International Monetary and Financial Committee

Twelfth Meeting
September 24, 2005

Statement by Honorable Palaniappan Chidambaram
Minister of Finance, India
On behalf of Bangladesh, Bhutan, India, Sri Lanka

Statement by Honorable Finance Minister
Mr.P.Chidambaram
Leader of the Indian Delegation to the
International Monetary and Financial Committee
Washington D.C., September 24, 2005

Representing the Constituency consisting of Bangladesh, Bhutan, India and Sri Lanka

Mr. Chairman,

1. At the outset, on behalf of my constituency, let me convey our deepest sympathies to the American people for the severity of death and destruction caused by hurricane Katrina. In our own modest way, we have offered some assistance as an expression of our sympathy and solidarity and we would be happy to offer any other assistance that we can provide to the affected people.

The Global Economy and Financial Markets—Outlook, Risks and Policy Responses

2. We broadly agree with the assessment of the global economy in the latest World Economic Outlook (WEO). It is encouraging to note that global economic activity continues to remain robust, though the 'soft patch' emerging from high oil prices, slackening growth of international trade, and weakening of growth indicators in the US needs careful monitoring. The Japanese rebound – both economic and political - is a heartening development, as is the momentum imparted to global growth by developing Asia, primarily China and India.

3. The medium-term prospects, however, continue to be clouded by geo-political uncertainties as well as some clear sources of potential setbacks. Developments of the 7th July further underscore the vulnerability of global economic prospects with regard to unanticipated security disorders. In addition, the stubborn global current account imbalances, continued escalation in energy prices, further compounded by the impact of recent hurricane Katrina on production facilities, and the possible reversal of the unusually benign conditions in global financial markets in the event of firmer inflationary expectations, continue to present major downside risks. These risks are exacerbated by what the WEO describes as 'richly-valued' housing market in some of the developed countries. The outlook becomes grave if one takes into account the increasing protectionist tendencies in advanced economies which threaten to thwart progress on trade liberalization. The WEO projects world trade volume growth to decelerate to 6.6 per cent in 2005 from 10.3 per cent in 2004. While the nature of risks remains somewhat ambiguous in terms of their manifestations in the short or medium-term, abrupt resolution of current account imbalances seems to have receded to the background. Indeed, optimism regarding orderly resolution of these imbalances has strengthened on account of welcome developments like a moderation in the US fiscal deficit and introduction of greater exchange rate flexibility by China and Malaysia.

4. The benign global economic and financial market conditions are increasingly marred by the heightening of oil price risk in the backdrop of persistent global imbalances. In this light, the downside risk due to upward and persistent pressure on oil prices appears to be underestimated. A combination of several adverse forces is at work: lack of investment for a long period, increasing demand caused essentially by global recovery, the supply side pressures exacerbated by both geopolitical and natural factors, and above all inefficient and non-transparent oil market structure as well as behavior and increasing activity of market speculators. Inflation risks on the other hand are underestimated because, the first order effects are not fully reflected due to lack of pass through and the second order effects are not fully captured yet. Unlike many industrial economies where services sector dominate the growth, in oil importing emerging market and developing countries, the oil price pressures are not completely embedded into both current and expected levels of inflation. The welfare implications of oil prices in developing countries impacting large segments of population needs to be recognized. The rise in oil prices has resulted in a redistribution of current account imbalances amongst countries and possibly augmented global savings, relative to investments. How such redistribution affects world currency markets need to be observed.

5. While both oil producing and exporting and oil consuming and importing countries seem to realize the gravity of the situation, in our view, much more needs to be done to realize orderly conditions in oil market and ease unwarranted pressures in oil prices. Greater dissemination and transparency of oil market data and improvements in market structure and behavior and continued thrust by the international community for active cooperation and alleviating balance of payments difficulties through compensating mechanism, including special oil facilities are some of the areas in which the IMF needs to take a pro-active role.

6. Achieving a broadly homogenous, balanced and reasonably well-distributed matrix of global growth pattern will continue to remain a challenge in the foreseeable future. The task has become all the more arduous given the changing demographic profiles across regions, the skewed pattern of absorption and utilization of information technology services by different nations and the complex political economy of sustaining reforms, particularly in labor and financial markets, even in advanced economies. However, the demonstrated resilience of emerging market economies in overcoming exogenous disturbances and accelerating macroeconomic consolidation is encouraging for the effort to accomplish a more stable pattern of global growth.

7. The dynamics of global currency markets are expected to change significantly following the currency reforms undertaken by China and Malaysia. The importance of the initiatives lies not in the size of corrections but in the positive signals embodied in such shifts in exchange rate regimes. While Fund surveillance mechanisms can now revisit the changing patterns of exchange rate regimes and the various stages of capital account liberalization, emerging market economies have room for maneuver in determining and operating their exchange rate regimes and capital accounts in tune with country-specific circumstances.

