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Statement by Duvvuri Subbarao
Governor, Reserve Bank of India

On behalf of Bangladesh, Bhutan, India and Sri Lanka

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(On behalf of Mr. Pranab Mukherjee, Finance Minister of India and Member IMFC representing the Constituency consisting of Bangladesh, Bhutan, India and Sri Lanka)

Leader of the Indian Delegation to the International Monetary and Financial Committee Washington D.C, April 24, 2010

Mr. Chairman:

1. Confounding our worst fears, the turn around in the global economy has been much faster than we had anticipated as recently as only a few months ago when we met in Istanbul. The global economy has experienced three quarters of positive growth following the sharp declines in the first quarter of 2009 and in the preceding quarter. There is, however, considerable heterogeneity in the pace of the upturn in different countries with emerging and developing countries leading the way.

The Global Economy

2. Although the global outlook is more reassuring than it was a few months ago, uncertainty about the shape and pace of global recovery persists. While macroeconomic risks have decreased, vulnerabilities remain. There is growing concern about the deterioration in the sovereign risk profile and dangers posed to financial stability in some countries. It is often said that every financial crisis is followed by a sovereign debt crisis because of the public sector's support to affected parts of the economy. Will this time be different? Recent developments have shown the merits of a gradualist approach to allowing external financing of fiscal deficits. The crisis and the post-crisis experience should usher in some rethink on how and by how much debt markets be opened up for external financing.

3. Volatile capital flows have been a central issue during the crisis, and continue to be so now as the crisis is ebbing. Emerging Market Economies (EMEs) saw a sudden stop and reversal of capital flows during the crisis as a consequence of global deleveraging. Now the trend has reversed once again, and many EMEs are seeing net inflows - a consequence of a global system awash with liquidity, the assurance of low interest rates in advanced economies over 'an extended period' and the promise of growth in EMEs. Capital flows can also potentially impair financial stability. The familiar question of how EMEs can maximize the benefits and minimize the costs of volatile capital flows has returned to haunt the policy agenda.

4. The recent crisis has clearly been a turning point in the world view on capital controls. The crisis saw, across emerging economies, a rough correlation between the extent of openness of the capital account and the adverse impact of the crisis. Surely, this should not be read as a denouncement of open capital account, but a powerful demonstration of the tenet that premature opening hurts more than it helps. Notably, the IMF published a policy note in

February 2010 that reversed its long held orthodoxy. The note has referred to certain '*circumstances in which capital controls can be a legitimate component of the policy response to surges in capital flows*'. Now that there is wide agreement that controls can be '*desirable and effective'* in managing capital flows, the IMF and other international bodies must pursue research on studying what type of controls and under what circumstances so that emerging economies have useful guidelines to inform policy formulation.

The Mandate of the Fund

5. The Fund has done a remarkable job of managing the crisis response. Drawing on the lessons of the crisis, the Fund needs to adapt to the post-crisis scenario. We welcome the review of the mandate of the Fund which should help it effectively refocus on areas such as macro-financial stability and the spillover impact of policies of systemically important countries. Such a review should lead to significant improvements in the surveillance and lending tool kits of the Fund.

6. The surveillance and lending functions of the Fund are distinct and need to be performed in a manner that best serves the interests of the global economy. A key lesson of the crisis is that systemic risks lie not only in less mature markets but in advanced countries as well. The clear lines of distinction between the surveillance and lending functions have to be maintained to ensure that the Fund's more intense surveillance focuses not only on borrowers and potential borrowers but also on the creditor members.

Surveillance

7. The Fund's surveillance has a preemptive role in focusing on vulnerabilities and detecting the onset of crises in contrast to the Fund's financing function which essentially plays a crisis mitigation role. The lessons of the crisis warrant a careful scrutiny of the manner in which the Fund conducts its surveillance, both multilateral and bilateral.

8. For surveillance to be effective and for it to inspire trust and confidence, it is vital that it is even-handed, candid and unbiased. How do we operationalize this? A mandate that is derived only from an Executive Board decision obtained by a simple majority could be open to differing interpretations subsequently, thereby sacrificing clarity for expediency. In our view, the best way to achieve this objective is by amending the Articles of Agreement to give the Fund oversight over the international monetary and financial system and over financial sector policies within the conduct of domestic policies by members.

