International Monetary and Financial Committee

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Statement by Pranab Mukherjee
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On behalf of Bangladesh, Bhutan, India, Sri Lanka

Statement by Honourable Finance Minister
Mr. Pranab Mukherjee

Leader of the Indian Delegation to the
International Monetary and Financial Committee

Istanbul, October 4, 2009

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

Mr. Chairman,

1. Since we met in the spring, there have been several developments that have given cause for cautious optimism. Fears of free fall have receded and the steep downslide that began in the second half of 2008 appears to be bottoming out. The broad sentiment is that the worst is behind us. The pulling out of the downturn is led by a strong rebound in Asia with remarkably synchronized signs of stabilization in other parts of the world. Global growth is estimated to have risen by about 1.5 percent in the second quarter of 2009 on an annualized basis, following a contraction of 6.5 percent in the first quarter; and indicators point to stronger growth in the second half of 2009. Various economies are poised at differing points of the cycle and the recession will likely last at least till 2010 before it can be pronounced as over.

The Global Economy and Financial Markets

2. The key questions are what lies ahead in the coming months and what will the world look like after the crisis is finally over. The two sectors that have suffered long and deep declines – manufacturing and housing – are showing signs of recovery. Alongside, inventories appear to be leaner, commodity prices (especially oil) are firming up, world trade seems to be stabilizing and capital flows are returning to the emerging world. The crucial issue is the translation of these upticks into a halt in rising unemployment and a rebound in sluggish consumer spending. The World Economic Outlook projects unemployment to stay above 10 percent in the US and western Europe through 2010. Financial conditions have undoubtedly improved from the seized state at the height of the crisis and in the ensuing months, with spreads coming down substantially in the financial markets as risk appetite has tentatively returned. Activity in securitized

segments of the financial markets is well below pre-crisis levels. Credit availability due to tightening of lending standards and continued de-leveraging is an issue in most countries.

3. By current reckoning, the recovery even when it takes hold is likely to be sluggish and protracted, jobless and credit constrained. The output losses on account of the crisis are likely to be relatively prolonged. The main trigger for the turnaround is strong monetary and fiscal stimulus across advanced and emerging economies. GDP growth in the second and third quarters of 2009 is essentially buoyed up by government consumption/investment, the technical turnaround brought about by inventories being run down and contribution to growth from net exports on account of falling demand for imports. At this juncture, there still appear to be some potholes in the path to recovery in addition to the concerns relating to unemployment, weak consumer spending and the credit squeeze. The real de-leveraging has not yet begun – losses of financial institutions are on government/central bank sheets for now with more than US $ 1.5 trillion out of total of US $ 2.8 trillion of potential write-downs still unrecognized. Bank profits essentially reflect accounting relaxations and massive subsidization by monetary policy (with interest rates held at or near zero) at the cost of the depositor. Inflation risks are rising, especially in developing countries, and there is a real danger that monetary policy in these countries which have led the recovery will have to be tightened and that growth will be stifled in its infancy. Thus, global recovery is not yet assured and this is no time to be complacent – the main concern is what will happen when the effects of policy stimulus taper off towards the close of 2009 and inventory de-stocking is over. In this context, fears are being expressed about the risk of a 'double-dip' of the global economy in the months ahead or even the danger of a extended stagnation.

4. Against this backdrop, a premature exit from monetary and fiscal policy support could well prove to be the gravest risk to a firm recovery. In our view, it is critical to sustain the policy effort. The first task is to follow through on existing commitments. We need to look beyond the second half of 2009 and if the judgment is that economic and financial conditions are not likely to improve, the fiscal stimulus may have to be

sustained. It is also necessary in the context of persisting tightness in credit standards to review the channels of monetary policy transmission to see what needs fixing.

5. There is also an unfinished agenda on repairing the financial system in terms of recognition of impaired assets, cleansing of balance sheets, capitalization and resolution. The perimeter of regulation has to be expanded not just to unregulated institutions but also to markets, instruments and havens, while being intensified over systemically important financial centers. The Basel-driven risk sensitive capital ratios have to be critically evaluated against more blunt leverage ratios focused on common equity. There also appears to be considerable merit in *ab initio* building in dynamic provisioning and counter-cyclical prudential frameworks.

