The International Economic Agenda: A View from the IMF

Remarks at the 45th Plenary Meeting of the Group of Thirty
By Stanley Fischer, First Deputy Managing Director, International Monetary Fund

Introduction

- Pleasure to be here and to be speaking alongside Larry.

- A marked slowdown in global economic activity is clearly underway, thanks to:
  - Significant deceleration in the US,
  - Another faltering in Japan's recovery, and;
  - Weaker activity in Europe and a number of emerging market countries.

- But no need to panic. Our best guess is that the pause will be quite brief and that activity will rebound later this year, with growth at 3.2 percent for 2001 as a whole.

- But there is clearly a risk that the downturn will be deeper and more prolonged.

- A substantial and abrupt fall in the dollar and equity prices - associated with a loss of consumer and investor confidence in the US and Japan - could take more than 1 percentage point off global growth this year and next.

- With inflation generally subdued, the message to policymakers is clear: move pro-actively to prevent the pause becoming something more serious.

- Let me begin by focussing on the outlook for the US, before turning to Japan and the euro-zone. I will then discuss the impact of the global slowdown on emerging markets in Latin America, Asia and elsewhere.

The US

- Activity was already weakening significantly by the end of last year, partly because of appropriate policy tightening to restrain excessive demand.

- But the slowdown has turned out sharper than expected as domestic demand and confidence have been hit by a number of shocks:
  - Higher energy prices,
  - Reassessment of corporate earnings prospects, which has hit equity markets;
  - Slower growth in the technology sector, and;
  - Tighter credit conditions.

- Household spending has held up OK, but growth looks likely to be just 1 ½ percent this year. Moderate recovery beginning next year, with growth at 2 ½ percent.

- Recovery will be helped by:
  - Fall in long-term interest rates during 2000,
  - More recent cuts in short-term rates,
  - Tax cuts (if front-loaded), and;
  - Lower oil prices.

- Markets are already pricing in another 75bp off Fed Funds by end of the summer.

- But downside risks are significant. Perceptions of productivity miracle have allowed the economy to sustain big imbalances: high current account deficit, overvalued dollar, negative personal savings rate and (still) high equity prices.

- These imbalances must unwind, but will they do so in orderly fashion? Danger that virtuous new economy circle (of rising productivity, rising stock prices, increased access to funding and higher technology investment) could go into reverse.

- Impact on consumer spending of falling equity prices, looser labor market and lower confidence is hard to predict.

- Fed should be ready to resume aggressive cuts if necessary. Modest, front-loaded tax cut could be helpful, but fiscal policy should be guided by long-term considerations.

Japan

- Further setback to already fragile recovery in Japan is clearly a worry.

- Stagnation in domestic spending and output in early months of 2001, including investment (which had been a bright spot).

- Depreciation of yen reflects cyclical weakness and is helpful. But too big a depreciation would take it further from equilibrium and could destabilise region.

- Growth not likely to be much above ½ percent this year, rising to 1 ½ percent in 2002. Clear risk of renewed recession.

- Weak economy and volatile equity prices have hit financial balance sheeets, with bank lending still contracting. Measures to write-off bad bank loans and purchase excess equities are useful steps, but more needs to be done to revive loan growth.

- Any remaining scope to reduce interest rates should be used. Significant quantitative expanion of monetary base will also be needed if deflation continues and economy goes back into recession. Fiscal easing should be last resort, given size of debt.

- Structural reform remains urgent, especially corporate restructuring and governance:
    - Introducing consolidated corporate taxation
    - Introducing defined contribution pension schemes
    - Strengthening the role of outside audiotors and directors.

Euro area

- Activity in the euro area has slowed in response to:
    - Higher oil prices,
    - Stock market declines,
    - Weaker business confidence, and;
    - External spillovers.

- The outlook has weakened particularly in Germany and Italy.

- Growth looks likely to be less than 2 ½ percent this year and 3 percent in 2002.

- Core inflation remains below 2 percent, so the ECB should be worrying more about the risk of weaker growth than higher inflation.

- Rates on hold since October tightening, despite easing virtually everywhere else.

- A moderate cut in interest rates is appropriate now, with larger reductions if signs of weakness increase.

- Weaker activity and a slowdown in capital inflows have weakened the euro again, despite 150bp off US short rates. ECB rate cuts would likely boost the euro.

- Tax cuts are providing some stimulus, but members should strive to meet long-term budget targets and match future tax cuts with lower spending.

- Structural reform remains necessary to boost long-term growth. Relatively high structural unemployment makes tackling pension and health care costs more difficult.

Emerging markets

- Now let me turn to emerging markets.

- Financial confidence remains fragile, with investors looking warily at stabilization efforts in Turkey and Argentina. Volatile oil prices do not help.