9. We believe that the Fund is strategically positioned to conduct effective multilateral surveillance by virtue of its universal membership and the forum for peer review that it provides. Accordingly, we can engage constructively and with an open mind towards building a wider consensus on improving multilateral surveillance through innovative instruments such as spillover reports; multilateral consultations; and enhanced interaction with regional/country groups. For a reality check, there should be trial runs before taking a view on their usefulness.

10. Bilateral surveillance is at the core of the Fund's mandate and the proposals for improving multilateral surveillance should not compromise the pursuit of robust and even-handed bilateral surveillance. There is need for ensuring synergy between IMF's bilateral and

multilateral surveillance. Improvement in timeliness and increased communication is desirable, but care needs to be exercised to eschew undue proliferation of reports whereby the quality of surveillance is compromised by spreading resources thinly and widely.

11. The issue of financial sector oversight is indeed a crucial one. We find merit in assessing the efficacy of new approaches. Mapping global financial networks, deeper engagement with large complex financial intermediaries (LCFIs), asset managers and central counterparties (CCPs); and closer and more effective cooperation with standard setting bodies, including the ongoing engagement with the Financial Stability Board (FSB) on the Early Warning Exercise (EWE) are some initiatives in this genre. The lessons of the crisis also underscore that the focus on important financial centres and systemically important countries should be intensified.

12. There is a rationale for strengthened financial sector surveillance in assessing macro-systemic risks in view of the lessons of the crisis. However, the modalities of operation in this role would need deeper consideration to guard against mission creep and to preserve the distinct roles of the IMF on the one hand and the FSB and the Bank for International Settlements (BIS) on the other. We have concerns about the need and utility of a mandatory Financial Sector Assessment Programme (FSAP) at this stage. It is better to preserve the voluntary nature of FSAP with enhanced efforts to secure the widest participation by making FSAP forward looking and focused. Priority should be given to the first round of FSAP for all systemically important countries before repeating FSAP for countries which have already gone through a similar exercise.

13. A key pre-requisite for effective surveillance is governance reforms that reflect changing global economic realities and ensure equity and balance. Effective implementation will also develop a broader consensus for further reforms.

The Financing Role of the Fund

14. The crisis affected even economies with sound policies and those far from its epicenter, highlighting the need to strengthen the global financial safety net as a matter of priority. The Fund should play a key role in putting together such a safety net. The global financial safety net needs to be "global" and encompass multiple partners - individual countries, central banks, regional arrangements, International Financial Institutions (IFIs) including the IMF and other multilateral institutions. The Fund needs to catalyze such a global arrangement, while being careful not to over-extend itself.

15. While flexible precautionary instruments would help crisis prevention, the crisis has also taught us that reserve accumulation by countries is a very important element of the financial safety net. This is particularly so in countries where reserves have been built up in the context of current account deficits to deal with inherently volatile capital flows. Such countries should be treated as partners in the global safety net, with multilateral mechanisms acting as a complement and not a substitute for reserves accumulated at the national level.

16. The proposed evolutionary reform of the Fund's lending toolkit should receive careful consideration on merits and on the basis of possible utility to a sufficiently large segment of

the Fund's membership. The attempt should be to improve existing and recently created instruments and keep the net addition of new instruments to the minimum. Such an approach would enhance the signaling impact and predictability of the instruments in the eyes of both potential users and financial markets.

17. The implications of the Multi-country Swap Line (MSL), which proposes a unilateral offer of Fund assistance in the interest of systemic stability, have to be considered carefully. The instrument holds the promise of mitigating stigma of borrowing from the Fund and the potential interest in such an instrument amongst the membership should be assessed. Communication issues and the market signals generated by an instrument of this nature could leave the Fund with enormous power over its sovereign members, which would have to be appropriately tempered. It will be advisable to allow more time for debating the merits and demerits of this proposal before taking a final view.

