FIRST DRAFT

**Policy Challenges for the New Millenium:**
**The Role of the IMF**

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## Introduction

Mr Chairman. Ladies and Gentlemen.

It is a great pleasure to join you here this evening - and to take part in this, the third Brookings Trade Forum. It is a testament to the quality of this event that each time a new one is held, the world economy seems to be in better shape. Three data points may not be quite enough to establish an unambiguous trend. But, to be on the safe side, let me just say that I hope you continue to meet for many years to come.

At the time of last year's forum, the collapse of Brazil's exchange rate peg was still fresh in our minds. Financial contagion had been limited, but it was too soon to be confident that things would stay that way. In the IMF's April 1999 *World Economic Outlook*, we predicted sluggish world growth of 2.3 per cent last year, rising to 3.4 per cent in 2000. World trade was expected to grow less than 4 per cent in 1999 and by less than 6 per cent this year. Other forecasters held similarly cautious views.

A year later things have turned out much better than we or anybody else had hoped. According to our latest *World Economic Outlook* - published a fortnight ago - the world economy grew by 3.3 per cent during 1999 and is on course to exceed 4 per cent growth this year. World trade has also been much more buoyant than predicted.

Growth has been stronger than expected in most emerging market countries, with a recovery in the Asian crisis countries that has been nothing short of spectacular.

With the clouds lifting from the global economy over the last 12 months, the international community faces an understandable temptation to relax in its efforts to reform the global financial system. But this is a temptation to which we cannot afford to succumb. Many lessons have already been learned and applied from the financial crises of the last five years. But much still remains to be done - and we cannot afford to sit back and wait for the next crisis before pressing on with the reform agenda.

The protests which accompanied our spring meetings last week – and the WTO meeting last November – provide an additional impetus. They are a stark reminder that the virtues of an open world economy are not recognised by everyone.

Let me begin by saying a little more about the lessons that we have taken from the recent demonstrations and the challenge we face amid concerns about globalization. I will then turn to a number of areas in which is the Fund is engaged in ongoing reform to meet this challenge: including the prevention and resolution of financial crises, and measures to ensure that the poorest see the benefits of economic integration.

**The Message from the Streets**

Last week's demonstrations were an important event for the Fund and Bank not simply because of the logistical difficulties they posed, but also because of the messages they sent. I am glad to say that with the help of our dedicated staff, the DC police and other law enforcement agencies, the weekend was successful and largely peaceful: the meetings took place as planned and the protesters had their say.

In drawing lessons, it is important to remember that the protesters were by no means a homogeneous group. Some of them were focused primarily on calls for greater debt relief for the poorest countries. For them we could report that the HIPC initiative is well under way and delivering results. Some, of course, would like us to be more generous still. That is a matter for our shareholders. But before going any further, we must remember that even the current scheme is not yet fully paid for.

Most of the demonstrators were protesting against globalization, just as they were in Seattle. Here again, motivations differed. Some sincerely believe that globalization inevitably hurts the poor and leads to environmental degradation and the exploitation of defenceless workers. Others were driven more by a sense of self-interest: the fear of competition for their jobs from less well-paid workers overseas.

In reality, globalization has brought enormous benefits to billions of people around the world. History has shown time and again that integration into the world economy is the best way for a country to prosper. Erecting barriers against the rest of the world is a sure way to condemn a nation – particularly a small developing nation – to poverty and economic underperformance. Export-oriented policies helped transform East Asia from one of the world's poorest regions 40 years ago into one of the most prosperous and dynamic today. In contrast, inward-looking policies in Africa and Latin America during the 1970s and 1980s contributed to mediocre growth and a lost opportunity to lift millions of people out of poverty. The communist economies also underperformed not least because they were relatively closed to the outside world.

Globalization is good for industrial countries too. Development elsewhere is a spur to efficiency at home, which in turn boosts productivity, incomes and living standards. Meanwhile, international trade offers consumers a wider range of better quality goods at lower prices. And the free flow of capital provides savers with a wider range of investment opportunities, offering more attractive combinations of risk and return.

The overall impact on rich and poor together is clearly positive. Between 1913 and 1950 – when globalization was in retreat – world GDP per head rose by less than 1 per cent a year on average. But when globalization resumed after 1950 it rose more than twice as quickly. This was no coincidence. Openness delivers the goods.

