International Monetary and Financial Committee

Seventeenth Meeting
April 12, 2008

Statement by 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 DC, April 12, 2008

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

Mr. Chairman,

The Global Economy and Financial Markets

1. We are meeting in Washington at a time when the global economy is in the midst of a financial crisis. We had drawn attention to the risks in the financial sector earlier, but the intensity of this crisis was unanticipated and is disturbing, particularly since the problems have emanated from one of the most advanced financial markets in the world. Moreover, it has also affected other advanced financial markets, particularly in Europe. The emerging market economies seemed to have been less affected by the initial impact of the turbulence. Since, the crisis is still unfolding, there are considerable uncertainties as to how the situation would evolve. It is therefore important for multilateral institutions including the Fund to continuously and closely assess the situation, and policy makers will need to exercise constant vigilance.

2. The immediate fallout of the financial crisis is reflected in a reversal of the robust trend of global growth during 2008. So far, the spillover to emerging markets and developing countries seems relatively contained mainly because of their limited direct exposure to subprime related securities. Buoyant domestic demand has sustained the growth momentum in many emerging markets and developing countries. Notwithstanding the increase in trade volume within emerging markets, the spillover effects could soon be evident as the US and Europe continue to remain the main destinations for the final products from emerging markets. There exist a number of imponderables at the moment. If apprehensions about the US recession turn out to be correct and the growth in euro area slows more than currently anticipated, domestic demand alone may prove inadequate to sustain growth in the emerging markets.

3. We have already seen increased volatility in equity markets in emerging economies. While debt flows to emerging markets continue,

borrowing costs have gone up. Simultaneously some emerging markets are experiencing a liquidity spillover with substantial injection of liquidity by central banks in advanced economies. This has exerted upward pressure on exchange rates in these countries and has also given rise to excess domestic liquidity that engenders inflationary expectations.

4. Another worrisome development is the emergence of global inflationary pressures. While growth expectations have dampened, inflationary expectations have not. The deflationary impact of globalization seems to have run out with increasing wage and inflationary pressures. There is growing apprehension that financial stability concerns are distracting central banks in advanced economies from emerging inflation risks. Strong inflationary pressures are also evident from the supply side. Rising food prices are an increasing concern not only in developing countries but also in developed economies. This rise has been exacerbated by the increasing diversion of foodgrains and other crops towards bio-fuels. Fuel prices continue to remain high and volatile. The confluence of these developments has implications for long term inflationary expectations. Policy makers and central banks will, therefore, have to carefully balance growth and financial stability considerations with the potential risks to price stability.

5. Amidst the turmoil, attention could easily get diverted from the continuing global imbalances. While the US current account deficit is projected to moderate, current account surpluses are getting concentrated in a few countries, further accentuating global imbalances. Already we have seen sharp movements in exchange rates of major currencies. This has implications for the orderly management of exchange rates by emerging market and developing countries which could have adverse consequences for growth and stability.

6. The current global scenario calls for policy action both by national authorities and international bodies like the Fund. It is important to restore the confidence in US financial markets so as not to let the credit squeeze deteriorate into a credit crunch. This calls for quick recognition of losses, recapitalization of solvent institutions and strengthening of regulation and supervision. We have taken note of the efforts of the US authorities to redress the situation. Other national authorities may also need to review the adequacy of their regulation and supervision of financial markets and institutions, focusing on ways to mitigate possible risks arising out of operations of entities that dominate cross-border

flows and increase the transparency in their operations. The Fund, entrusted with the task of maintaining global financial stability, should work closely with other international bodies to address these challenges.

Quotas and Voice

7. A degree of credibility in the IMF's governance has been undoubtedly restored in the recent exercise in realigning quotas and votes. In Singapore, we identified the need to arrive at a simple, transparent quota formula that adequately captures the changing economic weight of countries in the world today. I believe that the current formula is a definitive step in that direction. While we may still have issues on how "openness" or "variability" should be measured, there is no gainsaying the fact that the current construction is a marked improvement over the previous five formulae which were opaque and complex.

8. The second round ad hoc increase in quotas is also a move in the right direction. While there can be arguments both for and against the adequacy of the rebalancing, it can be nobody's case that the marginal rebalancing achieved is either perverse or in the wrong direction.

9. That said, I need to reiterate that India views the current round of quota and voice reform as only the first step in a process that needs to be carried forward. We would welcome a periodic realignment of quota shares as the global economy gets re-structured over time. We would welcome fellow Governors endorsing a programme of reviews not linked to concerns of liquidity alone, as is the current practice.

New Income Model and Medium-term Budget

10. We welcome the significant forward movement on implementing the New Income Model recommended by the Crockett Committee, particularly the sale of the post-Second Amendment Gold and the creation of an endowment. I expect that this proposal will be endorsed by the national authorities across the membership of the Fund expeditiously and a significant source of steady income would be available without further delay.