- Clear spillovers from developed to emerging markets eg. Between NASDAQ and emerging market equities, and between US high-yield paper and bond spreads.
- Given global uncertainties, external financing conditions likely to remain volatile.
- So far the impact of the global slowdown has been focused on countries with big trade linkages to the US.
- Financial market volatility may hit confidence more broadly, but fortunately vulnerabilities are less pronounced than prior to Asian crisis:
  - Exchange rate regimes are more flexible,
  - Short-term external debt has been reduced, and;
  - Fiscal imbalances are generally contained.
- Prospects depend on maintaining investor confidence. This means prudent macro policies and pressing ahead with corporate, financial and institutional reforms.

Latin America

- After growth of 4 ¼ percent last year, 3 ¾ percent looks likely for 2001.
- Financing needs remain large.
- Mexico, Venezuela and Central America most vulnerable to US slowdown.
- In *Argentina*, growth should be 2 percent this year. Financial conditions stabilized with Cavallo's appointment and policy announcments, but clearly big risks.
- Spreads remain high and policy room for manoeuver is limited. Measures to hit annual fiscal targets are essential to stabilize sentiment.
- In *Mexico*, growth set to halve from 7 percent last year to 3 ½ percent this year, with current account deficit widening to 4 percent of GDP.
- Delivering on promised prudent budget essential to hit inflation target. Monetary policy will have to balance risks to growth and relatively strong wage pressures.
- *Brazil* should maintain growth above 4 percent this year, with slowing exports offset by buoyant domestic demand. Good primary surplus and credible inflation target.
- But recent developments (largely Argentina) has put prospects in doubt as exchange rate has fallen and interest rates risen. Fiscal action may be necessary.

- Growth has slowed in *Chile*, but is expected to pick up in *Andean region*. Still uncertainties from delayed reforms in *Venezuela* and *Colombia*.

Asia

- Except in India and China, growth has decelerated sharply because of:
    - Slower US growth and global electronics slump,
    - Spillover from NASDAQ plunge,
    - Political uncertainties, and;
    - Worries about slow restructuring.

- The slowdown has been accompanied and exacerbated by:
    - Big falls in regional equity markets,
    - Declining portfolio inflows, and;
    - Downward pressure on some exchange rates.

- Regional weakness will be compounded if Japan deteriorates further.

- Growth is expected to slow sharply to 3 ½ percent in *Korea* this year. Monetary policy has been loosened. More corporate restructuring and deleveraging essential.

- In *Indonesia*, political instability, frictions with lenders and ethnic violence have driven rupiah to 28-month low and halved dollar stock prices since early 2000. Budget slippages have to be avoided, given fears about fiscal sustainability.

- Growth in *Thailand* should weaken slightly to 3 percent. *Malaysia* helped by strong domestic demand. Philippines hampered by political turmoil late last year.

- Modest slowdowns in *China* and *India*. Need for fiscal action, especially in India.

Elsewhere

- In *Russia*, lower oil prices, global slowdown and higher ruble should cut growth to 4 percent. Forex intervention must be sterilized to contain inflation risks.

- Big current account deficits in *Central Europe* – from 4 ¾ percent in Czech Republic to 5 ½ percent in Poland – signal need for tightetr fiscal positions.

- *Turkey* is obviously a focus of market attention. Overhaul of the banking system of central important. [Not sure what key messages you want to send here.]

Conclusion

- Don't panic, but policymakers should think proactively to forestall bigger problems.

Promoting Good Policies:
The Role of the IMF

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Indian Council for Research on International Economic Relations,
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1. Introduction

Mr Chairman, Ladies and Gentlemen.

[Nice words about hosts. Ratna may have thoughts on this after her visit.]

I want to talk today about the role of the International Monetary Fund in the modern world economy. I will start by talking briefly about the original purposes of the Fund, and how well they have stood the test of time. I will argue that Fund has remained faithful to the vision of its founders, but that to do so it has had to adapt to profound changes in the world economy and the international financial system. I will then discuss how these changes are throwing up challenges for the three main elements of the Fund's work – surveillance, technical assistance, and lending to countries in need.

2. The Purposes of the Fund

Looking back at the Bretton Woods conference at which the Fund, the World Bank and what is now the World Trade Organisation were designed, it is remarkable that agreement was reached at all. The trains in which the 700 delegates travelled to the

Mount Washington Hotel were dubbed "the Tower of Babel on wheels". And John Maynard Keynes, as well as complaining about the number of lawyers in the US delegation, despaired of "committees and commissions numbering anything up to 200 people, in rooms with bad acoustics, shouting through microphones, with many of those present having an imperfect knowledge of English, each wanting to get something on the record that would look well in the press at home". But agree the delegates did, spurred by a conviction that the breakdown of international economic cooperation during the inter-war years should never be repeated.

When journalists, academics and politicians scrutinise the Fund's day-to-day activities, they sometimes forget the fundamental purpose that motivated its creation. In joining the IMF, countries publicly sign up to a set of principles regarding the operation of the international economic system that are in their mutual interest. This confers legitimacy on the pursuit of those principles by the Fund and its members. The role of the Fund is essentially to promote what the international community has learnt from experience to be good policies: sound money, prudent fiscal policy, strong financial systems, and open markets, foremost amongst them. These policies are good not only for individual countries, but also for the world economy as a whole.