IMF Resources

18. The announcement of a trebling of the Fund's resources in the London Summit in April 2009 had a salutary impact on reducing uncertainty when the crisis was still raging. As a follow up to that announcement, we welcome the expansion of the New Arrangements to Borrow to US $600 billion, and call on all members to ratify the increased level at the earliest. Countries which have not been traditional creditors, including India, have come forward with sizeable contributions to the expanded NAB. This should signal the need for further governance changes in the Fund.

19. We have always affirmed the importance of maintaining the Fund as a quota based organization. This implies that the quota-based resources and borrowed resources should be in an appropriate proportion. We supported the decision to substantially increase the NAB on the understanding that since the need for resources is urgent, and a quota increase is time taking, the NAB would be a temporary bridge to an eventual quota increase. We do not see the need for the Fund's lendable resources to be increased any further at this stage. We support a substantial increase in the quota resources so that the NAB can be rolled back once an increase in quotas is effected. This will ensure that the Fund remains a quota-based organization as it should be.

Governance Reform

20. Governance reform will be central to the legitimacy and effectiveness of the Fund's mandate. We appreciate that the Managing Director has acknowledged this in his statement. If the clarification and refocusing of the mandate of the IMF is to have legitimacy, it should follow and not precede a change in the governance structure, including quota shares reflecting the present and emerging global economic realities measured in the most appropriate manner rather than on the basis of an improved but still flawed formula.

21. The size of the quota increase is closely linked to the crucial governance issue of realignment of quota shares in the Fund. A large quota increase not only affords the opportunity for, but also requires an ambitious realignment of quotas, to meet the expectations of the Emerging Markets and Developing Countries (EMDCs) who form a large section of the membership. Only such a substantial shift of quota shares from advanced countries to EMDCs

so as to better reflect current global economic realities would enhance the legitimacy of the Fund.

22. We reiterate our call for at least a 7 per cent shift in quota shares in favour of EMDCs as a group. The initial staff proposals fall well short of expectations. We are disappointed that the ambition displayed in proposals for expanding the mandate of the Fund and its resources are not matched by the ambition in the proposals for realigning quota shares.

23. The improved, but still flawed quota formula does not adequately reflect global economic realities. The shortcomings of the formula, including the relative weights and definitions of the variables are well known, and in April 2008 the Board of Governors of the Fund decided that the issue requires to be revisited before the formula is used again. The approach so far relies too much on the existing formula, rather than "working from it" and hence cannot be seen as enhancing the legitimacy of the Fund. Ideally, a rework of the formula is called for; with a substantial increase in weight for PPP-GDP in order to better reflect current economic realities.

24. To preserve credibility, the deadline of January, 2011 has to be adhered to. We are open to taking up the formula revision task on a parallel track with a longer time frame. In the meantime, the quota allocation in the present round can be completed on the basis of an alternative mechanism which operates on a uniform and transparent basis without complex and opaque adjustments. This approach should remedy real under-representation and automatically identify dynamic EMDCs.

25. We are committed to protecting the vote share of the poorest countries. This is best done through an allocation of quotas rather than through an increase in basic votes which would require further amendments to the Articles and could delay the whole process.

26. The most crucial area of governance reform is a significant and meaningful quota and voice reform. All other aspects of governance reform should follow and flow from this reform. Enhanced political engagement of Ministers in IMF related issues is certainly welcome. At this juncture, such engagement is best achieved through improvements in the functioning of the IMFC. We value the IMFC as a consensus based body and believe enhancement of the legitimacy of the Fund will enhance the effectiveness of the IMFC as well.

27. Redistributing the chairs in the Executive Board on a more equitable basis amongst the regions of the world is also a priority. An appropriate balance needs to be struck between representativeness and effectiveness. This could involve changes to the size of the Board, including a possible reduction, without affecting the representation of emerging market economies and developing countries. The special majority threshold of 85 per cent brings decisions closer to a consensus and we see no compelling reason to change the existing voting majorities in the Fund.

Developments in the Constituency

28. I now turn to developments in my constituency.

India

29. The Indian economy is recovering rapidly from the growth slowdown caused by the crisis. Current estimates are that real GDP had grown at 7.2 per cent during the just completed fiscal year 2009-10, up from 6.7 per cent during 2008-09. For policy purposes, the Reserve Bank of India (RBI) has placed the baseline projection of real GDP growth for 2010-11 at 8.0 per cent with an upside bias. The monetary and fiscal stimulus measures initiated in the wake of the global financial crisis played an important role, first in mitigating the adverse impact from the crisis contagion and then in ensuring that the economy recovered quickly.