8. Robust capital inflows are essential for complementing domestic savings in the emerging economies The WEO-projected decline in private capital flows to emerging markets from US$237.9 billion in 2004 to US$170.5 billion in 2005 and further to US$121.0 billion in 2006 is disconcerting. The investment needs for sustaining high growth rates in emerging markets are very large. Changing demographic profiles will have differential impact on the savings propensities of developing and developed economies in the medium term. Nevertheless, it is difficult to believe that there is a 'savings glut' relative to the enormous investment needs in developing countries. There is a glut only relative to the net dissavings in developed countries. There is a need for encouraging private capital flows into developing countries and sparing them the burden of macroeconomic imbalances of developed countries. Policy corrections are needed to reverse the WEO-projected decline in capital flows. Major advanced economies continue to have fiscal deficits of around 4 per cent of GDP. Fiscal consolidation in advanced countries will improve capital flows into and investment in developing economies.

9. In recent times, the debate over institutional reforms for changing incentive structures in national economies has intensified. The important question is, who will change the institutional framework? Solutions have the best chance of success when they are largely home-grown. The Breton-Woods institutions have been advocating the need for 'country ownership of programs for quite a few years. In an increasingly globalizing world, while outside help for promoting development and nurturing progress will undoubtedly play an increasing role, such help will have to be fine-tuned to avoid destroying the home-grown nature of reforms, including institutional reforms. Further, the Fund's focus, given its core competence, should preferably be limited to strengthening of economic institutions that are capable of promoting domestic growth and facilitating global integration.

10. Inflation targeting has discovered renewed research interests, particularly in emerging markets, in the larger context of assigning price stability as the fundamental goal of monetary policy. Effective application of inflation targeting instruments in developing countries, once again, is contingent upon substantive institutional reforms. Two issues of great relevance in this context are: the timeliness of the data, and what to do about 'one-off' supply-shocks. Timeliness of inflation data is critical for inflation targeting, as without such data, a contractionary policy in response to a step-up in past inflation may actually take effect when the inflationary pressure has subsided. Similarly, a pure inflation-targeting approach, without adequate attention to supply-shock induced inflationary bouts may involve a large sacrifice in terms of output losses.

11. The Global Financial Stability Report (GFSR) has matured over time as an effective surveillance instrument for global financial markets. This surveillance tool attempts to bridge the gap between regulatory systems and standard setters and the fast advancing markets, where investors are constantly searching for higher yields. We hope that the observations revealed by the GFSR will help in reducing possible market abuses and economic offences. In this regard, while it is possible that benign financial market conditions are maintained in the short term, the impact of the interplay of oil market speculative pressures, large global imbalances in currency markets and richly valued asset prices needs to be closely watched.

12. On the whole, we are happy to note the progress in enhancing financial stability, particularly in pension reforms and the size of institutional investors. The growing body of evidence about the stabilizing effect of large institutional participation on market volatility is encouraging. However, at the same time, lending standards across mature markets have eased over the past few years. Apart from reflecting deteriorating credit quality, this can also add to inflationary pressures. We firmly believe that enhanced transparency and disclosures in financial markets, relating in particular to measures on sound corporate governance and accounting standards, can further ensure financial stability.

IMF Objectives and Medium-Term Strategy

13. I congratulate the Managing Director Mr. Rodrigo de Rato for taking a significant step forward in shaping the strategic direction of the Fund and dovetailing it with the medium-term budgetary framework and an action plan. Given the rapid, far-reaching and multi-dimensional changes experienced by the world economy during the last decade, this strategic review is both timely and topical. We particularly welcome the attempt to address the challenges being faced by the Fund's diverse membership in responding to globalization, and in identifying priorities, country-specific strategies and policy advice in this regard. We wholeheartedly endorse the significant role carved out for low-income countries and intensification of poverty reduction efforts in partnership with the Bank and other multilateral institutions. I take this opportunity to emphasize a few specific issues:

- The action plan has turned out to be somewhat less ambitious than envisaged. However, there are several intricacies involving the Fund's core objectives and functionalities, its image, ownership and accountability. None of these aspects are mutually exclusive and should appropriately figure on the agenda, as we move along. We are satisfied to note that the issue of voice and quota figure prominently in the action plan.

- We are in broad agreement with reprioritization of activities by allowing flexibility in redirecting resources to strengthen the Fund's role in its areas of core competence. It also needs to be recognized that a higher functional priority need not necessarily imply larger budgetary outlays.

- Budget planning exercises usually involve a large gamut of trade-offs. However, Fund's surveillance activity should never figure in the contemplated trade-off. Both advanced as well as emerging market economies have to be active in their respective roles for crisis prevention, crisis resolution and financing and insurance. Stronger surveillance will call for symmetric treatment of regionally and systemically important economies while risks could shift among markets, regions and countries, from time to time.

- While, in principle, the Fund's communication strategy, including signaling, should emanate from its role of a confidential advisor to members, we are somewhat concerned at the attempts to marginalize this role to competing claims from 'markets'. The outreach strategy contemplated to promote public debate through the media should be carefully balanced so as not to have adverse impact on member nations.

- A larger agenda for crisis prevention still remains unaddressed. The Fund should seriously, and more pragmatically, consider the second round of discussions on precautionary facilities to members possessing consistent track records in pushing through sound policies. We do not feel that the resource commitment in this regard will be unduly large, since such commitments, in most cases, will be contingent and catalytic, and essentially in the nature of confidence building. The benefits yielded by such a strategy, however, can be enormous as far as realizing the goals of encouraging sound policies and attaining enduring global financial stability are concerned.

