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Statement by Honourable Finance Minister Mr. P. Chidambaram
Leader of the Indian Delegation to the IMFC
On behalf of Bangladesh, Bhutan, India and Sri Lanka

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Mr. Chairman,

The Global Economy

1. We are in broad agreement with the assessment and policy recommendations of the World Economic Outlook and the Global Financial Stability Report. Despite a perceptible slowdown during the later part of 2004, mainly on account of the contractionary impact of escalating energy prices, the outlook for global growth in 2005 remains above the trend level at 4.3 per cent. The robust outlook has been shaped by strong corporate performance, accommodative macroeconomic policies, and favourable financial market conditions, across various regions of the world. The apparently strong outlook, however, conceals the emergence of sharp imbalances and other risks. I shall revisit this issue later in the course of my remarks.

2. The 5 per cent plus growth rate achieved by the world economy last year was enabled with the buoyancy displayed by the US economy. There are indications that, through higher investment and sustained consumer demand, the US economy will maintain its growth during the current year also. In the euro area, however, business sentiments remain fragile, and consumer demand sluggish, mainly on account of faltering exports and weak domestic demand. Recovery appears to have lost momentum in Japan, though a revival of demand is a possibility, given the encouraging trends of business and consumer confidence. Growth rates in Asian Emerging Market Economies (EMEs), aided by various factors including strong domestic demand and liberalisation of textile trade, are likely to remain strong.

3. The current phase of global economic expansion has been aided by benign inflation levels in most of the countries, particularly the industrial ones. There are, however, strong downside risks emanating from hardening oil prices, strengthening of global non-oil commodity prices and difficulties in monetary management being faced by some emerging market economies (EMEs) in coping with the large inflows of foreign exchange reserves. Divergent monetary policy stances reflect varying constraints on monetary policy management across countries. Fiscal deficits and public debt in many industrialised economies have not only continued to be high, but also risen in some cases. Progress in fiscal consolidation during 2004 was scant. What is worrying is that the consolidation prospects for 2005 also do not appear encouraging. Despite well-laid out plans for medium-term fiscal reforms in the US, Euro area and Japan, there are concerns over whether the same can be implemented by overcoming various socio-political and economic constraints.

4. Financial markets across the world have remained accommodative to the recent global expansion with low interest rates and tight spreads. Markets have, however, shown evidence of tightening, and may move adversely in the event of supply-side price shocks or policy changes. As of now, the enabling environment offers significant opportunities for most countries to carry out further structural reforms. I may point out that financial sector stability has been maintained through improved profitability and deeper capital bases of banks, on account of better risk management and lower corporate defaults. Hence, there is need for extra vigilance in averting a sharp rise in interest rates, since this will hurt not only the accelerating growth in the developing world but also risk instability in some developed markets. Since real interest rates are currently negative, we take note that the long period of low interest rates and consequent risk-taking may well have created pockets of exposure highly vulnerable to unexpected interest rate increases. Market intermediaries and regulators need to be vigilant to signs of emerging stresses. While a sharp increase in interest rates has its implications, other downside risks temper the optimism regarding sustained global expansion in the medium term. These include sharp exchange rate volatility, continued weakness in the euro area and Japan, and further rise in commodity and oil prices. The broad strategy to address the imbalances continues to remain the same, but given the persistent risks, these adjustments need to be paced and sequenced in a non-disruptive manner.

5. Current expectations are that oil prices are likely to remain high and volatile in the medium-term, due to growing demand, narrowing excess capacity and overall susceptibility to shocks. The persistence of high oil prices pose a risk to growth in major oil importing economies, like the US, China, and India. As a developing country, I must voice my profound disappointment that the oil producing countries, and other developed countries, show little concern for the burden that high oil prices put on our development efforts.