By and large, countries have adhered to these principles of good economic citizenship over last 50 years, helping produce more growth and more prosperity for more people than in any equivalent period in economic history. Which is not to deny that much more can and should be done to spread the fruits of economic growth more widely.

The primary purposes of the IMF were set out at Bretton Woods in Article I of its Articles of Agreement. Let me remind you of the key ones:

- To create a permanent institution for consultation on international monetary problems;
- To promote trade, and thereby full employment and economic growth;
- To promote exchange stability and avoid competitive devaluations;
- To promote current account convertibility, and;
- To lend under adequate safeguards to enable member countries to adjust to balance of payments problems "without resorting to measures destructive of national or international prosperity".

The wording of this article has remained the same since our foundation. In pursuing the objectives the article lays out, the Fund has had to adapt to big changes in the international financial system, not least the demise of the fixed exchange rate system in 1973 and – more recently – the explosive growth of international capital flows.

The way the Fund has responded to these changes has been shaped by its governance structure, which is blessed with 3 virtues: legitimacy, accountability and efficiency.

- Since its foundation, the Fund's legitimacy – its ability to speak with authority as a voice of the international community - has increased along with its membership. Liberation from colonial role and the collapse of central planning in Eastern Europe and the former Soviet Union have helped increase the Fund's membership from 29 at the outset to a near-universal 183 today. Its legitimacy has been further enhanced by the cooperative working relations maintained by its executive board. The vast majority of the decisions the board takes are reached by consensus, without the need for formal votes.

- The board also ensures that the Fund is directly accountable to its member countries. This is an important and effective discipline on the Fund bureaucracy, one that has clearly been strengthened by the growing transparency of our actions and decisions to the general public. **[CT does not like suggestion staff are out of control – I think it still merits saying]**

- The Fund is efficient in part because the board has remained relatively small and can act quickly. As a financial institution, weighted voting ensures that the countries which contribute most resources to the Fund have the greatest say in when and how they are used. Some observers complain that weighted voting gives the US a veto over some important decisions. So it does. But the Europeans and developing countries as groups have vetoes too. **[CT says this is disingenuous and unconvincing, so perhaps we could add, pace the debate on charges: "Developing countries are using their muscle increasingly effectively in the board, reminding the Group of Seven that their word is not law."]** In practice, any important decision in the Fund needs the support of the international community as a whole. And this is as it should be.

3. Promoting Sound Policies: Surveillance and Technical Assistance

One of the most important ways the IMF promotes good economic citizenship is through what we call surveillance. The phrase conjures up an unfortunate image of hidden cameras and concealed microphones. But, as you know, it simply refers to our regular scrutiny of economic policies and developments – at national, regional and system-wide level. The growth of international capital flows has made surveillance more important now than ever, because it has increased the impact of policies and developments in one country on the welfare and policy options of others.

At a national level, surveillance is undertaken through our regular Article IV consultations. For many countries they are virtually the only professional appraisal of their economies and policies. In other countries – like India - other bodies produce high-quality assessments. But the IMF still provides added value because of its unique cross-country perspective and an objectivity that may not be available from private financial institutions and other organizations with political or other axes to grind..

Surveillance has become much powerful as a spur to good policies in recent years, because of the revolution that has taken place in the Fund in favor of greater transparency. The vast majority of member countries now publish the conclusions of the Article IV discussions in our board. The Public Information Notice for India's last Article IV discussion was published in June 2000. A growing number of countries also publish the detailed staff reports on which the Article IV discussions are based and the preliminary conclusions prepared by IMF staff teams at the end of their talks with the authorities.

Publication of these various documents contributes to the domestic policy debate, as well as providing information to actual and potential investors. If investors have access to impartial and well-informed analysis of a country's economic situation, they are less likely to succumb to herd behavior and withdraw capital just because they see others doing so and are nervous of being left out of the crowd..

Surveillance helps countries put their economic situation and policy options in an international perspective. This has been made easier by the recent proliferation of international standards and codes of conduct, monitored either by the Fund or other relevant bodies. These now cover a wide variety of policy areas, including statistical dissemination, monetary and fiscal transparency, banking supervision, accounting and corporate governance. Information on compliance with these various standards – which are voluntary - is being pulled together in what we call ROSCs, or Reports on the Observance of Standards and Codes. They should provide valuable information to country authorities, their peers, and to investors and lenders. India has already had ROSCs covering fiscal transparency and corporate governance.