Some argue that the benefits of globalization are distributed unfairly. They note that over the last century per capita incomes have risen three-fold in the poorest quarter of the world, but six-fold in the richest. In fact, when other elements of living standards are taken into account – health and life expectancy, for example – inequality appears to have narrowed. Indeed it is worth remembering that while in cash terms poor countries have lower real incomes now than today's rich countries did in 1870, they are much better off when broader measures of living standards are taken into account.

Having said this, we cannot afford to ignore the anxieties of those who feel threatened or affronted by aspects of globalization. One lesson of the protests is that we need to sell the virtues of globalization better. This cannot be left entirely to the international institutions. Our member governments have to play their part too. It is a testament to the wisdom and courage of policymakers in the Asian crisis countries that they did not enflame or succumb to protectionist pressures when times got hard. We must hope that policymakers elsewhere show similar foresight and fortitude in the future.

But there is more to the task than better public relations. The primary objective of the international institutions – including the IMF – must be to ensure that everyone has

the chance to benefit from globalization. This means minimizing the risks that globalization creates and the costs it imposes on vulnerable groups. If we want countries to stay open – to everybody's benefit - then we must do what we can to make the international financial and economic system more stable and efficient.

That is what the spring meetings were all about.

**Progress in Reform: Surveillance**

One of the most important contributions that the IMF can make is to reduce the risk of financial crises in a world of large and volatile capital flows. To this end, we have already sharpened our surveillance of economic policies, focusing more on sources of vulnerability. These include the choice of exchange rate regime, debt structures, capital account developments and financial sector soundness – on which we have made considerable progress through joint assessments with the World Bank.

[Identifying vulnerabilities is easier said than done, as the papers you have been discussing today make clear.

On exchange rate regimes, as Jeffrey Frankel and his co-authors from the World Bank point out, countries are increasingly moving away from intermediate adjustable peg regimes to the extremes of free floating or very firm fixes. They suggest that policymakers find it difficult to establish credibility for intermediate regimes - especially those involving complicated combinations of baskets, crawls and bands – because sceptical investors cannot be sure what policy is actually being followed.

But Guillermo Calvo and Carmen Reinhart rightly point out that abandoning an intermediate peg and opting for a free float has costs as well as benefits. Emerging market countries will be reluctant to see their exchange rates appreciate too much, fearing loss of competitiveness. And they will be reluctant to see them depreciate too much, fearing inflation and a rise in the burden of foreign-denominated debt. As a result, a supposedly free float may ossify and become a peg again in all but name.

At the other end of the spectrum, dollarization or the adoption of a currency board have potential drawbacks too. One argument is that the move from an intermediate peg regime to a firm fix sacrifices any remaining scope for independent monetary policy. Frankel et al argue that in practice the scope for independent monetary policy offered by an intermediate regime is often illusory because of the credibility problem. But even if this is so, there are other potential drawbacks too: for example, the ability

to use central bank credit to finance a lender-of-last-resort for the banking system is severely curtailed. And with dollarization, there is the loss of seignorage too.

With any exchange rate regime, there are costs and benefits. Different countries will prefer different regimes at different times. The Fund's job is to clarify those costs and benefits, offer our advice, and then to encourage countries to adopt whatever other policies are necessary to ensure that the chosen regime has the best chance of success.

The capital account regime is another important source of potential vulnerability – and one on which Fund surveillance now places much greater emphasis. It is worth emphasising that the argument in favour of free capital movements is much the same as that for free trade in goods and services. Some great minds argue that capital flows are somehow different. But similar arguments were being put forward for restricting trade in goods **xx** years ago – and they failed to stand the test of time.

In the meantime, Graciela Kaminsky and Sergio Schmukler make a valuable practical point: prudential controls on capital inflows may have a useful role for a time, but eventually the insulation they offer domestic financial markets seems to wear off. In that context, it is interesting to see that a number countries that have been regarded as poster children for capital controls have begun to remove them. Capital account liberalisation is a desirable objective, but it must be achieved in an orderly fashion.]

At the spring meetings, the International Monetary and Financial Committee endorsed the improvements we have already made to the surveillance process and urged us to go further. Among other things, they have encouraged us:

- To further develop indicators of financial vulnerability;
- To complete guidelines for sovereign debt management with the World Bank;
- And to integrate into the surveillance process assessments of the extent to which countries meet international standards and codes in different policy areas. More than 30 countries are already involved in a pilot program to develop Reports on the Observance of Standards and Codes (ROSCs).