30. The developments on the inflation front, however, are worrisome. Inflation, which was earlier driven entirely by supply side factors, is now getting increasingly generalised. Keeping in view the inflation risk, the Reserve Bank embarked on a calibrated exit from the expansionary monetary policy. The Union Budget of 2010-11 has begun the process of fiscal consolidation by programming a reduction in the revenue deficit to 4.0 per cent of GDP from 5.3 per cent, and in the fiscal deficit to 5.5 per cent from 6.7 per cent during the previous year. Going forward, three major uncertainties cloud the outlook for inflation. First, the prospects of the monsoon in 2010-11 are not yet clear. Second, crude prices continue to be volatile. Third, there is evidence of demand side pressures building up. On balance, keeping in view domestic demand-supply balance and the global trend in commodity prices, the baseline projection for WPI inflation for March 2011 is placed at 5.5 per cent. Against this background, the conduct of monetary policy will continue to condition and contain perception of inflation in the range of 4.0-4.5 per cent. This will be in line with the medium-term objective of 3.0 per cent inflation consistent with India's broader integration into the global economy. In this context, accommodative monetary policies in the advanced economies, coupled with better growth prospects in India, could trigger large capital flows into the country. While the absorptive capacity of the Indian economy has been increasing, excessive flows pose a challenge for exchange rate and monetary management.

Sri Lanka

31. The economy of Sri Lanka demonstrated resilience, growing at 3.5 per cent in 2009 amidst challenging domestic and external conditions. This performance was largely due to the steady recovery in the economy since the second quarter of 2009, building up to a robust growth of 6.2 per cent in the final quarter. Coordinated and timely policy actions of the authorities were instrumental in turning around the domestic economy, enabled by the end to the prolonged conflict. Enhanced investor confidence in the economy was reflected in a sharp reversal in foreign financial flows, resulting in an unprecedented surplus in the balance of payments (BOP) of US $ 2.7 billion. The level of foreign exchange reserves rose by more than 450 per cent to a historic high level of US $ 5.1 billion by end-2009. A notable achievement was the sharp deceleration in inflation to 4.8 per cent by end 2009 from 28.2 per cent in June 2008, a result of stringent monetary policy measures adopted over the last two years and the significant decline in global commodity prices. Inflation, as measured by the year-on-year change in the Colombo Consumers' Price Index (CCPI), eased to an average rate of 3.4 per cent in 2009, the lowest since 1985. Timely policy actions successfully mitigated

the contagion of the global financial crisis and the failure of a few entities connected to certain domestic financial institutions. The strong regulatory and supervisory framework and enhanced risk management systems enabled the financial system to withstand the shocks from the external and domestic fronts and maintain confidence in the financial system. In a challenging environment, financial institutions remained profitable and reasonably well capitalised, although credit risk increased due to tight market conditions. Despite several measures introduced during 2009, there was a significant shortfall in revenue due to the slowdown in economic activities and the contraction in imports. In addition, government expenditure increased due to higher security related spending during the decisive phase of the conflict and continued urgent rehabilitation, resettlement and reconstruction(RRR) activities since the second half of the year, as well as increased salaries and wages, interest payments and expenditure on continuing public investment projects. Accordingly, the budget deficit widened to 9.8 per cent of GDP in 2009 compared to the revised target of 7.0 per cent leading to an increase in the borrowing requirement. The end to the prolonged internal conflict and the restoration of peace provide greater optimism for economic prosperity and a strong basis for long-term sustainable development, supported by appropriate policies.

