



International Monetary and Financial Committee

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Statement by Yaga V. Reddy
Governor, Reserve Bank of India
On behalf of Bangladesh, Bhutan, India, and Sri Lanka

**Statement by Honorable Governor
Dr. Y.V. Reddy
Leader of the Indian Delegation to the
International Monetary and Financial Committee
Washington D.C., April 22, 2006**

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

Mr. Chairman,

The Global Economy and Financial Markets

1. We broadly agree with the Fund's assessment of the global economy in its latest World Economic Outlook (WEO). A positive feature of the current growth scenario is that it is becoming more diversified. Notwithstanding such positive developments, the continuing volatility of the international oil prices and the ever widening global imbalances continue to be the principal challenges which need immediate attention on the part of policy makers and market players. Another concern is that investment demand continues to lag behind savings in a number of countries. In addition, one has also to take note of the potential adversities on account of the possibility of an avian flu pandemic.

2. Inflationary pressures remained modest in 2005 despite rising international oil prices. While global headline inflation picked up slightly, core inflation remained contained during 2005. In recent years, stable inflationary expectations across the globe, reflecting in part, the increasing credibility of central banks worldwide, has been one of the most important elements of the growth revival. Globalisation, thus, seems to have provided some break on inflation in the industrial economies in recent years and led to a more measured monetary policy tightening so far. In this context, I would like to highlight the following points.

First, while inflationary pressures appear to remain muted, the second round impact of high oil prices is not yet evident in view of incomplete pass-through of high oil prices in a number of countries. As domestic prices of oil adjust more fully to international prices, it is likely that some inflationary pressures may surface. Moreover, the less than perfect pass-through on retail domestic oil prices may have important implications for fiscal and external positions of oil importing countries. However, given the complex relationships and feedbacks between the different components of global oil markets it would be quite difficult to quantify *ex ante* the extent of plausible adjustments. Broadly speaking, inflation would be more demand determined and expectations driven through the process of wage price setting in developed countries while supply constraints would be a dominant factor in the process of price setting in developing countries.

Second, an imminent risk is that the present spate of increase in oil prices, both in the spot and the futures markets, could result in an abrupt revision of inflationary expectations. That in turn, could raise interest rates, exacerbating the costs associated with the expected corrections of the overvalued asset markets, particularly housing markets, in the developed countries and the required adjustments to the growing global current account imbalances.

Third, non-fuel commodity prices, particularly metal prices have also increased recently which may further exacerbate inflationary pressures.

3. It is now widely recognized that rising international oil prices pose a grave concern for the global economy in view of limited spare capacity, and continuing geo-political uncertainties. On the supply side, we reiterate the need for investment, oil conservation measures, greater dissemination and transparency of oil market data and improvement in market structure and behaviour. On the demand side, monetary policy makers should continue to be vigilant for any signs of a pickup in inflation in the period ahead. An abrupt increase in oil prices is usually borne disproportionately by the developing and low-income countries given their higher dependence on oil imports. The welfare implications of rising oil prices on large strata of population in developing countries, therefore, need to be recognized.
4. Global financial conditions remained favorable in 2005 as evident from unusually low risk premia and volatility. This has been partly due to strengthening fundamentals and the continuing search for yield. However, there is evidence of some excesses in financial markets as reflected in higher equity prices and sharp credit growth. In the event of sudden corrections in the markets, the financing conditions for developing markets may turn adverse. Moreover, global short-term interest rates continue to rise resulting in flattening of the yield curve, particularly in advanced countries. In terms of recent financial innovations, the credit derivative and structured credit markets have grown rapidly during the past few years, allowing dispersion of credit risk by banks. While this is a welcome feature, it is necessary to evolve mechanisms to ascertain the size and structure of risk components, the scale and direction of risk transfers, and therefore the distribution of risk within the economy.
5. Given the increased emphasis of the financial sector in the Fund's surveillance activity, we welcome the improved focus and analytical content of the Global Financial Stability Report (GFSR). While the financial market conditions continue to remain favorable, cyclical developments, such as higher interest rates and the turning of the credit cycle, are likely to present a number of challenges to financial markets and institutions. In the near future the resilience of the financial markets may get tested against plausible macroeconomic shocks reinforced by the increasingly discernable financial market vulnerabilities.
6. Global economic prospects continue to be marked by the risk of a disorderly adjustment to the rising level of global imbalances and their changing distribution across

nation states and country groups. The probability of this outcome has increased as the stance of monetary policy is clearly set to move from accommodative to more neutral levels in the Euro area and Japan. In the event of an unwinding and sharp movements in exchange rates and asset prices, the adverse impact is likely to be disproportionately large on net oil-importing developing countries.