11. In implementing the expanded investment authority, the Fund should establish sound policies and transparent procedures and avoid

any perception of a potential conflict of interest. This is important given the Fund's unique position in the financial world as a confidential advisor to member countries with considerable access to privileged information.

12. We welcome the resumption of reimbursement of administrative expenditure related to the Poverty Reduction and Growth Facility (PRGF). We hope that the donor countries will honour their commitment and bear the cost of administration.

13. We are apprehensive that the failure to secure adequate support for the investment of quota resources will adversely affect the sustainability of the model. We would urge member-countries whose support is crucial for implementing this key element to be open to a review of this issue in the next two or three years.

14. The crisis in resources was an opportunity to refocus and reprioritize the activities of the Fund. I expect that the substantial expenditure reductions that have been proposed are in line with the broad strategic direction outlined in the Managing Director's statement on the medium-term budget and the Fund's capacity to deliver on its core mandate and to tackle any future crises is not compromised. The Fund should also now be able to shift its attention away from internal process issues to addressing the issues affecting the global economy.

Surveillance

15. I welcome the emphasis on multilateral perspective in bilateral surveillance and the efforts at improving the analysis of linkages between the real economy and the financial sector. Recent events demonstrate that in globalised financial markets, systemic risk to the financial sector could emanate from advanced financial markets. Hence, I suggest that the Fund gives greater focus to the financial sector in its bilateral surveillance of advanced economies. The Fund should also develop a common understanding of operational issues in implementing the 2007 Surveillance Decision in an even-handed manner.

Crisis Prevention

16. Keeping in view that the current financial turmoil has emanated from advanced markets, I welcome the extension of vulnerability exercise to include advanced economies. The Fund should expedite the

discussions on the design of a new crisis prevention instrument that could be made available to emerging market economies that seek such support.

Role in Low Income Countries

17. The clear recognition that the Fund is not a development agency is overdue. In working with low income countries, the Fund needs to focus on its core competencies and recognize that it does not have a lead role and it has to co-ordinate its efforts with other international agencies that focus on low income countries.

Developments in the Constituency

18. Let me now turn briefly to some key aspects of developments in my constituency. In **India**, GDP growth driven by domestic demand remains robust thus far, though it moderated somewhat to 8.4 percent in the third quarter of 2007-08. While inflationary expectations remain contained, headline inflation rose above the projected tolerance level of 5 percent recently reflecting higher food, fuel and other commodity prices, particularly metals. The overall external trade and current account situation is evolving as per expectations. However, strong capital inflows and their volatility continue to pose significant challenges to macroeconomic management. Financial market conditions are generally stable, though equity markets have exhibited greater volatility mirroring global trends. Revenue collection remains buoyant and fiscal marksmanship has improved. Fiscal targets set in the fiscal responsibility legislation are being met. We remain committed to economic reforms and conduct of macroeconomic policy to enable continuation of the growth momentum with stability.

19. The **Bangladesh** economy performed well during 2006-07 with GDP growth of over 6 percent, moderate inflation and balance of payments surplus. The economy, however, suffered a major setback from natural disasters of flood and cyclone in the later part of 2007. Consequently, the overall adverse effect on GDP is likely to be 0.7 percent in 2007-08 with direct budgetary cost of relief in the order of 0.6 percent of GDP. The most significant adverse impact would be on the balance of payments which were already under pressure from high world oil and food prices as well as a slowdown in garment exports. The authorities appreciate the understanding shown by the international

community and would like to thank the Fund for extending Emergency Assistance of about US$217.7 million. In implementing the relief and recovery program, the authorities remain committed to improving the fiscal position, allowing monetary policy to maintain reasonable price stability, and making progress towards MDG targets.

20. **Sri Lanka's** economy continues to maintain its growth momentum, and real GDP growth is projected at 7.0 percent in 2008. Manifesting the benefits from high economic growth, the unemployment rate in 2007 dropped to a record low of 6.0 per cent. Fiscal deficit and public debt to GDP ratio continue to improve and export growth remains robust. Overall surplus of the balance of payments and foreign reserves improved further. However, inflationary pressures have emanated from high and rising oil and commodity prices. The tight monetary policy measures are expected to bring inflation down to near single digit level by end 2008. A noteworthy development in 2007 was the establishment of the Inter Regulatory Institutions Council with the mandate for monitoring and co-coordinating the work of multiple regulators, specially with regard to supervision of financial conglomerates. Further, Basel II was implemented in January 2008.

21. **Bhutan** has undergone a historic political transformation to a parliamentary democracy with elections having been held for the first time in March 2008. This wisely-managed transition has been completely peaceful and orderly. With the coming on-stream of Tala hydro-electric project, Bhutan's real GDP growth during 2007 peaked at 18 per cent. Growth is now expected to return to the recent trend level. The current account of the balance of payments is in surplus and foreign exchange reserves remain comfortable.

Thank you.