Bangladesh

32. A broad-based upturn is taking hold in Bangladesh, drawing strength from the multi-speed global recovery and robust domestic demand that has been supported by resilient workers' remittances and the fiscal stimulus. In fact, Bangladesh has been adequately resilient to external shocks, particularly to the adverse impact of the recent world recession. Despite these unfavorable conditions, its external position remains robust with sufficient foreign exchange reserves and positive current account balances. Manufacturing returned to positive growth in the second half of 2009-10 and a rising trend in industrial imports is pointing to industrial activity firming up further. There are also lead indications that the decline in merchandise exports is bottoming out, with swelling order books in respect of textile and apparel exports which constitute more than three-fourths of total exports. The growing geographical diversification of export markets in favour of Japan and China is offsetting sluggish demand in the traditional export markets of North America and Europe. Construction activity is buoyant, especially in urban areas, fuelled by remittances and surging real estate prices. Service sector activity has also gained strength, especially in education, health, retailing and catering, and financial services. Agricultural production lost some momentum in 2009-10 after the strong growth of 4.6 percent in the preceding year. Improved terms of trade for the farm sector, timely availability of inputs and credit should brighten the prospects for agriculture in 2010-11, barring unforeseen weather adversities. Overall, real GDP growth is expected to be in the range of 5.5-6.0 percent in 2009-10 with an upside bias as against 5.9 percent in the previous year, thus extending strong and stable economic growth over nearly one decade. Inflation in terms of consumer prices has been on an easing path, retreating to 5.1 percent in October 2009 from 6.6 percent at the beginning of 2009-10. Reflecting the hardening of international food and non food commodity prices, however, domestic prices have been firming in recent months and may edge up to around 6.5 percent by June 2010. With domestic demand conditions remaining strong and with private sector credit and imports picking up, monetary and liquidity conditions have tightened. The inter-bank call money rate which went below one percent in July 2009 is now above four percent. On the other hand, public sector borrowing from the banking system has declined, freeing up resources for

growing private sector activities. It is expected that the stance of monetary policy will continue to remain accommodative while maintaining price stability. In respect of public finances, contingent fiscal pressures on the government are relatively benign as outstanding guarantees for state owned enterprises are low. However, public finances would be impacted by expenditure cutbacks on account of implementation capacity constraints, notwithstanding higher external and non-bank financing. The estimated budget deficit for 2009-10 is placed at 4.5 percent of GDP as against the projected level of 5.0 percent. Efficient and expeditious implementation of development programme projects can create conditions for crowding in private sector investments and together with monetary policy, can support broad- based, inclusive and environmentally sustainable growth.

Bhutan

33. Bhutan's economic performance has been strong in the recent past anchored in political stability and prudent economic policies. The country is well on its way to achieving it Millennium Development Goals with the 10th Five year Plan (2008-13) outlining a wide-ranging development agenda. The impact of the financial crisis very limited and confined to the tourism sector. Growth is expected to be close to 7 per cent throughout the medium term supported by the Punatsangchhu-I and Mangdechhu hydropower projects. Average inflation was lower in 2009, at about 4 percent but following inflation developments in India, inflation has risen in the first quarter of 2010. Government revenue and expenditure both rose strongly in 2008/09, with revenue rising to 39 percent of GDP from 33 percent, and expenditure to 41 percent from 33 per cent. In the external sector, convertible currency reserves remain high, while rupee reserves have increased sharply in recent months. In the financial sector, credit growth is still strong but slowing somewhat in the private sector. The focus of the financial sector liberalisation policy is on increasing competition and efficiency in the sector and three new private sector banks have been licensed and external commercial borrowing was also permitted for selected private sector entities.

Concluding Observations

34. Concerted and decisive actions by both advanced and emerging and developing countries helped the world to deal with an unprecedented financial and economic crisis. Our response has strengthened international cooperation and instilled confidence that together we can secure the financial stability of the world and achieve sustainable economic growth. Towards this objective, a number of significant and concrete steps have been taken, an important one being the substantial strengthening of the Fund, including refinements in its surveillance, the expansion of resources and the improvement of lending facilities. Looking ahead, the Fund will have a pivotal role in warning about future crises, strengthening the defences of its membership against potential threats to stability, mitigating the hardships brought on by crises if and when they strike, and in general, fostering a global environment conducive to strong and sustainable growth. This will require the Fund to reshape and redefine its role and mandate so as to adapt to the requirements of changing times. A lot has been achieved towards a new-look Fund, but more needs to be done, and in particular, the organisational and governance reforms that are being envisaged to vest it with acceptability, legitimacy and independence.