done.

It is particularly important that the Fund not simply go through the motions with surveillance. A strategic approach is required for all countries, with the objective of determining how best the Fund can help each member. Priorities must be set and the effectiveness of surveillance over each member, whether developed or developing, assessed to determine what is working and what can be improved. We would suggest that a similar concept to the *ex post* assessment of programs where there has been a prolonged use of Fund resources needs to be applied to surveillance. That is, to introduce a detailed assessment of past surveillance efforts in situations where there has existed for sometime significant differences between the Fund and the country in terms of policy choices. The prime task of oversighting surveillance rests with the Executive Board, and we trust that the role of the Board in the surveillance process will be covered in the forthcoming biennial review.

The work of the IMF and World Bank on the standards and codes initiative remains an important feature of the Fund's surveillance strategy. The institutions have recently expanded their responsibilities with respect to standards and codes, addressing money laundering and combating the financing of terrorism. We support this important work, and note the Fund will also need to maintain the momentum on implementing other key standards that pertain to its core function of promoting international financial stability.

Crisis resolution and the use of Fund resources

While effective surveillance will help minimise financial crises, they will still occur and continued efforts are needed towards improving crisis resolution mechanisms. A welcome development is the increased use of Collective Action Clauses in sovereign debt issues. Unfortunately, progress has been limited in achieving a voluntary code of conduct which would outline standards of behaviour of creditors and debtors. Work on this issue is now being advanced within the G-20 and we hope there will be renewed vigour towards reaching agreement on a voluntary code.

We are concerned about the concentration of the use of Fund resources among a few members, the result of programs, sometimes successive programs, involving exceptional access. Criteria were established in 2002 in an effort to better define and narrow the circumstances when exceptional access is appropriate. However, in the two cases involving exceptional access under the new framework, neither country met all the criteria. The answer is not to weaken the criteria for exceptional access, but to ensure that the consistent application of the framework ultimately results in better Board decisions that reflect the risks to the Fund from a high level of exceptional access. The application of the exceptional access criteria would be a good topic for the Independent Evaluation Office (IEO) to review.

Fund support for low-income countries

We welcome the ongoing review of the role of the Fund in low-income countries. The Fund has an important contribution to make, although it is only a partner in assisting with the development of low-income countries. It is essential that the Fund operate in close consultation with other international institutions, particularly the World Bank, and bilateral donors. The Fund should focus on the areas within its mandate and where it has the greatest comparative advantage. The main contribution that the Fund can make to assist low-income countries is through policy advice, helping to mobilise donor support, providing technical assistance and, where appropriate, providing temporary financial support depending on a country's balance of payments needs.

The Poverty Reduction and Growth Facility (PRGF) should remain the main source of the Fund's financial support to low-income countries, although much still needs to be done to enhance the effectiveness of PRGF supported programs, particularly in integrating them more with a country's Poverty Reduction Strategy Paper (PRSP) and internal policy making processes. We particularly look forward to the forthcoming PRSP/PRGF evaluation by the IEO.

PRGF resources are limited and it is important that they be used as productively as possible by countries in need. It is also appropriate for the Fund to continue to explore ways in which it can more effectively provide rapid and concessional assistance to low-income countries experiencing shocks. However, the Fund is not a source of long-term concessional development financing. Successive PRGF programs may reflect a country's deep-seated and protracted problems, but it may also reflect major policy shortcomings by the country and inappropriate program designs. A significant development following the IEO's evaluation of prolonged use of resources is the introduction of *ex post* assessments. A prolonged program relationship can undermine a country's policy-making capacity and result in 'program dependency'. We therefore welcome the concept of declining access norms for third and successive PRGFs, for while such norms need to be applied flexibly, they provide a signal that there should be an exit strategy for PRGF arrangements. Most importantly, the Fund must move beyond a program involving the use of resources as the main form of its relationship with low-income countries. This will involve enhancing the effectiveness of its surveillance operations over low-income countries and, in particular, convincing donors to rely more on surveillance in order to gain a 'signal' from the Fund in terms of the adequacy of a country's policy developments. As regards future PRGF financing, we support a self-sustained PRGF supported by new bilateral loans to fill funding voids.

Quotas, representation and Fund governance

There remains the pressing need to address the under-representation of countries in terms of the distribution of Fund quotas, as well as the concerns of developing countries regarding 'voice and participation'. The impact of Fund advice is eroded if the Fund is not seen as a truly representative and soundly governed organisation. We are particularly concerned about the under-representation of many Asian countries, especially Korea. Fund quotas, and in turn voting rights, must better reflect countries' relative positions within the world economy in order to restore the credibility of the Fund as a truly 'international' financial institution. In particular, the legitimacy of any decision based on majority positions is questionable if there are deficiencies in the distribution of voting powers.

While it is recognized that changes in quota shares is only likely to be addressed in the context of an agreement to increase Fund quotas, it is essential that work continue on quota related issues. Moves to address concerns over governance and representation in the Fund need not wait on the next quota increase, for we believe a key aspect involves addressing the role and functioning of the Executive Board. As we have noted in the past, we believe the Board should be subject to an external review.