Address to the
Board of Governors

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*Managing Director*
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WORLD BANK GROUP

INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT
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Address by **RODRIGO DE RATO Y FIGAREDO,**
Chairman of the Executive Board and
Managing Director of the International Monetary Fund,
to the Board of Governors of the Fund,
at the Joint Annual Discussion

**Remarks by Rodrigo de Rato, Chairman of the Executive Board and Managing Director of the International Monetary Fund, to the Board of Governors of the IMF at the Joint Annual Discussion, 2007 Annual Meetings of the International Monetary Fund and the World Bank Group, Washington DC, October 22, 2007**

1. Mr. Chairman, Governors, honored guests, it is a pleasure to welcome you to these meetings on behalf of the International Monetary Fund. I would also like to extend a special welcome to my friend and colleague Bob Zoellick, and to thank him for his inspiring speech. Bob's words make it clear that the Fund and the Bank are united by a common purpose—to serve the interests of the people of our member countries—and also a common commitment to reform. Welcome Bob.

***Global Economic Outlook: Implications of the Crisis in the Credit Markets***

2. Last year we met at what I called a time of opportunity, but today we meet at a time of uncertainty. Over the past few months, we have lived through an earthquake in the credit markets. Like most earthquakes, it has been distant for most people: something they have read about in the newspapers. But there is still a risk of aftershocks, and the full effects of the

disruption we have already had will only be felt over time. We need to consider what actions we can take to limit the damage, and also what lessons we can learn from the crisis.

3. The central question now is whether the global economy is at an inflection point. So far, it seems that growth will continue, although at a slower pace than in the past two years.

- In the advanced economies, the balance sheets of core financial institutions and corporates remain strong, labor market conditions are generally healthy, and the credibility of monetary policy frameworks is high. For these reasons, we expect a slowdown in growth but not a recession in the United States, and a smaller slowdown in other advanced economies.

- Emerging economies have become a source of stability in the global economy—something that would have been unthinkable a few years ago. The citizens of many emerging economies are reaping the benefits of globalization and of good policies pursued by their governments. For these reasons, we expect most emerging economies to continue performing very well.

- Low income countries are less integrated into global financial markets, but they have benefited from supportive global economic conditions as well as improved policy frameworks. We think their prospects are also good.

4. So you might ask, where does the uncertainty come from? It comes from downside risks that are much higher than they were six months ago. The turbulence in the credit markets is a warning that we cannot take the benign economic environment of recent years for granted. We still do not know the full effects of the decline in the housing market and the sub-prime problems of the U.S. economy. Further disruption in financial markets and further falls in housing prices could lead to a global economic downturn. If there is a downturn, other risks already present will loom larger.

- Up to now, movements in exchange rates have been orderly and in line with fundamentals. But there are risks that an abrupt fall in the dollar could either be triggered by, or itself trigger, a loss of confidence in dollar assets. And there is a risk that exchange rate appreciation in countries with flexible exchange rates—including the euro area—could hurt their growth prospects, and that in these circumstances protectionist pressures could worsen.

- Some emerging economies that have relied on external financing to fund large current account deficits could be tipped into crisis by a combination of reduced demand for their exports and tighter financial market conditions. These developments would also worsen the prospects of low-income countries.

- And there is a risk that central banks may falter in fighting the inflation which has been spurred in some countries by higher oil and food prices.

5. All of these risks make action on already agreed policies more urgent. Major economies need to recognize that global imbalances cannot be corrected by currency movements alone. They need to take supporting

policy actions—along the lines of the roadmap that came from the Multilateral Consultation held at the Fund earlier this year. Major trading partners, both in developed and developing countries, need to go the extra mile to complete multilateral trade talks. Potentially vulnerable emerging economies should prepare in case the crisis reaches their shores. And policymakers need to respect the independence of central banks and support their vigilance on inflation.

6. We also have to plan ahead. The effects of the crisis have the potential to spread from the credit markets to the real economy, from individuals and companies to governments, and across countries. We should anticipate and reflect these consequences and feedback effects in our policy responses. So far, central banks in advanced economies have reacted swiftly and sensibly. They have provided liquidity to support the functioning of credit markets; and they have adjusted their monetary policy stances to reflect changed economic prospects. Central banks in emerging markets also need to remain on the alert, and make sure that they have good information about the risk profile of major financial institutions. And governments in all affected countries need to recognize that revenue may have to be revised downward

and spending plans may therefore have to be reviewed. Meanwhile, the issues of aging populations and dangerous climate change have not gone away. If anything, they have become more pressing.

***Lessons From the Crisis***

7. We should also reflect on the lessons we have learned from the crisis. We already know that we should not try to regulate crises out of existence: that would be like trying to ban earthquakes. But the weaknesses in our infrastructure that have been exposed need to be addressed. We need to make sure that the regulatory infrastructure is strong enough and simple enough to handle crises in a globalized world. Let me give a few examples.