7. On the whole, it is heartening to note that cyclical factors have been very favorable over the past few years. Low interest rates and an abundant supply of liquidity have supported a solid global economic recovery and set in motion a search for yield. Strong improvement in balance sheets of financial, corporate and household sectors have created substantial financial cushions in major financial systems. Banking systems in emerging markets have generally strengthened following banking sector reforms and improved supervision. However, in the event of abrupt adjustment to global imbalances there is a recognition that the consequences would be severe with indeterminate second order effects. In this context, I fully endorse Fund's normative assessment suggesting efforts towards enhanced transparency and disclosures in financial markets for mitigating the probability of contagion risk.

Implementation of the IMF's Medium-Term Strategy

8. I compliment the Managing Director for crystallizing the Fund's Medium-term strategy and thank the members of the working groups for their supportive reports. It needs to be recognized that over the past decade and a half there has been a paradigm shift in global economic/financial environment with the increasing adoption of liberalization and globalisation strategy across the globe coupled with rapid technological innovation. This, in turn, catalyzed the process of global capital market integration, which has led to a spectacular increase in the volume and types of private capital flows.

9. The underpinnings of the international financial architecture hinges on the issues of evolving a stable global mechanism. The most important issue, I feel, pertains to the synchronization of the speed of adjustment of the national economies at different stages of development to independent changes in the global financial system. The global community's efforts to establish a stable global economic order would be contingent upon the recognition of three essential principles.

First, given the wide diversity of country realities and different "speeds of adjustment" there cannot be any "straight-jacket" approach towards reforms and adoption of reform initiatives both in terms of content and timing should be guided by the fundamental premise of voluntariness.

Second, the emerging market economies should get their rightful position in established framework for global financial governance given the changing pattern of global growth with a redistribution of "growth ownership" towards emerging market economies. 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 capital-surplus and capital-deficit countries.

Third, there is need to recognize the increasing importance of regional bodies and groupings in co-ordinating the decision making process in global policy space. I feel that several *supra-national* identities would have an increasing role in influencing the decision making processes in the international financial institutions in the near future.

Surveillance

10. During the last few years there has been a paradigm shift both in respect of the focus of surveillance as well as in terms of the instruments of surveillance. However, as regards strengthening of surveillance, we have come to a stage when we may have a multiplicity of tools, but there are still doubts about their effectiveness for a variety of reasons. The main issues of contention remain focused on improving “even-handedness”, “effectiveness”, reducing “intrusiveness”, and recognizing the “preventive” nature of Fund surveillance. I feel that the key challenge would be to effectively integrate bilateral, multilateral and regional surveillance mechanisms with a clearer focus on the end objectives. The recent findings of the McDonough Report and the Independent Evaluation Office (IEO) Report on Financial Sector Assessment Program (FSAP) and Multilateral Surveillance vindicate such a position. Furthermore, given the recent findings of the IEO Report on FSAP that about 20-25 percent of countries that are systemically important and/or have vulnerable financial systems have not been assessed, I stress the need for strengthening of incentives for systemically important countries to undertake FSAP while retaining the voluntary nature of FSAP.

11. Our view is that given the rapidly integrating global economy, issues of bilateral and multilateral surveillance essentially share a symbiotic relationship. The effectiveness of multilateral surveillance would thus 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 the global financial flows. In this context, I would like to flag two issues.

First, while we see merit in enhancing exchange rate surveillance, there is need for further technical work in the area of exchange rate determination with capital mobility so as to contribute to the debate and generate a broad consensus on the exchange rate issues. Given the sensitivity of exchange rates for emerging markets, the Fund has to balance its role as a confidential advisor on such issues. It would, therefore, be highly premature to consider publication of exchange rate assessments in the WEO.