6. We are also concerned that lack of timely and accurate data on both stocks and flows, combined with market distortions, leads to speculative pressures, price volatility and inaccurate forecasts. For example, the Fund's projections, based on futures prices, often turn out to be conservative. We welcome the initiative of the Fund to examine these issues in depth, and to come out with suggestions to improve oil sector data, generate hedging instruments, develop global standards for regulation and taxation of oil sector, encourage conservation and development of alternate energy sources, and increase energy efficiency. It should, however, be recognised that energy conservation is essentially a medium-term process and is unlikely to provide immediate relief. However, vigorous policy actions may influence expectations and, thus, prices.

7. The debate on the global imbalance and its solution is continuing. The adjustments and market reactions to the global imbalance, in particular the twin deficit in the US, have been orderly so far. But the risk of severe disruption from sharp adjustments in response to these twin problems continues to be substantial. These global imbalances cannot be solved through independent or unilateral action. It is important to give shape to a coordinated approach involving major global players like the US, the Euro area, Japan, and strong emerging market economies from developing Asia, in particular China and India. In the US,

for example, there is a need to curb household and government borrowings and bolster domestic savings. The gradual withdrawal of the fiscal stimulus needed for this purpose, however, needs to be carried out without hurting the global expansion and, at the same time, preventing jerky alignments of the US dollar. The Euro area, which continues to depend largely on external demand, needs to implement more structural reforms, especially in the labour market, for strengthening demand and broad-basing the recovery. Concrete measures aiming to strengthen the financial system, restructure the corporate sector, and reduce fiscal imbalances, are essential for Japan. There is a growing perception that greater flexibility in exchange rate policies followed by emerging market economies in developing Asia is worth considering on pragmatic grounds but as appropriate to each country's circumstances.

8. The importance of workers' remittances as stable external flows in reducing poverty in many developing and low income countries is well recognized. We commend the work that the IMF staff have done in this area. Efforts to improve the convenience and efficiency of the banking systems and policy measures to simultaneously encourage the non-banking financial intermediaries, like money changers and exchange bureaus, to undertake cross-border funds transfers should continue. However, I wish to sound a word of caution in this context. We should be cautious in directly linking workers' remittances with Anti-Money Laundering/Combating Financing of Terrorism (AML/CFT) issues, as the latter has a much broader dimension including the organized financial system.

Shaping the IMF's Strategic Direction

9. The institutional arrangements for decision-making of the Fund still remain heavily weighted in favour of the developed countries. The international community must pay attention to the hard reality that the arrangements evolving in the financial architecture cannot operate successfully without equal partnership between developed and developing countries, or between economies with surplus capital and capital shortages. Furthermore, the existing biases in representation and voting power, which are inconsistent with the increasing contribution of the emerging market economies in global growth, need to be addressed urgently. These imbalances, which are a democratic deficit, should not be allowed to undermine the basic co-operative principles of the world economy. Improving Fund governance and thus reducing the 'democratic deficit' in its functioning need to be approached through structural reforms aimed at redistribution of the voting power amongst member countries.

10. We welcome the Managing Director's initiative of discussing the Fund's Strategic Direction. The paper by the 'Committee on the Fund's Strategic Priorities' headed by Ms. Krueger has provided some ground for taking the necessary further steps. On the broad approach indicated on the Fund's strategy and operations, I would like to flag a few points:

- First, while we appreciate the inherent limitations in arriving at a consensus on long standing and difficult issues, the ongoing discussions should not side-step the long-standing issues only because of the difficulties in building a consensus.