But the growing importance attached to these standards and codes by the international community has not been entirely uncontroversial. Some countries – India among them – have concerns about the way that standards might be developed and assessed. They stress the importance of ownership and of ensuring that all countries have a role in shaping the standards against which they are judged. They are also keen to ensure that assessments of compliance take into account the stage of development of the country being assessed. These are all legitimate concerns. But like it or not, international

standards are becoming an increasingly important element of the international financial architecture. And – voluntary or not – countries seeking full intergration in the world economy cannot afford to run away from them. India has introduced a useful element of self-assessment in judging its performance against international standards, but it must be clear that this is not sufficient in itself.

In the wake of the recent emerging market crises, we have tried to focus our surveillance efforts more effectively on those factors that could leave our members vulnerable to sudden and disruptive capital outflows. These include macroeconomic policies, the exchange rate regime, the health of the financial sector, and debt and reserve management. All are important, but let me focus on a couple in greater detail.

First, the health of financial sector. Weak financial sectors constrain economic growth, increase the cost of crises, and render countries more vulnerable to spillovers from crises elsewhere. In 1999 the IMF and World Bank launched the Financial Sector Assessment Program to strengthen surveillance, promote soundness and increase diversity in financial sectors. I believe this is one of the most important innovations to emerge from the recent efforts to reform the international financial architecture. FSAPs involve a voluntary healthcheck of a member's financial system, carried out by officials from the Bank and Fund, plus experts from national central banks and supervisory agencies. This affords a valuable element of peer review.

The assessments identifies the strengths, risks and vulnerabilities in a country's financial system, helping the authorities develop appropriate policy responses. Some 36 countries will have had assessments by the end of the fiscal year. In the longer term we hope to carry out around 30 assessments a year. Evidence so far suggests that many countries – industrial and developing alike – have found them useful **[CT questions this]**. Identifying strengths and weaknesses in financial systems is also of value to the private sector and to the international community as a whole.

Second, let me turn to another increasingly important focus of surveillance: the choice of an exchange rate regime. Let me begin with a simple observation: each of the big capital-market related crises of the last six years – Mexico in 1994; Thailand, Indonesia and Korea in 1997; Russia and Brazil in 1998; Argentina and Turkey last year – has in some way involved a fixed or pegged exchange. Countries with other regimes also suffered during the crises, but to nothing like the same extent.

Little wonder, then, that policymakers have increasingly warned against the use of pegged rates in countries open to international capital flows. More precisely, intermediate regimes between hard pegs – by which I mean currency boards, dollarization or membership of a currency union – and floating rates do not seem

sustainable. Willingly or otherwise, this advice has been taken by a growing number of emerging market countries during the 1990s. (For these purposes, I regard as emerging markets the 33 countries that appear in either JP Morgan's EMBI+ index or the emerging markets index complied by Morgan Stanley Capital Management.)

The distribution of exchange rate regimes changed significantly between 1991 and the end of 1999. In 1991 almost 65 percent of emerging market countries had intermediate pegged exchange rate regimes, by which I mean conventional fixed pegs, crawling pegs, horizontal bands and crawling bands. Five percent had hard pegs and 30 percent floated. By the end of the decade, the numbers were very different. The proportion with intermediate regimes had dropped to 40 per cent, while the number with hard pegs and floats had risen to 10 and 50 per cent respectively. There had been a "hollowing out" of the middle and a move to the corners.

Some observers argue that this was the result of pressure from the IMF and the US Treasury. That simply is not so. Countries have abandoned intermediate regimes because time and again, they have proved vulnerable to speculative attack.

Of the emerging market countries that moved to floating rates, Indonesia, Korea, Thailand, Russia, Brazil and Mexico did so in spectacular fashion after major financial crises. Colombia joined the group in 1999. The move to hard pegs between 1991 and 1999 was less dramatic: only Bulgaria made this transition, moving from a floating rate to a currency board in 1997. But since the end of 1999 two other countries have joined this group: Ecuador, which moved from a float to dollarization; and Greece, which moved from a target band to join the euro. In the next few years, the hollowing out has further to go. Hungary and Poland are hoping to join the euro, Israel is likely to adopt a floating rate, and Turkey is scheduled to do so too. **[CT wonders if we should qualify implication that Korea floats freely]**

In essence, experience has dramatized the lesson of the impossible trinity – that while many countries would understandably like a fixed exchange rate, capital mobility, and a monetary policy dedicated to domestic goals, they can only have two out of three at any one time. But why do countries seem incapable of directing domestic monetary policy credibly towards the sole objective of maintaining the fixed exchange rate?

Despite some exceptions, the answer must be that if politicians have the opportunity to change the exchange rate at a time when the short-run benefits appear to outweigh the costs, they are likely to take it. And financial markets know this.

Defending an overvalued exchange rate peg typically requires monetary and fiscal tightening to reduce the current account deficit and to discourage outflows of capital.

If the disequilibrium is small, and actions to address it are taken promptly, it should be possible to stabilize the situation. But if the disequilibrium is too large, the required action may not be viable – either for political reasons or because of the damage they will inflict on the banking system or economic activity. Under those circumstances an attack on the peg is likely to succeed.

