International Monetary and Financial Committee

Fourteenth Meeting
September 17, 2006

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

Singapore, September 17, 2006

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

Mr. Chairman,

The Global Economy and Financial Markets

1. We are meeting in Singapore at a time when the performance of global economy has continued to exceed expectations displaying remarkable resilience notwithstanding the unprecedented rise in oil and commodity prices and global uncertainties. We broadly agree with the latest World Economic Outlook (WEO) assessment of an improvement in global growth prospects for 2006 from the last assessment in April 2006. The growth scenario is now more widespread with the expanding potential of the Euro area and a resurgence of growth in Japan. China and India continue to reinforce the impetus to growth in the emerging markets. The global economic recovery of the past two years has been broad-based, including sub-Saharan Africa.

2. However, downside risks from inflationary pressures, high and volatile oil prices, a possible disorderly unwinding of global imbalances and apprehensions of a sudden slowdown of the US economy, continue to persist.

3. The deepening of global imbalances continues to pose a major risk to global growth and stability. The imbalance is concentrated with the US current account deficit and mirrored by surpluses in China and the Middle East. The unwinding of these imbalances is likely to have global ramifications. It is a matter of concern that the US current account deficit is projected to reach 6.5 per cent of GDP during 2006, which in the normal course would not have been considered sustainable. Globalization, technological innovation and structural changes in the financial markets have made financing possible thus far, without major disruptions. It would be

necessary to reduce the deficit to minimize the possibility of an adverse reaction from the markets as the US net foreign liabilities position deteriorates.

4. The trend of US growth continues to have a significant impact on global growth. There is a risk that any abrupt correction in the housing market could slowdown US growth and consequently affect global growth. At the same time, growth in the Euro area is projected to slow down next year from its level this year. In addition, both the Euro area and Japan remain vulnerable to a sharp currency appreciation in the event of a reallocation of the global asset portfolio in the context of global imbalances.

5. The increase in oil prices had initially pushed up headline inflation. However, with spare capacity, increase in productivity and stronger balance sheets of the corporate sector, the second-round effects of higher oil prices have not been immediately apparent. As a major part of the oil price increase has acquired a permanent character, core inflation seems to have moved up with a lag, prompting major central banks to respond with increases in their policy rates. A key question in this regard is whether the global disinflationary forces will continue to be effective and put a restraint on world inflation or will they wane as output gap narrows down further. Furthermore, it is not clear as to how far higher policy rates will slow down growth and how far they will reduce inflation if oil prices continue to remain at elevated levels. Higher interest rates in advanced economies have implications for financial markets. A tightening of financing conditions for emerging markets may exacerbate vulnerabilities.

6. The medium-term oil outlook does not give much comfort, particularly to net oil importing developing countries. Continued geopolitical tensions in the Middle East and possible supply disruptions in other major oil producing regions are pointers to the lingering nature of this oil shock. A sustained level of higher oil prices has failed to provide the stimulus for higher investment to augment oil supplies, reflecting the rigidities in the oil market. It is difficult to fully explain the sustained high oil prices purely as a result of underlying supply-demand balance; we think that there is a strong element of speculation and profit taking in the market. Given the dependence of the global economy on oil, there is a need for policy intervention, both at national and international levels, to improve the market microstructure and incentivise investment in oil production. We have, in past meetings, urged the Fund as a cooperative institution to be more proactive in regard to the oil market, and we once again do so.

7. Alongside oil prices, non-fuel commodity prices have also increased to record levels. It has had a favourable impact on growth performance of a number of countries in Sub-Saharan Africa, Latin America and Commonwealth of Independent States (CIS). Major commodity exporters, however, remain vulnerable to cyclical change in the commodity markets. In order to sustain the growth momentum, it would be desirable to diversify the production base with greater emphasis on value addition. Although, with high oil prices, the economic outlook for the Middle East remains favourable, the region faces the challenges of spending oil surpluses judiciously and of high asset prices.