- The crisis in the credit markets arose in part because investors did not exercise sufficient due diligence. But they were also impeded in exercising due diligence by a lack of transparency and disclosure about the risk profile of new structured credit instruments. So we should look for low-cost ways of improving transparency in credit markets.

- Financial innovation seems to have increased banks’ abilities to move risks off their balance sheets, but not their ability to avoid taking them back on again. This suggests that assessments of banking soundness and capital by supervisors and ratings agencies should pay more attention to off-balance sheet exposures.

- Banks’ growing reliance on securities markets for financing has increased their vulnerability to liquidity risk. Regulators need to reflect this new reality in their assessments of liquidity requirements.

- In some areas, and especially in mortgage markets, the crisis reveals a need for better consumer education and protection, and simpler disclosures. We should not forget that the main victims of the crisis so far have been those who were persuaded to buy houses they could not afford, and who are now losing their homes.

- The crisis has also demonstrated the importance of coordination between supervisors, regulators, central bankers, and finance ministries, and it has also demonstrated, in some countries, a need to simplify the regulatory infrastructure.

8. Perhaps most importantly, the crisis reveals the range and the risks of financial globalization. Those at risk are not just loan originators in the United States, but banks in Germany and the United Kingdom, borrowers in eastern Europe, and ultimately exporters in Asia and Africa. This points to the vital importance of multilateral cooperation on financial market issues. It is possible for a few countries to get together and come up with regulatory changes, but they are unlikely to come up with the best global solution, because they do not represent all of those affected. And without the participation and ownership of all countries who have to implement it, translating even the best-designed proposal into reality will be a very difficult task.

9. This is why it is important that the Fund, together with other multilateral agencies with relevant expertise, does its part. The Fund has a global membership, which both provides a forum for multilateral discussions and gives authority to the outcomes of those discussions. We also have the

instruments—from Article IV consultations to Financial Sector Assessment Programs—to provide the necessary perspective on economic and financial issues. And we have an independent staff which is accumulating a growing knowledge base, as was demonstrated when we warned about the recent financial market risks before problems emerged. The crisis in the credit markets has tested the international financial system, and it will probably give us further tests. But if we learn from it, and if we cooperate in applying the lessons we have learned, we can emerge from the crisis stronger.

***A Changing Fund in a Changing World***

10. Let me now turn to the ways in which the Fund is changing to meet the demands of a changing world. The international spillovers that we have seen in the crisis in the credit markets are symptomatic of the challenges that come with increased economic integration and financial globalization. If we are to meet these challenges, many economic issues will need to be considered in a multilateral setting. These include financial market monitoring and regulation, global imbalances, crisis prevention, poverty reduction, trade reform, aging populations, and the response to climate

change. On each of these issues, no group of countries can impose changes on their own, and both advanced and emerging economies have responsibilities.

11. A relevant and legitimate Fund can make important contributions in all of these areas. The Fund must be ready to help our members reap the benefits and contain the costs of financial globalization, and also to help our members work together to address the problems most in need of multilateral solutions. This is why the reform program that we are undertaking is so important: we must change and evolve to keep up with a changing world. Let me now say something about how the Fund is evolving, and about some of the challenges that the Fund will face in the period ahead: in the areas of quotas and voice, surveillance, crisis prevention, financial market issues, our work in low-income countries, and our work on developing a sustainable income model for our institution.

12. I will begin with the reforms that we are making to quotas and voice. Reform of the Fund's governance is a marathon, not a sprint, and the milestones we have passed during the past year are not as dramatic as those

embodied in the Governors' Resolution in Singapore in 2006. But they are very important. There is now increasing convergence among members on key elements of a new quota formula and especially on the need for GDP calculated using purchasing power parities to play a role in the reform. More fundamentally, there is a consensus on the need for a shift in voting shares toward emerging and developing countries as a whole. We also agreed this weekend that the total quota increase should be of the order of ten percent, and confirmed that basic votes should be at least doubled, to protect the position of low-income countries. These are all essential features of the governance reform that we need in order to preserve the Fund's legitimacy. Of course, the reform process now needs to be completed, and we should not underestimate the challenge involved or the commitment required. But I believe that members will rise to the challenge. You showed your commitment to reform in Singapore; and you showed it at this weekend's IMFC meeting. You can show it again. When you return to Washington in 12 months time you can make the Fund the first multilateral institution to complete a path-breaking reform of its governance.

13. Let me now turn to surveillance. I would like to congratulate the staff and the Board on the agreement reached in June on a new surveillance decision. The new decision is the first major revision in the surveillance framework in some 30 years, and the first ever comprehensive policy statement on surveillance. It reaffirms that surveillance should be focused on our core mandate—namely, promoting countries' external stability. And it reaffirms the centrality of exchange rate analysis, an area where we have been steadily stepping up our work. I realize that reporting the outcome of our analysis of vulnerabilities and exchange rates sometimes involves telling an inconvenient truth. But we need to do it, while giving due respect to both the complexity and the sensitivity of the issues involved.