[CT believes that the case against capital flows is stated too weakly. I confess I feel we are overly reliant on the revealed preference argument too, but I am not sure what room for manoeuver we have in toughening this up?]
So why not impose capital controls to protect the exchange rate from the effects of unwanted capital flows? To begin with, I think it is fair to say that almost all countries will in the course of their development ultimately want to liberalize the capital account and integrate into global capital markets. This view is based in part on the fact that the most advanced economies *all* have open capital accounts. It is also based on the view that the potential benefits – including those obtained by allowing foreign competition in the financial sector – significantly outweigh the costs.

We should distinguish between controls on capital outflows and inflows. For controls on outflows to succeed, they need to be quite extensive. And as a country develops, these are likely to become both more distorting and less effective. **[CT: Why?]** In addition, controls on outflows cannot prevent a devaluation if domestic policies are fundamentally inconsistent with maintenance of the exchange rate.

Where outflow controls are in place they should be removed gradually, at a time when the exchange rate is not under pressure, and as the necessary infrastructure – in the form of strong domestic financial institutions and markets, a market-based monetary policy, an effective foreign exchange market, and the information base necessary for markets to operate efficiently – is put in place.

Some countries have tried to impose controls on outflows once a crisis is already under way. This normally fails. Imposition of controls in this situation is also likely to make it more difficult for the country to raise money on the international capital market in the future.

Recently, the IMF has cautiously supported the use of market-based capital inflow controls, like those pioneered by Chile. These can help a country avoid the difficulties posed for domestic policy by capital inflows. The typical instance occurs when a country is trying to reduce inflation using an exchange rate anchor, and for anti-inflationary purposes needs interest rates higher than those implied by the sum of the foreign interest rate and the expected rate of currency depreciation. A tax on capital inflows can in principle help maintain a wedge between the two interest rates.

In addition, by taxing short-term capital inflows more than longer-term inflows, capital inflow controls can also in principle shift the composition of inflows towards the long end, reducing the threat of sudden outflows.

In Chile these prudential controls seem to have been successful for a time in allowing some monetary policy independence, and also in shifting the composition of capital inflows towards the long end. But empirical evidence suggests that they lost their effectiveness after 1998. So much so that Chile has abandoned them.

So how has India dealt with the impossible trinity? The country moved from a basket peg exchange rate regime to a managed float following the 1991 balance of payments crisis. As a result, the authorities were well placed to deal effectively with the financial market turmoil that followed the Asian crisis. The exchange rate was not obviously overvalued at the beginning of the crisis, and the authorities were able to respond flexibly to the financial market turmoil - tightening monetary policy while allowing an 18 per cent depreciation against the dollar.

Despite recent liberalization, India also maintains significant capital controls. These controls helped contain short-term debt and limited the linkages between India's financial system and the rest of the region. But they come at a cost, as the authorities themselves have acknowledged: net private capital inflows and foreign direct investment in India are relatively low by the standards of other developing countries.

In order for India to fulfill its potential and maximize growth, its access to foreign capital must be increased. But as the authorities have acknowledged – and as the 1997 Tarapore Report concluded - the necessary macroeconomic and structural pre-conditions need to be in place if liberalization is to be successful.

4. Promoting Good Policies: Technical Assistance

A second mechanism through which the Fund helps promote good policies is technical assistance to governments and central banks. The objective is to help countries develop and maintain an effective policy-making capacity. The advanced industrial countries take this type of infrastructure for granted, but its absence is a critical hindrance to good policy-making in many of our member countries.

During the last fiscal year the Fund devoted no less than 290 person years to technical assistance, both at our headquarters and in the field. Our technical assistance focuses on the traditional core areas of IMF expertise: fiscal, monetary and financial policymaking, plus the provision of the good statistics on which all these rely. India

has made use of the Fund's technical assistance in areas like public expenditure management and the development of public debt markets.

In recent years there has been a gradual regional shift in our technical assistance efforts, away from the transition economies of Eastern Europe and the Former Soviet Union, and towards our poorer member countries. About 60 per cent of our technical assistance takes place in countries that borrow from us, 40 per cent in countries that do not. Increasingly our efforts are focusing on countries emerging from conflict, where the need to build a policymaking infrastructure is often most acute.

5. Promoting Good Policies: Lending

IMF surveillance and technical assistance make a valuable contribution to the well-being of the world economy. They are greatly appreciated by our members, but rarely get much recognition from outside observers. Reading the newspapers, you would never guess that the IMF devotes more than twice as many staff resources to these two functions, taken together, than it does to the operation of its lending programs.

But, inevitably, the latter are more newsworthy. So let me turn now to the Fund's lending role and to some of the challenges we are addressing to ensure that this function plays its full role in promoting good policies.

As you are all aware, the Fund attaches conditions to the loans it makes to its members. These constitute the "adequate safeguards" required by our Articles of Agreement. They ensure that the loan will be used to support reform, and that it will be repaid and available to other members who may need it in the future.

