Tarisa Watanagase: The global economy, policy challenges, and the role of the IMF

Statement by Mrs Tarisa Watanagase, Governor of the Bank of Thailand, at the Seventeenth Meeting of the International Monetary and Financial Committee (IMFC), Washington DC, 12 April 2008.

Mrs Watanagase is representing the constituency of Brunei Darussalam, Cambodia, Fiji, Indonesia, Lao P.D.R., Malaysia, Myanmar, Nepal, Singapore, Thailand, Tonga, and Vietnam.

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1. We are meeting at a time of unprecedented challenges and risks. The financial turbulence that started last summer has gathered steam and spread across markets and economies. Global growth prospects for this year have indeed deteriorated markedly since the last IMFC meeting in October, owing to tightening credit conditions and continued deleveraging. The US growth outlook has been revised down sharply and growth in the other advanced economies is also much weaker. So far emerging markets have remained relatively resilient, but going forward, this will depend on the severity and length of the US slowdown. Much will also depend on the depth of the shock to the financial system, the breadth of spillovers across countries and markets, and the effectiveness of policy responses.

2. We note that while growth forecasts have been marked down significantly, there is no sense yet that a global recession is the most likely scenario. Nevertheless, we concur with the message of the Fund that risks are clearly tilted to the downside, and agree that it will be prudent for policymakers to prepare for more adverse outcomes, though we hope such outcomes will not come to pass. It is telling that emerging markets, which have already been responsible for the greatest part of the world's economic growth, will play even more significant role in cushioning this downturn. We note that even at the slower growth rates projected, emerging markets are still expected to expand at a healthy 6.7 percent this year, and will sustain that pace in 2009. Developing Asia can be expected to see even more robust growth, in excess of 8 percent, led by China's near double-digit rate of expansion. It is heartening to note that self-sustaining domestic demand is expected to be a greater feature of the expansion of individual Asian economies, along with greater intra-regional trade.

3. We welcome the ongoing correction of global imbalances we have experienced thus far. While recognizing that there is still a risk of disorderly unwinding of these balances, we are cautiously optimistic that responsible actions by all parties will prevent such an event. In our region, we have significant adjustments in domestic demand, underpinned by improved economic fundamentals. As a result, the surplus countries in our region continue to experience a gradual but significant decline in their current account balances, partly due to the acceleration in the rate of exchange rate appreciation in the region. Importantly, some members of our constituency have been able to utilize the fiscal space arising from past reforms, which is a contributing factor behind the stronger demand in these countries. Nonetheless, the concurrent challenge is to keep inflationary pressures under control while ensuring that strong domestic demand does not lead to a build-up of imbalances.

4. Notwithstanding the baseline scenario, it is clear to us that the Fund is correct in identifying the financial turmoil as the single greatest risk to growth. In the US, given the loss of confidence, the immediate priority for the authorities was to limit the financial contagion and counter the downside risks to growth. Following that, the first line of defense was monetary policy and monetary operations to inject liquidity. The second line was fiscal stimulus. We view these actions as steps in the right direction, although one should also recognize the limitations of such policies at a time of impaired balance sheets and ebbing sentiments. The third line of defense was using public money to safeguard the stability of the financial system. In view of the systemic nature of the crisis and the potential for spillovers we appreciate the need for decisive policy actions and the drastic unorthodox measures.

Indeed, our own experience during the Asian crisis was that adherence to a market-centric philosophy in an environment where markets have seized up is simply not tenable. At that time, we advocated a more pragmatic approach that prioritizes the resumption of credit activities in the financial markets. While welcoming the newly-apparent pragmatism shown by national authorities in advanced countries and international bodies like the IMF, we caution that actions must be carefully designed to return the system to stability without unduly giving rise to moral hazard concerns.

5. Admittedly, any attempt to draw lessons now will be tentative as the crisis has yet to run its full course, notwithstanding the recent collapse of one of the biggest investment banks, which many have taken as a nadir in this crisis. Our own view is that until a full extent of exposure to these markets is tallied up, an early conclusion to this episode is probably not imminent. From an Asian perspective, there's a sense of déjà vu when we look at this crisis. While the form of various crises may change, the underlying root causes are similar: imprudent lending and borrowing by poorly or unregulated agents, inability of existing regulation to catch up with financial innovation, over-extended balance sheets, easy monetary conditions, and asset price bubbles. In addition, there are obvious questions as to the over-reliance on inadequate statistical models and the central role played by credit rating agencies in assigning high credit ratings on papers built on less credit-worthy assets that will need to be answered.

