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INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT
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INTERNATIONAL DEVELOPMENT ASSOCIATION
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Statement by the Hon. **YAGA V. REDDY**,
Alternate Governor of the Fund for **INDIA**,
at the Joint Annual Discussion

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**Alternate Governor of the Fund for India,**
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Mr. Chairman:

1. Since we met last in April 2003, there have been some signs of improvement in the global environment. Recent economic data of some countries as well as some forward looking market indicators, particularly those relating to financial markets indicate that we may be seeing some signs of global economic recovery. While we share the view that this could indicate the beginning of a stronger recovery, we recognize that considerable risks still persist, though the upside risks appear to outweigh the downside risks.

2. The outlook for the United States, Euro area and Japan presents a mixed picture. If current trends are any indication, global recovery in the near-term would be led by the United States. However, the widened and historically high twin deficits, in fiscal and current accounts, of the United States pose the threat of possible disruptive adjustment of the US dollar against other major currencies. We recognize this as a necessary short term trade-off for realizing medium-term gains. We, therefore, urge all the major currency areas to coordinate their policies and to carefully monitor currency market behavior to minimize potential adverse repercussions on financial markets and on sustainability of global economic recovery. The recent depreciation of dollar has, to some extent, minimized the possibility of such disruptive adjustment. Further, continuing robust productivity trends support the strong prospect for recovery in the United States. In this regard, there is considerable merit in the U.S. evolving a medium-term fiscal framework to bring its fiscal position on to a sustainable path.

3. The outlook for the Euro area seems rather flat. As in the US, there is a comparable element of trade-off. While the monetary stimulus provided by the European Central Bank is encouraging, scope exists for using fiscal stimulus in a more countercyclical manner. In our view, the Stability and Growth Pact should be applied in a flexible manner to allow the automatic stabilizers to run their courses in the short-term, even if that results in marginal breaching of ceilings on fiscal deficits, especially in countries where this could trigger recovery.

4. We welcome the reforms undertaken to improve the accounting and auditing standards and corporate governance practices both in the US and the EU. These improvements are partly reflected in the strengthening of corporate bond and equity markets. The primary bond market issues have become more buoyant. Sovereign yields, in general, have declined, combined with a compression of yield spreads. We consider these developments as supportive of increased capital flows into emerging markets and

for the general strengthening of intermediation in international capital markets. Though there was a temporary upward shift in the long-term yields of bonds in the US, potential for significant risks of further increase in bond yields appear remote. First, the policy interest rates have declined to historically low levels and upward hikes in quick succession are therefore unlikely. The housing and mortgage markets as also bond markets cannot withstand such sudden shocks. Second, the probability of inflation undershooting and the consequent adverse implications for deflationary expectations are feared by many.

5. The question also remains as to how long and to what extent the US would lead the global recovery. It is important for the EU and also Japan to intensify structural and financial sector reforms with redoubled vigor. In some countries, labor and product market reforms should receive priority as important components of such reforms. We encourage the Euro area countries to take steps to promote productivity and efficiency gains, given the minimal scope, in the short-run, for achieving higher labor participation rates. The necessity of achieving these gains, and a general increase in demand arises from the impending medium-term fiscal risks associated with demographic trends and the attendant pension reforms. Similarly, we recognize that more vigorous steps may help Japan counteract deflationary expectations an address the fragility of the financial system. In the medium-term Japan also requires further restoration of fiscal stabilization.

6. Growth is expected to remain robust in most emerging market economies and, to some extent, in Africa. These are propelled in no small measure by stronger macroeconomic policies, structural reforms and improvements in the institutional structure. Prospects have also improved due to general improvements in major industrial countries, favorable terms of trade due to non-oil commodity price increases, and improved financial market conditions, especially in the bond markets. It is imperative that greater resources flow into these countries to help sustain growth. The current favorable financial market conditions, no doubt, provide an opportunity for these countries to steer ahead with remaining structural reforms and achieve greater fiscal and external sector sustainability.

7. Among the developing countries, emerging countries in Asia continue to remain a bright spot. They have shown extraordinary resilience in the face of the recent global slowdown and continue to exhibit healthy recovery. While timely and complementary policy actions taken by a number of countries to facilitate the revival of external demand and expand intra-regional trade are promising, medium-term prospects would depend on the recovery in major industrial countries.