Experience clearly shows that the success of an economic program depends crucially on the commitment shown by the authorities - and by society more generally - to the reforms required. Of course, in the process of negotiating the loan, the Fund will usually ask the authorities to do more than they initially want.

In practice, the government's commitment can be difficult to gauge, especially if it is divided and if the program is being used by those who favor reform as a vehicle to implement changes that some of their colleagues oppose. Although an IMF-supported program is often seen in the press as the international community's way of imposing changes on a country's economy, it is more often the international community's way to support a government or a group within the government that wants to bring about desirable economic reform conducive to strong and sustainable growth. **[CT thinks**

this a dangerous admission of political interference, but you have said it more than once. It is also an interesting issue to raise for sophisticated audience.]

Fund programs are typically – but not always – unpopular. We are generally called upon only when weaknesses have already developed into a crisis, because the government has been unwilling or unable to take the necessary corrective action earlier. If the medicine to cure the disease had been pleasant, the country would likely have taken it long ago. Instead it is usually unpleasant, and more so because of the delay, requiring the country to take tough measures with short-term political costs that do not yield positive results for some time. Traditionally, authorities have used the Fund as a scapegoat to take the blame for what has to be done.

On occasion we still play this role. But the lesson of experience in recent years has been that a program is much more likely to succeed if the authorities consult with civil society and establish a national consensus about what needs to be done. It also helps if the borrowing country joins the growing number that choose to publish the Letter of Intent giving details of the program – another example of the transparency revolution that the Fund has gone through in recent years. When people are told clearly and honestly what is being done – and why - they are more likely to support measures that are difficult in the short-run, but which promise long-term gains.

The role of conditionality in Fund fund lending has always been a source of controversy and our Board is currently reviewing it again. One concern is that the scope and detail of policy conditions has increased substantially during the 1990s.

This has largely reflected greater emphasis on structural and institutional dimensions of economic management, which have rightly been seen increasingly as important determinants of long-term growth prospects – especially in the poorest countries and those making the transition from central planning. Another reason lies in our collaboration with the World Bank : the Fund has frequently seen a need to apply conditions outside its areas of expertise – notably public enterprise restructuring and privatization - because they are important to the program's macroeconomic objectives and the Bank does not have the clout to impose them as conditions of its own.

But demanding too many and too detailed conditions can be counterproductive. There is evidence that it reduces the commitment of the authorities to the underlying strategy of reform and therefore makes the successful implementation of the program less likely. So our board is looking at how conditionality could be streamlined and better focused.

The guiding principle determining the scope of Fund conditionality is that it should only cover what is critical to the macroeconomic objectives of the program. So we need to pose the following question more rigorously: if the conditions in question were not fulfilled, would the achievement of the program's macroeconomic objectives – including the restoration of sustainable growth – clearly be jeopardized? If the answer is no, then although the reforms in question might be desirable – and even macroeconomically significant – they should not necessarily be imposed as conditions.

This has a number of implications for the way the Fund does business. One question it raises is the role of the Letter of Intent – should this be a parsimonious description of the conditions that determine whether the Fund hands the money over? Or should it be a signalling device in which the authorities lay out a comprehensive reform program and the international community signals support for it? Our board will discuss these questions in coming weeks and we look forward to the International Monetary and Financial Committee tackling them as well in April.

Under our Articles, every one of the Fund's members is entitled to financial assistance when they need it and when they meet the necessary conditions. But different countries run into different problems, and the Fund tailors its lending to their needs.

Let me deal in a little more detail with four categories of Fund lending in turn:

- conventional lending to countries with current account problems,
- crisis lending to countries facing big capital outflows,
- precautionary lending in support of crisis prevention measures, and;
- concessional lending to poor countries to support growth and poverty reduction.

Conventional lending to countries with current account problems

In recent years attention has naturally focused on the Fund's role in high profile capital account crises. But traditional Fund programs – designed to help countries that find themselves unable to earn enough foreign currency to pay for essential imports – remain an important part of our work. The justification for such lending is the same as it was in 1944. Without temporary financial assistance to support economic reform, a country in trouble may feel that it has to impose trade barriers, to engage in beggar-thy-neighbour devaluation, or to engineer a draconian contraction of economic activity. This may provide a short-term solution, but in the longer-term it is bad for the country, bad for its trading partners, and bad for the international community.

Financial assistance supports reform. It does not substitute for it. Sometimes the country finds that an IMF-supported program can provide the framework for a coherent attack on long-standing problems that had hitherto looked intractable. It has a signalling function too – the Fund's involvement instills confidence in both domestic residents and foreign investors that that framework will be implemented.