## Progress in Reform: Review of Facilities and Safeguards on Lending

In addition to surveillance, the Fund contributes to crisis prevention by offering precautionary credit lines to countries with good policies, but which nonetheless fear a contagion effect from crises that might erupt elsewhere. So far no country has yet taken advantage of this Contingent Credit Line facility. The IMFC has urged us to examine ways to make the scheme more effective, so that countries have a greater financial incentive to take their own crisis prevention measures.

This re-examination will take place as part of a comprehensive review of the IMF's lending facilities. This has already seen the scrapping of four lending windows that have outlived their usefulness, plus the simplification of another. The review will focus on the maturity and pricing of IMF loans, bearing in mind the need to help countries with both short- and long-term balance of payments problems - without encouraging countries to borrow from us over and over again.

In addition to examining the structure of the IMF's loan facilities, we have taken steps to guard against the misuse of the resources we pay out. This will be done by carrying out "safeguards assessments" of the central banks in the countries to which we lend - checking for example that they are independently audited to international standards.

We are also looking at ways to deter countries from misreporting indicators to secure loans to which they are not properly entitled. Misuse and misreporting are both rare events, but they undermine both the trust on which the institution is based and the credibility it enjoys in the outside world. Both must be protected.

**Progress in Reform: Crisis Resolution**

Crisis prevention is the first line of defence, but it can never be impenetrable. So a second strand in the reform of the international financial architecture has been to improve the management and resolution of crises when they do break out.

In many cases it will remain possible to restore a troubled country's access to the international capital markets through the IMF's traditional catalytic role: a combination of short-term official financial support and a policy package to tackle the underlying problems. But there is now much greater acceptance among market participants that more concerted involvement of private sector creditors may be necessary if a country faces a large financing requirement, has little hope of a quick return to the capital market or if its debt burden is unsustainable.

We will have to take a flexible approach from case to case. But in this context the IMFC has urged us to be more more clear about the terms and conditions on which we are prepared to lend to countries in trouble, [including what we require them to secure from their private creditors]. The committee has also urged us to set out publicly the approach that is being taken to private sector involvement in each individual case.

**Progress in Reform: Helping the Poorest**

Better surveillance, reform of our lending facilities and improvements in crisis resolution should all help to limit the risks that globalization implies in a world of volatile capital flows. But we also need to ensure that the benefits of globalization reach those millions of people who are in effect shut out of the global economy.

We can do this – working closely with our colleagues in the World Bank – by supporting good policies in the poorest countries. Operating through our new Poverty Reduction and Growth Facility, the Fund will remain focussed on its core areas of expertise: macroeconomic and exchnage rate policies, plus structural issues like tax policies, fiscal management, budget execution, fiscal transparency and tax and customs administration. But through close cooperation with the Bank, our efforts should be attuned more clearly to the ultimate objective of poverty reduction.

The debt relief available through the HIPC initiative can make a valuable contribution too, removing disincentives to investment and freeing budget resources for spending on poverty reduction measures. But one clear lesson from recent experience is that the country itself must drive the development and poverty reduction agenda. This will be done through Poverty Reduction Strategy Papers, drawn up by the country authorities in partnership with civil society, the Fund, the Bank and other donors.

If the benefits of globalization are to be spread more widely, then industrial countries will have to play their part. Debt relief is not enough on its own. The Fund will also do whatever it can to persuade industrial countries to open their markets to the exports of poorer nations. In your discussions on the world trade system tomorrow, I hope that this will be an important theme.

**Conclusion**

As you can see, the reform agenda on which the IMF and the other international financial institutions are embarked is an ambitious and wide-ranging one. Much has been done, but much remains to be done. As an institution, we are determined to maintain the momentum of reform – for us and our member countries.

Transparency and accountability will play an important role in ensuring that this happens. The transparency of our members' policies and the advice we give them has increased enormously over the last few years. People can see much more clearly what we are doing and how well we are doing it. In addition we are subjecting ourselves to the scrutiny of an Independent Evaluation Office, which will further increase our accountability to our member countries and to their citizens.

All this is essential if we are to meet the key policy challenge that we face in the new millenium: to promote an open world economy which can deliver rising living standards to all its citizens. We are determined to play our part.