8. The scope for exchange rate flexibility, particularly in view of the recent build up of reserves in many countries, has generated a lot of debate over the last few months. This calls for a more dynamic and pragmatic approach in the analysis of recent trends in exchange rates and reserve management practices keeping in view country specific circumstances. The recent strengthening of external position of many developing countries through building up substantial foreign exchange reserves can be viewed from

several perspectives. First, it is in part, a reflection of the lack of confidence in the international financial architecture. International liquidity support through official channels is beset with problems relating to adequacy of volumes, timely availability, reasonableness of costs and above all, limited extent of assurances. Second, it is also a reflection of efforts to contain risks from external shocks. Private capital flows which dominate capital movements tend to be pro-cyclical even when fundamentals are strong. It is therefore necessary for developing countries to build cushions when times are favorable. High reserves provide some self-insurance which is effective in building confidence including among the rating agencies and possibly in dealing with threat of crises. Third, the reserve accumulation could also be seen in the context of the availability of abundant international liquidity following the easing of the monetary policy in industrial countries. The resultant excess liquidity flowed into the emerging markets. In the event of hardening of interest rates in industrialized countries, this liquidity may as quickly dry up; in that situation, emerging market should have sufficient cushion to withstand such reverse flows of capital. Fourth, and most important, the reserve build up could be the result of countries aiming at containing volatility in foreign exchange markets. It should be recognised that the self corrective mechanism in foreign exchange markets seen in developed countries is conspicuously absent presently among many emerging markets.

9. It is also necessary to recognize that developing countries face major challenges in their effort for sustained economic growth which could enable them to make a significant impact on poverty reduction. Recent studies by the World Bank indicate that there would be considerable shortfalls in achieving the Millennium Development Goals (MDGs). These failures would not only be limited to some under-performing low income countries; even countries which have made rapid strides in sustained economic growth over the past decade, would not be able to meet critical goals. The level of development assistance currently available and even the additional commitments made at Monterrey, and subsequently, would not be sufficient to meet the minimum financing needs. Developing countries have huge unmet financing needs relative to MDG targets and even with their best efforts, they would not be able to make up the deficiency. There is a very strong case for substantially stepping up the quantum and improving the quality of development assistance.

10. There are two aspects to this which we would like to stress. One, is the need to make allocation of development assistance to countries equitable. The guiding principles should be the incidence of poverty and the effectiveness of poverty reduction efforts. This is best done in multilateral settings so that allocation based on national or strategic considerations are kept to the minimum. The breadth of their work, especially the analytic services and the richness of their development experience improve the quality of policy dialogue. There is also the need to reduce transaction cost of development assistance through better harmonization of procedures and processes. The Rome initiative needs to be followed up and bilateral donors should look at ways of working with multilateral institutions so that common mechanisms for project preparation, appraisal, procurement, monitoring, reporting, auditing, etc. could be evolved. Another way would

be to cofinance projects and programmes that recipient countries draw up and avoid running parallel stand-alone projects that yield sub-optimal results and strain country capacities.

11. Developing countries have been taking courageous steps in reforming their policy environment, improving their institutions of governance and in general, widening, deepening and making more equitable the delivery of services to the poor. Timely and productive development assistance as well as increased access to markets are required to complement and strengthen these efforts. Developed countries must be prepared to play the role of partners in this process as they agreed to do at Monterrey. All players in the development process—developing countries, developed countries and the multilateral institutions—have to work to bring about greater accountability. The monitoring of policies, actions and outcomes needed to achieve MDGs can be a useful tool to bring about increased effectiveness of the development process. While this would require considerable efforts at improving the capacities in developing countries, particularly in gathering reliable and accurate statistical data, such efforts should be a part of the overall development process and should not be seen as an end in itself. Side by side, we need to develop strong partnerships so that country ownership is assured.

12. Further work is also required in order to enhance the voice and participation of developing and transition countries in the multilateral institutions. While we appreciate that there are no quick fixes, we would stress that on-going dialogue and efforts to evolve solutions that better reflect changed realities is the way forward.

13. Together, we would work towards improving the environment where we see the benefits of economic growth percolating to those who have been hitherto denied and to those who have suffered painful adjustments. There is no single *mantra* that would work everywhere and our policies should recognize this. But, if we are able to develop a real partnership, with each nation allowed to exploit its comparative advantage, and not be held back by artificial barriers and constraints, there is no reason why we will not succeed.