6. Demand re-balancing may lead to the global economy settling at a level distinctly lower than pre-crisis levels. This will call for structural reforms to revitalize productivity and efficiency. Food price inflation could have serious social repercussions in emerging market economies and developing countries. Contingency plans should be drawn up if inflation were to overtake us on the road to recovery. Several medium-term challenges confront us: how to provide sufficient policy support to entrench the recovery while returning to fiscal sustainability and viable sovereign debt/debt servicing; unwinding central bank balance sheets without destabilizing financial markets while ensuring that excess liquidity does not build inflationary pressures; avoiding trade and financial protectionism; making financial sector regulation more effective without stifling innovations and risk-taking; facilitating durable increases in investment; and resuming the fight against poverty. It is in the context of this evolving future that we would temper optimism with caution and this should condition the setting of macroeconomic and financial policies going forward.

The Role and Response of the Fund

7. The unprecedented nature of the crisis brought forth unprecedented policy responses. That the first tentative signs of stabilization are being sighted somewhat earlier than initially anticipated bears testimony to the first round success of this massive policy effort to do whatever it takes to repair and restore the global economy.

Unlike in previous crises, the Fund has been at the centre of the global fight back. It has worked to coordinate the global response, stepped up country-specific and cross-country surveillance, significantly reformed its lending instruments, and scaled up financial support to a wide range of countries, including through new instruments such as the Flexible Credit Line. Spearheaded by the G 20 process, the Fund's membership has also invested it with a sizeable augmentation of its lending capacity, both normal and concessional.

The Future Mandate of the Fund

8. While the international community expects that the Fund should be concerned with global financial stability and the Fund itself has been emphasizing this issue, the formal mandate of the Fund is still focused heavily on balance of payments issues, exchange rate arrangements and the multilateral system of payments. This will be inadequate to enable the organization to foresee and warn about financial meltdowns like the one that occurred in 2008. Therefore, the Fund's mandate should include ***"promoting international financial stability, in order to provide a sound foundation to the global growth process".*** With a financial stability mandate, the Fund's surveillance and lending should also focus on reducing and mitigating volatility of financial flows. We call for the setting up a working group of the IMFC – including representatives of all the IMFC members – to study the issue of redefining the Fund's mandate.

Surveillance

9. The function of surveillance – bilateral, regional and multilateral - is central to the Fund's role of oversight of the international monetary and financial system. Against the backdrop of the current crisis, the surveillance role of the Fund has assumed high relevance in the global effort to stave off the crisis, and to regain and anchor stability. It is in this context that we stress the need to persevere with efforts to enhance the effectiveness of Fund surveillance through policy advice and communications that are able to gain traction with members with an emphasis on candour, even-handedness and independence. The lessons of the crisis underscore that the focus of the Fund's surveillance on important financial centres and systemically important countries should be intensified. Further progress on these fronts is closely linked to the progress to be

made in quota, voice and governance reforms that would enable more effective participation of emerging and developing countries in the functioning of the Fund.

10. We welcome the revision of the economic priorities of the Fund's surveillance in response to changes in global economic circumstances. While there is broad agreement that the main factor driving the setting of economic priorities should be to ensure a sustained and balanced recovery, there is need for clarity on the content, timing and pace of exit policies. Countries entered the crisis at different points of time and under differing circumstances, some affected by the financial turmoil and some pulled down by the economic downturn. Consequently, the content as well as the timing of stimulus measures differed from country to country. The exit from stimulus should also be country-specific, each country judging when it is firmly on the path to recovery.

11. We welcome the collaboration between the Fund and the Financial Stability Board (FSB) on the early warning exercise (EWE). It is important to look for consonance among the various indicators rather than warning flashes. Policy recommendations should be prioritised to gain traction with policy authorities while avoiding destabilizing market sentiment. In our view, it is best to treat the EWE as having qualitative signaling content rather than as a precise predictive tool for dating future crises. It should be regarded as a systemic tail risk exercise to be continuously refined and updated. Vulnerability exercises should cover both advanced and emerging economies, linkages and spillovers, if they are to be truly effective in enabling peer reviews. We look forward to carrying this valuable work forward so as to facilitate continuous monitoring of risk indicators of predisposition to crisis vulnerability in surveillance.

12. Integrating financial sector and bilateral surveillance is, in principle, logical, but we have concerns about the need and utility of such integration at this stage. Tensions between a voluntary process and a mandatory exercise could risk dilution of objectives and outcomes of both. A critical catalyst for the integration will be the recognition of financial stability in the mandate of the Fund. Pending the broadening of the Fund's mandate, the voluntary character of the FSAP should be preserved with enhanced efforts to secure the widest participation, including those members that have undertaken

transparent self-assessments. A more intensified surveillance of macro-financial linkages under the Article IV consultations is essential. We also strongly support the improvements being envisaged under the FSAP for assessing macro-prudential frameworks, providing greater focus on cross-border issues as well as enhanced candour and comparability. We particularly welcome the modular approach to the FSAP which should make it more continuous and flexible and fill the gap between successive FSAPs.