8. In recent years, financial market conditions have been supportive of growth. Financial institutions in mature and emerging markets remain well-capitalized. There has been considerable improvement in emerging markets' sovereign debt structure. Also, corporate performance continues to remain strong. Notwithstanding these strengths, the continuing vulnerability of financial stability to changes in underlying macroeconomic conditions has been adequately revealed by the recent turbulence in currency and equity markets. Given the openness of emerging markets to portfolio flows, the unwinding of positions by institutional investors had its reflection in the foreign exchange markets. While the recent adverse developments in the financial markets were more in the nature of a correction rather than a fundamental reassessment of risk, financial markets now are likely to be more discerning of risks. Such risks emanate from multiple sources. *First* is the risk of a disorderly unwinding of global imbalances and consequent changes in exchange rates. *Second*, there are concerns about protectionist pressures. *Third*, the persistence of high oil prices: its second round effects exacerbate risks on the inflation front and the consequent increase in interest rates. *Last,* but not the least, the continuing geopolitical tensions constitute an added source of complication for financial markets. Though market pressures have subsided for the time being, it is necessary to guard against market volatility that can resurface if expectations were to turn adverse.

The IMF's Medium-Term Strategy

9. The medium-term Strategy aims to reposition the Fund in the global financial architecture. While the implementation of the strategy is an ongoing process, we note the progress made on various aspects of the Strategy since the Spring Meetings in April.

Quotas and Voice

10. We are firmly of view that the current quotas, based on a flawed formula, do not reflect the relative economic strength of countries, and fundamental reforms are overdue. The need of the hour is to evolve a new, simple, transparent and linear quota formula. In this context, we share the objective of better alignment of quota shares with economic weight. We are, however, not convinced by the proposed two-stage or multi-stage approach, including *ad hoc* increases in the first stage, to progress towards the objective. We believe that the starting point of reforms is a new quota formula as a central ingredient, realigning country quotas consistent with the formula, and an increase in basic votes. Given the volatility of market exchange rates, the formula should have GDP on purchasing power parity (PPP) basis as the dominant variable. I may point out that, currently, many IMF documents and analyses use GDP on PPP basis, and there is nothing startling in this suggestion. Furthermore, the ‘openness’ variable in the calculation of quotas needs a close scrutiny in the context of countries having a common currency. We are of the view that our proposal for comprehensive reforms alone will result in adequate, equitable and appropriate representation for developing countries. Such a broader representation of the developing countries would enhance the acceptability, ownership and effectiveness of IMF’s programmes and policies.

Surveillance

11. Surveillance is well recognized as a means of reducing the likelihood of crises and minimizing the cost of crises, if they were to occur, by promoting economic resilience through sound policies in member countries. The key challenge is to give shape to regional surveillance, and integrate bilateral, regional and multilateral surveillance with a clearer focus on the final objective. Under the provisions of Article IV, surveillance is a cooperative effort between the member country and the Fund, one sustaining the other.

12. We do not see any legal and institutional impediment for the conduct of surveillance. All responsibilities of the Fund under Article IV are reflected in the 1977 Decision and, in our view, the framework does not need any amendment in order to achieve the five objectives sought to be achieved in the “Medium-Term Strategy”.

13. The main issues of contention in Fund surveillance remain focused on how to improve its "even-handedness" and reduce its "intrusiveness", while recognizing the preventive nature of such surveillance. Similarly, the effectiveness of multilateral surveillance would depend crucially on its coverage of the plausible policy spillovers from the systemically important countries, especially the industrialized countries, since such countries account for a significant share of global financial flows. Evidence suggests that the origins of the crises could well be in the industrial economies and advanced financial centres. Accordingly, there is a need for the Fund to have an even-handed approach to surveillance in order to build confidence among both borrowers and lenders. While the objective of such surveillance is unquestioned, clarity about the target of surveillance would be in order. Furthermore, there is merit in the Fund eschewing proliferation of activities outside its basic mandate. Notwithstanding the increasing outreach activities, the Fund needs to preserve its role as a confidential adviser to national authorities, recommending measures that could help in containing vulnerability and reducing recognition lag.

14. As regards the specific attributes of surveillance, the following aspects would have to be kept in view.

- The need to enhance exchange rate surveillance is recognized. However, in the absence of a broad agreement on an appropriate methodology, and the fact that alternate approaches produce widely divergent estimates, it would not be appropriate to anchor policy advice on such exchange rate assessments. Moreover, given the sensitivity of exchange rates for emerging markets, it would be desirable to keep the exchange rate assessment internal and continue with the Fund's role as a confidential adviser.