Various arguments have been put forward that such lending is inappropriate:

First, why can the Fund not give its seal of approval to an economic program, without handing over any money? Staff-monitored programs are sometimes used to establish a policy track record before a loan is negotiated. But governments and markets alike appear to place greater value on financial agreements, possibly because it is seen as a greater commitment by the official sector. The money also helps cushion the pain of adjustment, which falls disproportionately on the poorest and most vulnerable.

Second, there is the fear that lending creates a culture of dependency among borrowers. But repeated borrowing from the Fund is less of a problem than critics have suggested, with only four members having borrowed on standard terms for more than five of the last 15 years and still having large amounts outstanding. More problematic are situations in which borrowing countries still owe money to the Fund some time after their balance of payments problems have been resolved. Our board addressed this problem last year, shortening the period within which countries are expected to repay loans. The board also agreed to charge a higher interest rate when countries borrow large sums relative to what they contribute to the Fund's coffers.

Third, there is the suggestion that IMF programs simply do not work. Attempts to judge the success of IMF lending have long been hampered by the problem of the counterfactual - our inability to know how a program country (which by definition is already in serious economic difficulty) would have performed had it not come to the Fund. But the consensus view now seems to be that in a typical program, economic activity will be depressed to begin with as macroeconomic policies are tightened, but that growth revives subsequently as structural reforms take root. Meanwhile, the balance of payments improves, removing the need for further Fund assistance.

Crisis lending to countries facing big capital outflows

Now let me turn to the Fund's lending in capital account crises. In recent years, the huge expansion of international capital flows – loans and investments across national borders – has been one of the most spectacular manifestations of globalization. These

flows have big economic benefits. But as capital flows have increased relative to the size of national economies, so has the disruption threatened by their sudden reversal.

The need to maintain investor confidence can be a valuable discipline. But in recent years flows have become much more volatile than changes in the economic prospects of individual countries can reasonably explain. Economies have therefore become vulnerable to crises of investor confidence, akin to bank runs. In a conventional IMF loan, the country needs money to help meet the shortfall between its imports and exports. But in a capital account crisis, a country may need much more financial assistance than the Fund could provide under a conventional loan.

Our board responded to this need in 1997 by creating the Supplemental Reserve Facility, for countries that face exceptional financing needs arising from a sudden loss of market confidence. The SRF moved the Fund in the direction of Walter Bagehot's classic prescription for a lender of last resort: providing large amounts relatively short term at penalty interest rates. There is no formal limit on the size of an SRF loan, they are supposed to be repaid within 12-18 months, and they carry a surcharge of 300-500 basis points over a conventional Fund loan. The Bagehot rules also demand that loans be made on the basis of good collateral. For the Fund, conditionality plays that role.

In acting as a crisis lender and crisis manager, the Fund fulfils critical lender of last resort functions. But unlike a domestic central bank that operates as a lender of last resort in its own currency, the resources the Fund has available to lend are strictly limited. For this reason, and to reduce moral hazard on the part of investors who might otherwise be tempted to lend recklessly in the expectation of being bailed out, it is necessary in some cases for private sector creditors to contribute to crisis resolution.

The question of when and how best to involve the private sector in crisis resolution has been one of the most difficult issues in the reform of the international financial system – and our response is still evolving. The approach has varied from case to case, depending among other things on the characteristics of the creditors and the nature of the debt. Restructuring bank debt is relative easy, because the creditors are typically small in number. Private sector involvement in this case has varied from a light touch in Brazil to a more heavy-handed approach in Korea. Rescheduling bond debt is typically more difficult as creditors are relatively numerous, anonymous and difficult to coordinate. But experience with restructurings in Ukraine, Pakistan and Ecuador have been less painful than many imagined. In particular disuptive litigation has by and large been avoided, although Peru's recent expensive settlement with vulture company Elliott Associates may encourage dissident creditors elsewhere.

Private sector institutions now accept the principle of their involvement in crisis resolution, but many are frustrated by the lack of clear rules of the game. The challenge for the Fund is to make the framework for private sector involvement as transparent as possible, without sacrificing essential flexibility. The basic principle is as follows. In cases where agreement on an economic adjustment program and IMF financial support would not in itself be sufficient to restore a country's access to private finance, a country would have to approach its creditors to seek a breathing space until corrective policy measures had chance to take hold. In extreme cases, where creditors are unwilling to give this support voluntarily, they may be required to exercise restraint to return the country to a sustainable profile of debt repayments.

Precautionary lending in support of crisis prevention measures

Throughout its history , the IMF has concentrated its lending on countries that are already in trouble. But as the international community witnessed the rapid and sometimes indiscriminate way in which various emerging market countries succumbed to crises over the last few years, it became clear that this had to change. Hence the creation of our Contingent Credit Line facility in 1999.