13. The Fund needs to upgrade resources and focus going into global and regional surveillance, especially monitoring of systemic risks wherever they may lie. We welcome the sharper focus of Fund surveillance on cross-cutting themes relating to systemically important economies. Such cross-country assessments could lay the foundations for an effective peer review processes centered around the Fund. In this regard, it is important that the Fund's policy advice is clearly communicated so as to attract both individual and collective policy attention and traction.

14. We support the efforts being made to imbue bilateral surveillance with regional and multilateral perspectives. We believe that it will also be necessary to enhance the independence of the IMF's regular bilateral surveillance, but the manner by which this can be achieved need careful consideration. In this context, we see considerable merit in strengthening the engagement of the Executive Board in Fund surveillance so as to benefit from analytical and technical expertise as also from peer review, but through processes that secure transparency, accountability and representativeness. In particular, it is important to ensure that an unbiased assessment of members' positions *vis-à-vis* those of the Staff in Article IV consultations are available, as in Executive Board deliberations, before the publication of these reports.

Lending Instruments and Policies

15. To go with the proposed Fund's mandate for global financial stability, a new financing role for the Fund, as part of an insurance mechanism against capital account shocks, merits careful consideration. Such insurance mechanisms are expected to be a complement to self-insurance through an appropriate level of reserves and not to

completely replace them. The Flexible Credit Line (FCL) and the High Access Precautionary Arrangements (HAPAs) were important innovations at the time of the crisis and need to continue in the Fund's post crisis tool-kit as well. The expanded lending role of the Fund with easier availability of fund financing as the central feature should not also lose sight of the safeguards for Fund resources.

16. To keep pace with the changing lending role of the Fund, a permanent increase in Fund resources cannot be delayed much longer. There was a case for a substantial increase of Fund resources even before the crisis to keep pace with the growing size of output and the volume of trade and financial flows. The crisis underscored the role of an adequately funded IMF to meet the needs of developing countries, which were not the cause of the crisis but were the worst hit. The fact that actual drawal was lower does not mean this scale of funding was not necessary. In fact, it was precisely the boldness of the action which prompted early stabilisation. An appropriate proportion has to be maintained between the quota resources and the borrowed resources of the Fund. A general quota increase would also reduce the need for very high levels of access for countries in need, which could undermine the co-operative nature of the Fund. Hence, we call for, at the very least, a doubling in the quota resources of the Fund.

17. We welcome the recent initiative of the Fund to reform the financing instruments for low income countries (LICs) and to revise the conditionality framework so as to better reflect their diverse needs and circumstances and heightened exposure to global volatility. At the same time, the crisis reinforces our view that the Fund, by concentrating on its core mandate of ensuring macroeconomic stability, developing cross country perspectives and drawing and disseminating lessons from the experiences of advanced and emerging market countries, could greatly benefit LICs which, in turn, would allow the development partners to effectively carry out their mandate. The main challenge continues to be the raising of adequate resources to enable concessional lending to the LICs. The Fund should make all out efforts to seek additional subsidy resources from advanced and resource rich countries. Any proposal to utilise the newly allocated SDRs for supporting LIC lending should meet the tests of transparency and equity.

Issues in Governance Reform

18. The global crisis has highlighted the need for an expanded role of the IMF and the Fund cannot emerge from this crisis unchanged. The Fund can regain its legitimacy and perform its expanded role effectively only with further significant and meaningful quota and voice reform. Resistance to such overdue change only detracts from the Fund's legitimacy and credibility.

19. Early ratification of the April 2008 package of quota reforms is an urgent requirement. However, the April 2008 package was a limited first step. The next quota review, which is scheduled to be completed by January 2011, should help furher rebalance the governance structure of the Fund while substantially expanding the quota base.

20. Parity in the vote shares of developed and developing countries would greatly enhanced the legitimacy of the Fund and can be achieved through a 7 to 8 per cent shift in quota shares. The G20 Leaders in Pittsburgh have agreed on a shift in quota share to dynamic and emerging markets and developing countries of at least 5 per cent which we believe is a significant step forward. This critical minimum gives us an opportunity to realign quota shares in a manner that reflects current global economic realities appropriately.

21. The new quota formula still does not adequately reflect the current global economic conditions. Even when it was agreed upon, it was decided that the formula would have to be reviewed before it was used again. Therefore, we have to work further on the formula to achieve the shift called for by the G20 leaders in Pittsburgh. The reforms to the formula should provide an improved reflection of the Fund's role in delivering the global public good of surveillance. To achieve such democratization, population would have to be an objective variable and in its absence, the nearest proxy has to be PPP GDP.