- Second, building “broad economic and political institutions” is an ambiguous pursuit that in any case falls outside the Fund’s core areas of expertise. Any expansion of the Fund’s activities should ensure a sharper and deeper focus on the Fund’s mandated core areas of responsibility as stated in its Articles rather than result in the Fund spreading its resources too thinly or diluting its ‘role clarity’ or effectiveness.
- Third, there needs to be a coherent view on the role of the Fund’s bilateral surveillance in ‘non-program’ countries. While pure signalling may have some usefulness, it could reduce the Fund to a ‘rating’ institution.
- Fourth, the Fund’s financing facilities and mechanisms need a thorough review. The Fund’s stabilizing and confidence building role as part of the international financial architecture is likely to increase rather than diminish with the enlargement of private market flows. In the immediate future, an effective precautionary financing mechanism, with greater automaticity to support countries with sound policies, should be evolved. In the medium-term, the role of the Fund as a lender of the last resort needs to be revisited. The issue of strengthening the Fund’s financial position including its income, even in a crisis-free environment, also needs to be urgently addressed.
- Fifth, Fund’s insistence on the pursuit of sound policies and institutions in low income countries should be grounded on the right premises. The primary focus of Fund support to low-income countries should be based on its core area of expertise, namely helping them establish and maintain macroeconomic and financial stability.
- Sixth, the present stance of Fund policy in promoting and supporting the gradual and orderly liberalization of the capital account may be continued in the near term. It would be premature to bring capital account liberalization as a central focus of the Fund, on par with current account transactions.

Fund’s Finances

11. We agree that the Fund’s current financial structure has served it well. The fundamental area of concern has been the long term viability of the Fund’s income position. Ensuring such viability may not warrant any major change in the Fund’s Articles of Agreement, but necessitates some fine tuning of the existing mechanisms. Over the last decade and a half, the changes in the global growth paradigm have also brought about concomitant changes in the financing pattern and the financial situation of the Fund. New issues have surfaced including the (i) implications of the gradual shift of the Fund’s portfolio from short-term revolving credits to long-term lending to a relatively small group of countries to support structural reforms and resolution of debt crises, (ii) issues relating to the ‘de facto’ separation of Fund members into ‘debtor’ and ‘creditor’ groups, given the easy access to private finance by developed countries, and (iii) the management of the contingent risk associated with the high degree of concentration of Fund’s outstanding resources.

12. The evolving circumstances have also given rise to a few challenges. First, the unusually high credit concentration with the top three debtor members has significantly increased its exposure to developments in a few countries, thereby raising contingent risks.

Second, though it is widely believed that the Fund's income position is secure, the charges co-efficient is high by historical standards, raising concerns about the distribution of the burden of adjustment for the Fund's income target. Third, the Fund's administrative expenses have multiplied significantly during the last decade reflecting, in part, its increased involvement in areas going beyond its basic mandate. There is some room for rationalization in this respect. Fourth, the suggestions relating to formation of an "Investment Account" for rationalizing the Fund's income base is beset with some issues relating to its design.

IMF Support for Low Income Members' Efforts towards Poverty Reduction and Strong Sustainable Growth

13. There is urgent need for transforming the Monterrey consensus into concrete action. We recognise that while inadequacy of finance is an important constraint in improving economic growth in low-income countries, this problem can be mitigated by ensuring their access to private capital. Thus, institutional changes, along with appropriate economic policies, can be the critical components for success. We reiterate that the primary focus of Fund support to low-income countries should be based on its core competencies. While the PRGF remains the principal tool of the Fund's financial assistance to low income countries, further work is needed to address the unresolved issues regarding the role of the Fund in the PRS process and establishing an appropriate link between the PRSP and PRGF lending.

14. It is important to view the larger issue of debt relief in the context of the future lending capacity of the Fund and the sources of financing. Thus, debt restructuring for low income countries in general, and HIPCs in particular, must look beyond outright debt write-offs and explore innovative measures such as debt-equity swap, use of export proceeds to donor countries to retire debt and stepping up investment opportunities in these countries.

Further Debt Relief under HIPC Initiative

15. We support the extension of further debt relief to HIPCs. But, if possible, the same may be extended to low income countries facing problem of inadequate resources for financing MDGs. However, our support to the initiative would be subject to the caveats that (i) extension of debt relief should not proliferate into perpetual 'lend and forgive' cycles raising serious issues of moral hazard and the use of the Fund's scarce resources; (ii) the sharing of the financial burden should be made more broad-based with increasing participation from other creditors like the Paris Club and, more specifically, bilateral creditors and the main non-Paris Club creditors from the developed countries; and (iii) though we recognise that the funding of the HIPC is beset with several challenges, we do not support the usage of the IMF gold stock to finance such an objective. Further debt relief could only be considered with concrete proposals for additional financing that would not impair lending operations. It is widely agreed that financing needs must come upfront as additional pledged resources from major donor countries.