The idea was a straightforward one: to offer a precautionary line of credit to countries that have demonstrably sound policies, but which nonetheless believe they may be vulnerable to spillover effects from crises elsewhere. In effect, the CCL allows them to augment at relatively low cost the stock of foreign exchange reserves that they have available to draw upon in a crisis. There is obviously a risk of moral hazard here. Countries have an incentive – in theory at least – to run weaker policies if they have an extra financial cushion in place. To counter this problem, the CCL is aimed explicitly at countries with first-class policies, who face a loss of access to private capital because of events elsewhere rather than domestic policy weaknesses. There are stringent eligibility criteria in place to ensure that this is the case.

In the first year of the CCL's existence, several countries discussed applying for one but none did. One welcome reason is that the global economic environment was relatively unthreatening. But there were also structural weaknesses with the facility that we had to address. One was the pricing of CCL loans, which was originally the same as for the SRF even though the qualifying countries have far better policies. So the cost of CCL loans has been reduced. A second weakness was that countries with a CCL in place had to jump extra policy hurdles to get the money, hardly suggesting a vote of confidence on the part of the official sector. It has now been agreed that countries will be given "the strong benefit of the doubt" as to their policy intentions, giving a greater degree of automaticity to the activation of the facility.

As of now, still no country has yet applied for a CCL. The problem is partly nervousness about how an application would be interpreted by the financial markets: as a source of weakness or as a source of strength? But I believe that the facility is attractive enough to overcome that nervousness before long, especially if more than one country signals its readiness to make the leap at the same time. **[Can we say more on this?]** In years to come, I believe that the CCL will be seen as an important part of our lending armoury.

Some observers would like IMF loans to be available *only* to countries that have prequalified with good policies. This is unrealistic. The international community could not be indifferent to the fate of countries that did not meet the prequalification requirements, or to the instability that might be generated when they got into trouble and were denied help. In practice, the large industrial countries would probably find another, less transparent, way to help. There is also an ethical question too. IMF loans are not designed simply to help governments – which often change anyway during the course of an economic crisis. They are also designed to help cushion the impact of bad luck or bad policies on individuals and families.

Concessional lending to the poorest countries

Finally, let me turn to the IMF's lending in the poorest countries. The IMF lends to these countries on concessional terms, originally under the Enhanced Structural Adjustment Facility (ESAF), and now under the Poverty Reduction and Growth Facility (PRGF). The PRGF was introduced in conjunction with the enhanced debt relief initiative from which 22 highly indebted poor countries are now benefiting.

The objective of our lending in these countries is to help build a platform for strong economic growth and to reduce high levels of poverty, objectives that are each desirable in their own right but also mutually reinforcing. To that end, PRGF programs provide a framework to ensure macroeconomic stability and medium-term viability. Such a framework is needed for at least two reasons:

First, macroeconomic stability is necessary for sustained growth and the efficient use of resources. This is all the more essential in very poor countries where the very few resources available need to be used efficiently.

Second, since the international community will be providing large amounts of assistance to these countries - in debt relief or other aid - the creditor countries need assurance that the resources they provide will be used in a stable macroeconomic

environment. The IMF can help provide these assurances. The IMF has to certify that a country's macroeconomic policies are satisfactory before debt relief is granted or new concessional lending provided. Otherwise the country might not make a lasting exit from its debt problems into sustained growth and poverty reduction.

This, of course, is easier said than done. But it is in everbody's interest that debt relief and the new approach to lending int the poorest countriers is seen to deliver results. Were it not to do so, there is a risk of undermining support for the already inadequate level of development assistance provided by the industrial countries. If that happened, some middle income countries, as well as the poorest, would suffer..

6. Conclusion

I hope I have demonstrated today that the IMF continues to play a valuable role in the modern world economy, promoting good policies and helping countries live up to the ideals of good economic citizenship. The IMF has undergone far-reaching reform in recent years – increasing its transparency, strengthening its surveillance, refocusing its technical assistance, and rationalising and modernizing its lending facilities. But we have done so in a way true to the ideals of our founders and according to the wishes of the international community.

But, as I have described, we still face many challenges. Let me close by mentioning one more.The international community needs to ensure that all member countries have an appopriate voice in the decisionmaking of the Fund and other international institutions.

By increasing the spillover effects from policies in one country to the welfare of others, globalization is rightly seen as strengthening the need for effective surveillance and adherence to international standards of good economic behaviour. Inevitably, the burden falls most heavily on those countries in the process of becoming fully-fledged players in the world economy. It is essential to the legitimacy of global economic governance that these countries have an adequate voice in determining the rules that affect them.

Fortunately, as I mentioned earlier, the IMF's governance structure is a democratic and accountable one, and developing countries are playing an increasingly assertive role. But we need to do more. Our members are already looking again at how the voting shares of IMF members are determined, helped by the conclusions of a panel of outside experts that included Montek Ahluwalia.

But this is not the only determinant of a country's voice in the system. We need to look at the distribution of seats on our board, almost a third of which are currently held by Europeans. [?] And we also need to ensure that executive directors have adequate resources to represent their constituents effectively. It is hardly sensible for a director representing one country to have same resources as a director representing more than 20.

[Closing reference to hosts]