- The Fund's work on deepening financial sector soundness and capital flows with particular emphasis on vulnerability is important. At the same time, it needs to be recognized that there is a wide diversity in the level of development of the financial sector across the majority of Fund membership and a one-size-fits-all approach would not be appropriate. Furthermore, while bringing in additional focus on the financial sector, the traditional rigour of macroeconomic analysis in Article IV consultations should not be diluted, as this is the area of core competence of the Fund.

- While surveillance in non-programme countries is for preventive purposes, in programme countries it is more of a curative nature. It is important to maintain this distinction.

15. We are in favour of country consultations focused on key issues of concern to enhance value addition from surveillance. In a rapidly integrating global economy, issues of bilateral and multilateral surveillance share a symbiotic relationship not only with respect to the systemically important countries but also with respect to the developing and emerging market countries. Coverage of the plausible policy spillovers from the more mature markets is crucial for effective surveillance. We await the results of the first multilateral consultations on the critical issue of global imbalance.

Role of the IMF in the emerging market countries

16. With the change in the pattern of global capital flows, the emerging market economies are increasingly relying on private capital to finance their balance of payments. The pace of international capital flows has, however, been anything but smooth. In particular, past financial crises in emerging economies have been frequently associated with dramatic downturns in capital flows that often are hard to rationalize.

17. In the event of a crisis, the financing requirement for emerging markets, particularly for the larger ones, is beyond any single institution. Accordingly, a number of central banks, particularly in Asia, have built up large reserves as a matter of self-insurance.

18. In this context, we see the need for a high-access contingent financing instrument. We recognize the challenges of effectively designing such an instrument, given the Fund's experience with the Contingent Credit Line (CCL), which had no takers. Another issue is the probable usage levels amongst member countries. A number of emerging market countries have built up substantial reserves. Moreover, the objective of a precautionary arrangement is quite different from a non-precautionary one. A country adopts a precautionary arrangement as a 'choice' while a non-precautionary Fund arrangement is usually adopted under compulsion in a crisis. Thus, the set of conditionalities and standards attached to precautionary arrangements should reflect this crucial difference. We understand that the Fund is actively engaged in an appropriate design of such an instrument.

IMF support to help Low Income Members achieve the MDGs

19. We welcome the positive steps taken for the low income countries since the adoption of the Fund's medium-term strategy. The Fund should continue to remain fully engaged in the multilateral effort to help its low income member countries achieve MDGs and address the issues of ensuring debt sustainability with supportive policies.

Developments in the Constituency

20. Let me now turn briefly to some key aspects of developments in my constituency. In **India,** the prospects of sustaining a growth rate of over 8 percent achieved during the last three years, appear favourable. Inflationary pressures have by and large been contained so far by appropriate monetary policy action and supply side measures. Business confidence and corporate performance continue to be favourable. The investment boom is continuing for the third year in a row. Strong fundamentals helped the economy negotiate effectively the recent stock market volatility, and underlying investment sentiment in the financial markets continues to remain positive. Despite the surge in the oil import bill, the external current account situation is manageable, underpinned by robust exports and invisible receipts, and capital flows. The foreign exchange market remained orderly exhibiting two-way movement. We are committed to continuing the process of fiscal consolidation in 2006-07 and thereafter too.

21. The **Bangladesh** economy has continued to exhibit robust growth. The authorities' stewardship of fiscal and monetary policies has been broadly appropriate, as reflected in the falling overall deficit as well as the size of the current account deficit. While there have been some slippages in performance under the Poverty Reduction and Growth Facility (PRGF) performance targets, there is every reason to believe that these are temporary. The country has weathered the phasing out of the Multi-Fibre Agreement exceptionally well, as can be judged from the robust increase in garment exports.

22. The **Sri Lankan** economy is performing strongly in 2006, and is expected to record a high GDP growth of around 7-8 per cent for the year. Though inflation increased, reflecting pass-through of oil prices, monetary policy has been tightened to dampen inflationary pressures. The tsunami reconstruction placed an additional burden on the fisc. The government is vigorously

pursuing economic policies with the objective of rapid and equitable development of all regions towards the realization of the MDGs.

23. **Bhutan's** economy is poised to take off on a more sustainable path with the commissioning of the Tala hydro-electric project. GDP is estimated to grow at 14.6 percent in 2006 and inflation remains moderate. Bhutan has also experienced a phenomenal improvement in socio-economic indicators.

Thank you.