Operational Framework for Debt Sustainability in Low Income Countries

16. We need to recognise that debt sustainability for low-income countries is quite different from that for middle-income countries given their higher vulnerability to shocks, policy deficiencies, weak institutions and most importantly their high dependence on official concessional aid. In this context, the use of stock measures or more fittingly the adoption of the multiple indicator approach may be considered instead of NPV. The issue gains particular significance at this juncture in view of the potential impact of a significant increase in oil prices and of a possible downward drift of the US dollar on the debt portfolio of the HIPCs. Given the inelastic import basket of many low income countries, sustained rise in oil prices could severely strain their balance of payments. Such circumstances warrant that the flow of new financing to low income countries should not only be based on an *ex-ante* approach of measuring their debt sustainability at a point in time, but should be complemented by a more effective and continuous evaluation and monitoring of *ex-post* financing instruments and needs.

Mobilising Aid for the MDGs

17. We agree with the observation in the Global Monitoring Report, 2005 that the MDGs and the Monterrey Consensus have created a powerful ‘global compact’ for development. The Monterrey Consensus has created a framework for mutual accountability between the developing and the developed countries. However, the continuing paucity of Official Development Assistance (ODA) from the developed world has seriously constricted the reform process. Consistent shortfall in the provision of ODA to developing countries points to the need for a re-examination of the role of the Breton Woods Institutions in facilitating the fulfilment of such a commitment.

Developments in the Constituency

18. One of the most unfortunate events since we last met was the Asian Tsunami which affected India and her neighbours. Even-though India was itself affected, it provided relief and rehabilitation assistance to the tune of USD 28 million to the affected countries. It has also contributed USD 2.5 million to the Emergency Assistance for Natural Disasters.

19. Now a brief overview of the economic performance of the countries in our constituency is in order. In India, the Union Budget for 2005-06, like in the previous year, was framed against the backdrop of the National Common Minimum Programme (NCMP), and envisages achieving and maintaining an annual growth rate between 7-8 per cent, promoting investment, generating employment, accelerating fiscal consolidation and ensuring higher fiscal devolution. Greater emphasis is laid on agriculture, manufacturing and infrastructure. The Budget aims to directly address the issue of poverty by focusing on the linkage between agricultural and infrastructure development and employment generation. India, which has emerged as one of the fastest growing countries in recent times, is estimated

to have achieved an output growth of 6.9 per cent in 2004-05, following the robust growth of 8.5 per cent witnessed during 2003-04. The growth momentum was maintained last year despite uneven monsoons, rising global oil prices and the loss of precious lives and resources on account of the Tsunami. The momentum appears to be continuing.

20. Maintaining price stability is an important policy priority in India. Both monetary and fiscal policies have given considerable attention to price stability and inflation expectations, as part of a growth-oriented strategy. Through prompt and proactive fiscal and monetary actions, inflationary expectations that emerged in the early parts of 2004-05 were reined in. The net outcome of our policies has been higher-than-expected growth and lower-than-expected inflation. We look forward to a year of growth and moderate inflation in 2005-06.

21. The Reserve Bank of India continued its policy of active demand management of liquidity through open market operations including Liquidity Adjustment Facility (LAF), Market Stabilization Scheme (MSS) and Cash Reserve Ratio (CRR), and using the policy instruments at its disposal flexibly, as and when the situation warranted. The financial sector has acquired greater strength, efficiency and stability by the combined effect of competition, regulatory measures, policy environment and motivation among the banks. A distinguishing feature of the current year has been the strong growth in bank credit at about 26 per cent. India's external sector remained robust with merchandise exports posting in the first 11 months a strong growth of 27 per cent. By virtue of increase in oil prices, trade account turned into a deficit and with buoyant investment activity, current account also turned into a deficit.