- With regard to market-based initiatives for debt restructuring and crisis resolution, we reaffirm our view that the Fund should act primarily as a facilitator. Any contrary inclination on the part of the Fund will not only come in conflict with its preferred creditor status, but may also invite unwarranted legal disputes.

- We welcome further studies aiming to enhance improved understanding of issues surrounding capital account liberalization and the dynamics of capital account management. The present stance of Fund policy in promoting and supporting the gradual and orderly liberalization of the capital account should continue.

Strengthening IMF Support for Low-Income Countries—Instruments; Financing; and Debt Relief

14. We welcome the recent initiatives taken by the Fund to support low income countries (LICs) with regard to operationalization of the G-8 proposal for cancellation of the outstanding debt stock of HIPC countries. However, granting eligibility only to HIPCs might entail breaching the uniformity of treatment laid down in the Articles of Agreement. Such an eventuality can be avoided by broadening the coverage of the G-8 proposal to include all PRGF-eligible, IDA-only members, including those in Asia, Latin America and Europe. The resource envelope identified by the G-8 can be appropriately distributed across the low-income country membership. Such an enlargement can potentially free domestic resources as part of the efforts to meet MDGs in two members of my own constituency: Bangladesh and Sri Lanka. An expanded coverage will certainly infuse a sense of fairness across the membership.

15. Let me now turn to the financing of the proposal. The cost of debt cancellation should be financed on a sound basis without endangering the capacity of the Fund to assist member

countries with concessional lending, as and when required. The soundness of the General Resources Account should be maintained without burdening the borrowers from the account. The G-8 proposal for financing the debt cancellation through drawing down of the Special Disbursement Account is fraught with risks that include the risk of impairing the viability of the self-sustained PRGF. The Fund might also consider the possibility of modifying the quantum of debt relief for eligible countries in order to honor the principle of equity and uniformity of treatment.

16. In a somewhat disturbing development, the Policy Support Instrument is also being considered as a new instrument along with the Shocks Window within the PRGF Trust for complementing the regular PRGF financing in addressing the varied needs of LICs. We have strong reservations on the proposal for a Policy Support Instrument and the Fund's envisaged role of a rating agency *vis-à-vis* its current role as a confidential advisor to member nations. There are several complexities involved in creating a policy instrument requiring countries to develop policy standards similar to upper credit tranche conditionalities and mandating the Executive Board to undertake periodic, intensive reviews. In our view, stronger policy support should continue to emanate from Article IV consultations, which have traditionally been a part of the Fund's strategy to garner credibility with markets and donors.

17. Given the likelihood of commodity shocks in LICs, we favor the creation of a standby window within the PRGF umbrella. During the last Spring meeting, we had called for an oil facility. I am happy to note Fund's favorable response in this regard.

Developments in the Constituency

18. Let me now turn to some key aspects of development in my constituency. **India's** outlook for 2005-06 continues to be very positive. With buoyant industrial production, strong credit growth, improved business sentiments, increased efficiency gains in the corporate sector, stronger trade performance, and continued robustness in the services sector, we expect to achieve a growth rate of 7.1 percent or more in the current fiscal year. Despite the severe impact of global oil uncertainties, a judicious combination of monetary and fiscal measures has helped in maintaining inflation at moderate levels. Stability has been maintained in the financial and foreign exchange markets. Capital flows have remained robust and the Indian Rupee continues to demonstrate adequate flexibility in response to global currency market developments. As noted by the WEO, India is well poised to become a leading driver of global growth given its favorable demography, expanding domestic market and rising disposable incomes. Despite allocating large funds to social sectors, the fiscal outcome for the central government turned out to be better than expected in 2004-05. Revenue collections have improved and the experience with VAT has been encouraging. In the coming years, we are committed to deeper and stronger fiscal consolidation and reforms, and are confident that growth will accelerate from the current levels.

19. Having dealt successfully with the immediate relief work following the tsunami tragedy, **Sri Lanka** is now engaged in the reconstruction and rehabilitation phase. The strategy continues to aim at accelerating growth, with emphasis on pro-poor strategies.

Growth, expected at around 5 percent in 2005, is likely to broad-based. Efforts of the government and the private sector have minimized the impact of the phasing out of the Multi Fiber Agreement (MFA).

20. **Bangladesh** continued to exhibit strong economic growth. The strong per capita growth performance, aided by the beneficial impact of NGO social programs and broad-based micro-credit programs, have led to significant fall in poverty levels. With the recent lifting of the MFA, there has been a sharp increase in textile and garment exports. The challenges of deepening structural reforms, which still remain, continue to engage the focus of the country authorities.

21. **Bhutan's** economy grew at above 7 percent in the 2004-05. Despite a persistent trade deficit, inflows of aid helped to maintain a current account surplus in the balance of payments. Foreign reserves also grew, and presently cover above 18 months of imports. Fiscal position remains sustainable.

Thank You.