22. 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. The Executive Board has made useful suggestions on

improving the functioning of the IMFC, some of which have already been adopted for this meeting. Any consideration of the idea of activating the Ministerial Council can be only after substantial quota realignment in favour of emerging market economies and developing countries.

23. There is an urgent case for redistributing the chairs in the Executive Board on a more equitable basis amongst the regions of the world. It would also be necessary to re-organize some of the constituencies to achieve such redistribution. 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. We do not see this provision merely as a veto of any one country. Even a group of smaller countries can use this provision as a safeguard in exceptional cases.

Developments in the Constituency

24. I now turn to developments in my constituency.

India

25. The Indian economy is estimated to have grown by 6.7 per cent in 2008-09 following a pronounced deceleration in the second half of the year as the global crisis set in. Exports, domestic manufacturing and corporate activity were adversely affected while business confidence plummeted and dented investment demand. While the financial sector remained relatively unaffected, given its negligible exposure to toxic assets and relatively high levels of capital and liquidity buffers, financial markets were strained by the loss of confidence and the severe stress caused by the global deleveraging process, which triggered capital outflows in the second half of 2008-09. Policy responses mitigated the adverse impact of the crisis substantially – the fiscal stimulus amounting to 3.5 percent of GDP bolstered sagging demand while liquidity facilities of the order of 7 percent of GDP ensured that financial markets continued to function normally albeit with tighter lending conditions and higher spreads than before. The decline in demand and fall in commodity prices due to the crisis resulted in a sharp

decline in headline wholesale price (WPI) inflation to negative levels by June 2009 although consumer price inflation led by food prices remained elevated in the range of 8 - 10.2 per cent. The current account deficit widened to 2.6 per cent of GDP in 2008-09 from 1.5 per cent in 2007-08 reflecting deterioration in the trade balance. Industrial production rebounded during the first quarter of 2009-10. With the return of capital flows and narrowing of the trade deficit, foreign exchange reserves have increased by US$ 29 billion, taking them to US$ 281 billion by September 18, 2009.

26. Since the beginning of 2009-10, recovery, led by industrial production, is setting in, but downside risks remain. A firm uptrend in the growth momentum is unlikely before the middle of 2009-10 and real GDP growth is likely to be around 6.5 per cent for the year as a whole. The sharp decline in WPI inflation has not been commensurately matched by a similar decline in consumer prices or in inflation expectations. Keeping in view the global trend in commodity prices, WPI inflation for end-March 2010 is projected at around 5.0 but risks to this projection appears currently to be on the upside. The fiscal deficit for 2009-10 is estimated to go up to 6.8 per cent of GDP, thus providing a continuing stimulus of about 4 per cent of GDP. As a durable pick-up and a return to the pre-crisis high growth trajectory takes hold, India will have to redraw priorities towards fiscal consolidation and structural change.

Sri Lanka

27. Sri Lanka has exhibited distinct resilience in the face of shocks in the first few months of 2009 from the global recession and the resultant slowdown in domestic economic activity. Favourable developments such as the continuous decline in inflation and a narrowing trade deficit have, however, enabled a rapid recovery in key sectors of the economy in the ensuing months. The ending of the 26-year long conflict and the approval of the Fund's Stand-By Arrangement (SBA) in July 2009 also bolstered confidence and helped to improve investor perceptions. The economy registered a real growth of 1.8 per cent during the first half of 2009. Benefiting from the relatively lower international commodity prices and a pick-up in remittances from Sri Lankan expatriates, the current account deficit narrowed down significantly. Coupled with a sharp increase in foreign investments in government securities, inflow of export

proceeds, the receipt of the first tranche under the SBA and the general and special allocation of SDRs by the Fund, the overall balance of payments, which recorded a sizeable deficit of US $ 1.4 billion in 2008, turned into a surplus of about US $ 1.9 billion in the first half of 2009. Consequently, the gross official reserves, which declined to US $ 1.1 billion by March 2009, increased gradually and exceeded US $ 4 billion by mid September 2009. The exchange rate, which had depreciated to its lowest level of Rs. 120 per US dollar in April 2009, has appreciated gradually and remains stable around Rs.114.80 per US dollar. With recent economic developments turning out to be stronger than expected, real GDP growth in 2009 is now projected at 3.5 percent. Inflation remains subdued and is expected to be in single digits over 2009. Exports are showing signs of recovery and import demand is expected to pick up in the second half of the year as economic activity gathers momentum.