22. Sri Lanka maintained economic growth of more than 5 per cent in 2004, partly reflecting the operation of expansionary monetary and fiscal policies. The Government's strategy is to consolidate progress from the previous market-oriented growth strategy, while placing more emphasis on regional development and reducing unemployment and poverty. The Budget for 2005, approved in December 2004, envisages a reduction in the overall deficit to 7.5 per cent of GDP. It also focuses on reducing poverty through rural development and higher spending on health, education and public infrastructure. Despite a healthy export performance, the external current account deficit, from a near balance in 2003, widened to about 3 per cent of GDP in 2004.

23. On December 26, 2004, Sri Lanka was devastated by the Tsunami triggered by one of the most powerful earthquakes in 40 years. Beyond the unquantifiable human cost, preliminary assessments place the cost of replacing damaged infrastructure at $1.5–1.6 billion (7.5 per cent of GDP). Overall damage is estimated to be around $1 billion (4.5 per cent of GDP), but needed upgrades will increase the cost of reconstruction. In March 2005, the Fund approved SDR 103.35 million (about US$157.5 million) as emergency assistance for Sri Lanka. Sri Lanka is now engaged in rehabilitation and reconstruction. The authorities extend their gratitude to the international community, including the Fund, for the ongoing assistance being provided. The authorities look forward to the upcoming Article IV

consultations and to resume discussions on issues related to the Poverty Reduction Growth Facility (PRGF)/Extended Fund Facility (EFF) program.

24. In Bangladesh**,** despite a difficult political environment, progress in implementation of structural reforms covering nationalized banks, tax administration, and State Owned Enterprises, has continued. With the phasing out of the multi-fibre arrangement (MFA) in the textile sector, the country now has the opportunity to break new ground in increasing textile exports. Policy measures in Bangladesh have focused on diversifying the export base, enhancing competitiveness, and preparing a better business climate by removing structural impediments, upgrading infrastructure, and improving governance. As these initiatives may take time to fructify, the government intends to avail of augmented access under the PRGF-supported program through the Fund's new Trade Integration Mechanism.

25. Aided by strong GDP growth and low inflation, Bhutan continues to enjoy a stable macroeconomic environment conducive to sustained growth with the major impetus being provided by construction, manufacturing, transportation and tourism. With a view to implementing a comprehensive poverty reduction strategy, the Royal Government of Bhutan has finalized a Poverty Reduction Strategy Paper (PRSP) after an extensive consultation process.

Effective IMF Surveillance and Crisis Prevention

26. Traditionally, the Fund's surveillance relates to (i) bilateral surveillance under Article IV consultations and (ii) multilateral surveillance through the regular publication of the twice-yearly *World Economic Outlook* and the more recent *Global Financial Stability Report*. However, during the last few years, there has been a paradigm shift, in respect of both the focus of surveillance as well as the instruments of surveillance, reflecting the Fund's effort to meet the challenges of an increasingly integrated global economy. There has also been a significant improvement in the multilateral surveillance system. Recent Fund initiatives including the proposals to (i) integrate the 'balance sheet approach' for IMF assessment of member countries as a part of the Article IV process, (ii) design an operational framework for assessing debt sustainability in low-income countries, (iii) increase the emphasis on inclusion of trade related areas in the Article IV consultation process and shift the emphasis from the use of trade-related conditionality under Fund-supported program to enhanced focus on trade vulnerabilities, (iv) include FSAP as a part of the Article IV process in the IMF tools of multilateral surveillance, and (v) review 'program design' and the working of the '2002 Conditionality Guidelines', underscore the Fund's increasing emphasis on using surveillance as the primary instrument for vulnerability assessments.