6. From our perspective, a number of important lessons ought to be drawn from the turmoil. First, macroeconomic policies need to be adjusted pragmatically and where appropriate, swiftly. We do not simply mean that policy must be loosened but rather authorities ought to consider carefully their full range of options, giving due regard to the circumstances they find themselves in. For instance, in an environment where credit markets have ceased to function, monetary policy alone cannot do the heavy lifting needed to stabilize economic conditions. Second, swift action to clean up the balance sheets of financial institutions is very important to allow the financial system to resume its key intermediation role. Third, reforms, be they structural, legal, regulatory or accounting, should be an important part of the medium-term agenda, as they would serve affected countries well going forward. Not only should regulators be alert and vigilant in systemically important markets, they also need to keep up with the rapid pace of innovation. Finally, there needs to be a multilateral effort to improve transparency, standards and the quality of regulation. We welcome the work being undertaken by all parties in the Financial Stability Forum, of which the Fund is a key member, and expect the results will prove illuminating.

7. In drawing these conclusions, we must remember that we cannot entirely exempt ourselves from the booms and busts in credit markets, but instead recognize that sound regulations and prudent capital market practices can play a role in alleviating these cycles. However, putting too much emphasis on regulations can also become a double-edged sword and hinder innovation and further development, should the pendulum swing the other way. To this end, it is rather pragmatic and sound policies that remain alert to developments in financial and asset markets, and strong macroeconomic fundamentals that are our best buffers.

8. It is trying times like these that remind us of how interconnected we are and how important it is for the IMF to continue to play its role effectively as the guardian of global economic and financial stability. In our view, the Fund's role is determined by its mandate. The Fund cannot do what it was not built to do. For example, it is neither a regulator nor a central bank. As we see it, the Fund's role is in analyzing and evaluating policies and its impact, facilitating dialogue and disseminating, both the warning signs and the lessons learnt, providing guidance and lessons learnt, forcefully where necessary. To this end, we see three areas where the Fund can be useful:

- The first is in providing policy guidance to individual members. Within its surveillance mandate, the Fund should be advising members what to do and how best to respond to the fallout from the crisis.
- The second is in the provision of appropriate financing instruments to ensure that members are able to ride out the turmoil. The recent market jitters are clear reminders of a still-fragile global financial system. Another crisis is inevitable – it is just a matter of time – and the Fund must stand ready to support its members when that happen. In this regard, the review of access limits and the development of crisis prevention instrument, such as the Rapid Access Line (RAL) and the Financial Stability Line (FSL), are critical and should be given priority.
- The third is in facilitating a global dialogue such as the IMFC meetings. It is probably wishful thinking to expect a large diverse group such as this to agree on policy coordination strategies. Nevertheless, even the more modest goal of learning from one another has great value by serving to deepen our understanding of the issues, which should not be underestimated.

The Fund's governance reform

9. In an increasingly integrated global economy, the distribution power within the Fund must adapt to reflect the growing weight of developing and emerging market economies in order to make the Fund more effective as an institution. Giving voice and ownership to member countries will increase the legitimacy and efficacy of the IMF. In this regard, we have indeed come a long way from where we started two years ago. We thus would like to thank the IMF Executive Board, management, and the staff for their dedication and hard work in delivering the current quota and voice reform package before us.

10. We welcome the flexibility and compromise shown by the members of the Executive Board in agreeing to the package we have at these Spring Meetings. It is indeed a delicate balancing act, having to take into account the differing views and interests of all member countries. We particularly underscore important progress that we made to agree to a more transparent quota formula. With the inclusion of GDP at purchasing power parity in the GDP variable, and the tripling of basic votes, the quota reform could better account for the dynamism of emerging economies, while improving the representation of low-income countries. While no quota reform package is perfect, it is broadly in line with the objectives set out in the Singapore Resolution. Like many others, however, we are disappointed that the headline shift of quota shares from advanced countries to emerging market and low-income countries – which will be the public's point of focus – is a meager 1.1 percentage points.

11. Difficult compromises have been made, and we believe it is now time to bring this important issue to a close. Agreement on the package by the Fund's membership will be critical to restore the Fund's credibility and legitimacy. Within our constituency, many of us will still be highly under-represented after the second round of ad hoc quota increase. However, in the spirit of compromise and flexibility, we are prepared to support this package on the understanding that this is the first of many steps in a reform process which will eventually see all countries close their under-representation. In this connection, we underscore the importance of future realignment of quota shares on a periodic basis, beginning with the Fourteenth General Review of quotas, as is currently proposed in the package. We maintain that PPP GDP and compression factor should remain in the formula for it to credibly capture the dynamic contribution and relative economic size of countries in the world economy. We also support the future work program, in particular further refinements to the definitions of openness and variability to guide future realignment of quota shares.