28. Meeting the overall budget deficit target of 7.0 per cent of GDP in 2009 remains a daunting challenge, mainly due to lower than expected revenue collection owing to the slowdown in domestic economic activity and decline in imports. Nevertheless, the commitment to achieve the fiscal target is strong. Looking ahead, the integration of the Northern and Eastern provinces with the rest of the country would enhance the country's growth potential significantly, creating new opportunities in the post-conflict era. As the recovery in the global economy firmly takes hold, the Sri Lankan economy is expected to move back to its earlier high growth path commencing from 2010, along with a stronger external position than before.

Bangladesh

29. The impact of the global crisis on Bangladesh has been relatively benign with real GDP growth having dipped marginally to 5.9 percent in 2008-09 (July-June) from a robust growth of 6.2 percent in the preceding year. The absence of exposures to the financial turmoil appears to have largely shielded the economy from the brunt of the global downslide even though contagion transmitted through the trade channel took its toll on a broad range of exports and imports and, in turn, on investment demand with dampening effects on output expected to persist into the near-term. Inflation, which peaked at 10.0 percent in July 2008, softened in the ensuing months to about 2.3

percent in June 2009, aided by the rise in domestic agricultural output and the collapse of global commodity prices. There are, however, indications of the firming up of inflationary pressures, supported by the persisting upward trend in real estate prices. Consequently, annual average CPI inflation is likely to remain at around 6.5 percent in 2009-10.

30. The setting of monetary policy has responded to these macroeconomic developments. With the ebbing of inflation and slackening of credit growth alongside the weakening of export demand, increases in key policy rates effected in 2008-09 were reversed in March 2009. With import growth at 4.2 percent decelerating faster than export growth at 10.1 percent in 2008-09 and remittances increasing by over 22 percent in spite of the slowdown in host countries - partly repatriation of savings from crisis-affected host economies and partly lower diversion to informal channels - a swelling current account surplus put upward pressures on the exchange rate in the foreign exchange market, prompting sizeable unsterilised interventions by the Bangladesh Bank. These purchases have kept the inter-bank market awash with liquidity. Excess liquidity conditions have, however, not translated into an easing of credit conditions. It is in this context that monetary policy for 2009-10 lays emphasis on bringing competitive conditions to bear on lending rates while ensuring that the credit needs of the private sector are met. Capital adequacy and risk management in banks and financial institutions are being carefully monitored. Public finances were impacted by tax revenue shortfalls in 2008-09, reflecting the weakening of economic activity and imports. At the same time, expenditure cutbacks were necessitated by implementation capacity constraints. Accordingly, the budget deficit at 4.1 percent of GDP fell below projections. For 2009-10, a step-up in public expenditure on expanding social safety nets, agricultural and rural development as well as support to sectors affected by the global downturn is expected to take the deficit to 5.0 percent of GDP. Real GDP growth in 2009-10 is expected to be in the range of 5.5 to 6.0 percent at the current juncture with some downside risks associated mainly with the outlook for the global economy and the implications for exports and remittances. The modest fiscal stimulus and judicious use of foreign exchange reserves built during 2008-09 should enable some smoothing of domestic consumption and investment and support growth.

Bhutan

31. Bhutan completed a year of momentous transition to a constitutional monarchy with new democratic institutions. Policies are directed towards achieving the core objective of poverty reduction by pursuing focused socio-economic development strategies within a sound macro-economic framework. Despite the global crisis growth continued to be strong and is estimated to be 8.1 per cent in 2008-09 with a similar level expected in 2009-10 as well. The impact of the global crisis has been confined to the tourism sector with a small fall in tourist arrivals and earnings. Inflation, which reached a high of 9.3 per cent in 2008, has been on a downward path this year. In the external sector, convertible currency reserves remain high, while rupee reserves show signs of stabilization on a 3-month moving average basis. In the financial sector, credit growth is still strong and concentrated in the housing, manufacturing and trading sectors. The focus of the financial sector liberalisation policy is on increasing competition and efficiency in the sector.

Concluding Remarks

32. The recent crisis has starkly revealed the interdependence of our economies. While it has demonstrated that this integration can turn into channels of contagion, it has also tested and eventually strengthened international coordination. We must collectively build upon this defining moment in history to develop our capabilities to manage the pressures and risks of globalization and to reap its rewards in the years ahead. The key lesson of the crisis is that cooperation backed by political consensus can be effective in converting countries' own interests into a robust and resilient global policy response. The Fund has to play a central role in anchoring our collective resolve to secure and preserve global financial stability which is the key to the resumption of strong and sustainable growth. Critical to this evolving role will be the organisational and governance reforms that are being envisaged to vest it with acceptability, legitimacy and independence. The world will not be the same after the crisis; the Fund, too, will have to change in its structure, approach, culture and strategy to be relevant, useful and effective in a changing world.