27. As regards strengthening of surveillance, we have reached a stage where, despite possessing all the available instruments, doubts about their effectiveness continue to linger. We must recognise that the origins of past financial crises were in the industrial countries and advanced financial centres. While markets have started to learn to discriminate among countries, there is still a long way to go. In this context, we would like to highlight the following points:

28. First, it should be pointed out that much remains to be done in improving the effectiveness and even-handedness of the Fund's bilateral surveillance across members. Second, it is also felt that the Fund is becoming increasingly intrusive in its approach and using surveillance as an instrument to rate country performance, thereby subordinating its primary role of a confidential advisor and the co-operative principles underlying its existence. Third, there is a growing body of opinion that the surveillance reports in the case of advanced economies remain rather weak. Fourth, there is need to recognise that while the role of Fund surveillance in program countries is curative, in non-program countries it is preventive. Fifth, it should also be recognized that there are quantifiable tradeoffs in the Fund's objective of having a deeper coverage of the financial sector and integrating Report on Standards and Codes (ROSCs) and Technical Assistance (TA). Given the Fund's resources, it may not be possible to build up surveillance without squeezing FSAPs, ROSCs or TAs, let alone advance its recent forays into AML/CFT issues. Finally, with respect to the Fund's recent emphasis on trade related areas, though we appreciate the pro-active stance of the Fund, it needs to be re-emphasized that given the resource constraints of the Fund and the vexed issues relating to the overlap of the domain of influence between the Fund, World Bank and the WTO, there is need to concentrate on 'what is attainable'.

Progress with Crisis Resolution Initiatives

29. We welcome the increasing adoption of Collective Action Clauses (CACs) for most new sovereign bond issues governed under New York Law and the increasing share of issues with CACs in the total outstanding stock of emerging market sovereign bond issues. It is also encouraging to note that the increasing adoption of CACs in new debt issues has not resulted in any higher risk premium. Moreover, bond contracts are converging to some harmonious practices, particularly in respect of the threshold level of voting of creditors for activation of restructuring.

30. The publication of the draft Principles for Stable Capital Flows and Fair Debt Restructuring in Emerging Markets is an important step towards formulating a voluntary 'Code of Conduct' (CoC) between creditors and debtors. These principles reflect the sustained efforts of country groupings, like the G-10 and G-20, and also institutions like the Institute of International Finance (IIF) in coordination with select debtors and creditors in the sovereign debt market. We emphasize that adoption of the CoC should be voluntary and involve extensive consultations with both creditors and debtors, besides developing countries. Moreover, any involvement of the IMF in the development of CoC should be primarily as a 'facilitator'.

Fund Conditionality

31. Over the years, the design of Fund conditionality has given rise to the serious problems of proliferation, overload, and intrusiveness, with respect to national ownership of Fund-supported programs in member countries. In this context, we welcome the adoption of

the new “Conditionality Guideline (2002)” and the results of the recently completed review on their applications. We believe that conditionality should not only be made consistent with its intended purpose, but should also be responsive to the institutional realities in member countries for respecting sovereign decision making. In this context, I wish to emphasise upon three basic principles pertaining to the rationale of Fund conditionality. First, the ‘proliferation’ of Fund conditionality into areas outside the Fund’s core responsibilities based on the notion of ‘everything depends on everything else’ must be eschewed. Second, the Fund can avoid asking ‘a sick man to demonstrate his fitness by carrying out a tough regimen of exercise’. Third, Fund’s conditionality, especially structural conditionality, should be transparent and clear without being either overambitious or overtly stringent.

32. Any assessment of the role of the New Conditionality Guidelines should, therefore, be benchmarked against these basic principles and more importantly, the current state of the global economy, which reflects in the pattern of IMF lending as alluded to earlier. In this context, I also wish to particularly highlight the concerns expressed by the Fund about the plausible conflict between the objectives of ‘criticality’, ‘parsimony’ and ‘clarity’ in the formulation of conditionality and the design of Fund programs. In our view, such contradictions essentially reflect the prerogative of the Fund to protect its own resources, when its portfolio is highly exposed to a few select debtor members and should not be construed to justify the dilution of the principles of ‘criticality’, ‘parsimony’ and ‘clarity’ to the old ‘everything depends on everything else’ norm.

33. I would be remiss if I didn’t take this opportunity in thanking Mr. de Rato, who took time off from his busy schedule, in visiting India in March. The wide ranging discussions we had with the Managing Director and his team have been extremely useful and certainly of mutual benefit.

Thank you.