12. The New Income Model is also a critical element of the Reform Package, without which the Fund cannot discharge its functions properly. We are pleased to note the broad

consensus on the core elements of the proposed new income model for the Fund and are prepared to give our support to the emerging package. We would simply underline the importance of establishing the necessary governance arrangements that allow the Board and the Management to deal effectively with the risks that broadening the Fund's investment mandate will undoubtedly bring. We are also pleased to support the limited sale of Fund gold to establish an endowment to generate income. In fact, we see this as a critical component of the new income model, without which it may be difficult for the Fund to close its budget deficit. We look forward to a prompt resolution on this issue, particularly from the major shareholder.

Strategic directions

13. As we said in our IMFC statement last October, reform must go beyond quota and voice. The Fund should rethink the areas where it has a comparative advantage and where it does not. We are glad to note that the Managing Director has taken up the suggestion and made this the focus of the refocusing. Thus, we support the shift in focus in the three broad areas: strengthen analysis on macro-financial linkages, integrating multilateral perspectives in bilateral surveillance, and sharpening the work in financial markets.

14. We welcome the use of these same yardsticks in guiding the ambitious expenditure savings that the Managing Director has proposed. When the IMFC asked for significant expenditure reductions last October, we are aware that some of these reductions have been painful, particularly those arising from the difficult decision to reduce staffing levels at the Fund. It is critical that in managing this process, the Fund does not lose the capacity to deal with emerging issues effectively and with the high level of professionalism that we have come to expect. In that regard, we consider the diversity of the Fund's staff an important asset that ought to be preserved in the restructuring process. As an international organization, we believe that the face of the Fund ought to reflect that of its membership. More importantly, diversity in terms of expertise, experience, linguistic abilities and cultural backgrounds, helps the Fund leverage on a wider base of knowledge, understand country circumstances and navigate the subtleties of dealing with a diverse membership more effectively.

15. We see the Managing Director's statement as a good basis for the Fund to move forward and appreciate the urgency with which he has sought to implement the strategy. In particular, we welcome the budgetary savings projected under the medium-term budget and the envisaged implementation of reforms in the other organizational aspects. We would only urge more careful consideration to be given before agreeing to the proposal to charge for technical assistance. Technical assistance is a key public good of the Fund and is critical to improving surveillance and the capacity to design and implement macroeconomic policy in many developing and low-income countries. As such, we should ensure that countries who need technical assistance will continue to receive it, regardless of their ability to pay.

16. We also welcome the Fund's proposed program of work on sovereign wealth funds (SWFs). These funds play a positive role in the global financial market by adding both depth and breadth to them, allowing for the efficient distribution of funds, and lowering the cost of capital in recipient countries. The established SWFs are professionally-run, long-term investors, with little leverage. Their ability to accommodate short-term volatility has contributed to liquidity and stability during periods of market stress, as illustrated in the recent crisis. For countries that operate SWFs, they are a useful tool in managing intergenerational savings in a manner that preserves macroeconomic and external stability. They help build a buffer against future liabilities arising from population aging or other concerns. In other words, their use has been driven by purely economic and commercial motives.

17. The growing concerns over SWFs and various proposals to restrict either the mode of their investments or areas in which they might invest are signs of a worrying trend of rising investment protectionism, and pose a risk to international financial stability. We are

sympathetic to concerns in recipient countries and acknowledge that these worries, if left unaddressed, would only increase protectionist sentiments. In our last meeting, the IMFC called on the IMF to play a role in identifying best practices for SWFs. We share the view that as a multilateral platform, the Fund could play a useful role in this area, by allowing issues to be discussed in an open and neutral manner. We welcome the inclusive, collaborative, and voluntary approach taken by the Fund. The principles should focus on governance, institutional arrangement, and transparency and be co-written by the SWFs and for the SWFs, hence would help increase ownership of the best practices, which is critical to its successful adoption. We also welcome the parallel work undertaken by the OECD in drawing up a similar set of guidelines for recipient countries to forestall the risk of protectionism. It is highly important that in drafting such guidelines, the standards for SWFs should not be more onerous than for other large institutional investors.

Conclusion

18. In a challenging global economic and financial environment, the IMF has crucial role to play to safeguard global financial stability and growth. The Fund's value lies in its truly global perspective which should be leveraged on to produce much needed analysis and guidance for its members. As recent events have shown, no country big or small, advanced or developing is immune to bouts of financial instability and its spillovers. It is the deepening inter-dependence that calls for a global response and analysis at the regional and multilateral level. We believe that the Fund has the expertise and talent to do this job well.

19. However, it can do so effectively only with the full cooperation of the membership. The current quota and voice reform is an important step towards this end. But this is not enough. Further reforms are needed to strengthen its role as a global institution that facilitates global monetary and financial cooperation. This can only be achieved by refocusing the Fund's role in line with its mandates and comparative advantage.