14. This year also saw the successful completion of the first Multilateral Consultation. The process helped to clarify members’ intentions on measures to reduce global imbalances. And it also has the potential to be used on other issues of multilateral concern. As such, it is an important new tool for our members.

15. We have done substantial work on the design of a new lending instrument to support crisis prevention which contains the essential features of automaticity, substantial frontloading, and high access. However, so far we do not have sufficient consensus on the instrument among members to give us confidence that it would be used. Members should not be complacent about this. Emerging market crises have not yet been consigned to history, and we will be making a mistake if we delay taking a decision on a necessary tool until a crisis is already upon us.

16. The Fund has continued to deepen its work on financial market issues. In doing so we have drawn on the work of the McDonough committee, and I would like to thank again Bill McDonough and his colleagues for their work. We have increased the participation of financial market specialists in Article IV missions. Area departments are strengthening their own capacity to address financial issues and raising the profile of these issues in their reports. We are improving the Fund’s analytical tools for gauging financial market vulnerabilities. And all of these changes are reflected in increased demands for Fund technical assistance and for FSAPs and FSAP updates.

17. We have been improving the focus of our work on low-income countries for some time. This includes improving our projections of aid inflows and making sure that countries have the fiscal space they need to expand social programs, especially in health and education. We have enhanced our valued technical assistance work, including opening a third Technical Assistance Center in Africa this year. And we are deepening collaboration with the World Bank in areas that are key to promoting higher growth and greater poverty reduction in low-income countries. In doing so, we are drawing on the work of the committee led by Pedro Malan, and I would like to take this opportunity to thank Pedro and his colleagues again for all of their important work on this issue.

18. Finally, we are now well advanced in designing and reaching consensus on a new income model for the Fund. We now have complete acceptance of the need for a new model and substantial consensus on the details of that model. In our work on income, we have benefited from the advice and analysis of the external committee led by Andrew Crockett, and I would like to give special thanks to Andrew and his colleagues for their work. On the expenditure side, we have implemented medium-term

budgeting and have drawn up a budget which will cut expenditure by six percent in real terms over a three-year period. Now we need to reach consensus on policies that will anchor income and expenditure for the future. Management and staff are ready to put forward different scenarios. I hope that the membership will also be ready to make the decisions needed to keep the institution on a sound financial footing.

## ***Conclusion***

19. Let me now end with a few personal observations. I have been privileged to serve as Managing Director for the last three and a half years, and I consider it to be one of the highest honors of my life. Of course, a Managing Director of the Fund does not own it: he just looks after it for a while, and in the best case helps a committed staff and an engaged membership to work in harmony. I see the reforms that we have begun under the Medium-Term Strategy as part of an evolutionary process, one that began before I came here and will continue after I leave. The ability of the Fund to evolve is shown in the ways in which the Fund is changing in

response to the changed world of financial globalization. It is also shown in the Fund's willingness to set and embrace an agenda of reform, and in the smooth way in which the Fund has handled a change in both the Managing Director and the Chair of the IMFC in the course of the last two months. Let me take this opportunity to congratulate and welcome to these Annual Meetings and to the Fund a man who brings exceptional talents and energy. I welcome as my successor Dominique Strauss-Kahn. I would also like to congratulate and welcome Tommaso Padoa-Schioppa, who presided over this weekend's IMFC meetings so effectively and so gracefully. And I cannot let this occasion go by without thanking and congratulating Gordon Brown, who was an immensely gifted IMFC Chair for almost a decade, and who is now Prime Minister of his country, the United Kingdom.

20. During my time as Managing Director, I have been blessed by the friendship and support of very many people. I would like to thank my Management colleagues over the years: Anne Krueger, John Lipsky, Agustín Carstens, Murilo Portugal, and Takatoshi Kato for their friendship and their loyalty; and also my colleagues at the World Bank: Jim Wolfensohn, Paul Wolfowitz, and Bob Zoellick. I also want to thank the Fund's Executive

Board for selecting me and for giving me their support. But I especially want to thank the staff of the Fund, whose dedication to the Fund and to its mandate is outstanding. Outsiders sometimes assume that the staff of international institutions are resistant to change. This is not true of Fund staff. Each time I have asked them to change they have risen to the challenge. Indeed they have gone further: they have themselves been the engine of change in the institution. I also want to thank you, the Governors, for your support, and to ask you to show your continuing support for the Fund by coming together on key issues like quotas and income, as you came together in Singapore a year ago and as the founders of the Fund came together 63 years ago.

21. Thank you very much.