Second, on the issue of integrating macroeconomic and financial market analysis, we feel that that the WEO should continue to remain as the Fund's flagship publication for multilateral surveillance along with the GFSR.

12. With respect to bilateral surveillance, we broadly agree with the Fund prescriptions for streamlining procedures and the adoption of a multilateral perspective and focus. However, the suggestion for realigning the Fund's traditional macro-oriented surveillance mechanism to place financial sector issues at the centre of the Fund's country surveillance needs to be judged from the right perspective. It needs to be recognized that there is a wide diversity in the level of development of the financial sector across Fund membership and a one-size-fits-all approach would not be appropriate. Hence, the content of financial sector analysis and the level of emphasis would need to be different for different countries or groups of countries. It is also important to ensure that, while bringing in the additional focus on the financial sector, the traditional rigor of macroeconomic analysis in Article IV consultations should not be diluted as this is the area of core competence of the Fund.

Fund's Role in EMEs

13. As alluded to earlier, we feel that the potential value of the Fund as a co-operative institution would depend on how efficiently it assimilates the changing aspirations of the fast growing EMEs into its structure of governance and functioning. We seek merit in the proposal for modification of the framework for high access contingent financing, but much would depend on the design of the instrument.

Fund Governance

14. We have always reiterated the position that the issue of voice and representation is critical for establishing the legitimacy of the governance structure of the IMF. It is regrettable that, while the relative weights and importance of different countries have changed in the dynamic global economy in a major way, the international community has not been able to revise the quotas of the IMF since 1998 which itself was done in an *ad hoc* manner. A two-stage process with an *ad hoc* increase is not consistent with the need for a comprehensive review and reallocation of quotas. By definition, a comprehensive reallocation of quotas to reinforce legitimacy cannot be achieved by a short-term *ad hoc* approach.

15. Mr. Chairman, in recent years, the international community is commending India's contribution to world growth and global stability. In this context, it will be difficult to satisfactorily explain how this can be reconciled with a decline in India's share of IMF quota implicit in the current proposal. Furthermore, I doubt that the legitimacy of the IMF will be enhanced if three out of the four much acclaimed BRIC (Brazil, Russia, India and China) countries get their quotas reduced, even if it is for a brief period. As regards the two stage procedure, it is being suggested by certain quarters that an agreed framework for the second stage would constitute a pre-requisite for the consensus regarding the first stage. However, it is clear that if an agreement on the basic framework at the second stage were possible now, the rationale for a two stage process would disappear. The Group of Twenty-Four (G-24) have in their latest communiqué expressed a strong preference for a comprehensive package that would deal with all the major issues simultaneously within a firm deadline. In this context, for moving forward, a firm prior political consensus is called for before launching a technical exercise.

Low Income Countries: Multilateral Debt Reduction Initiative (MDRI)

16. We note the progress in the implementation of the MDRI Debt Relief Initiative. Looking forward, a continuing Fund involvement in low income countries should broadly address all the outstanding challenges with emphasis on ensuring debt sustainability and supporting policies and institutions conducive to sustained private sector-led growth, trade and reduction in poverty. The MDRI debt relief needs to be complemented by an effective surveillance mechanism to monitor use of resources made available from the Fund. We view that the adoption of a country-based approach would be crucial in this respect.

Developments in the Constituency

17. Let me now turn to some key aspects of development in my constituency. **India's** real GDP grew better than anticipated at 8.1 percent in 2005-06. Despite the severe impact of global oil uncertainties, a judicious combination of monetary and fiscal measures has helped in anchoring inflation expectations and containing inflation at 4 percent. The current account deficit widened in line with the growth in investment demand in the economy and was comfortably financed as capital flows continued to remain buoyant. Financial markets were generally stable. The Indian Rupee continues to demonstrate adequate flexibility in response to global currency market developments. Despite large allocation to the social sector, the fiscal situation turned out better than expected. The outlook for 2006-07 continues to remain positive and the policy endeavour would be to maintain growth momentum consistent with price stability while being in readiness to act in a timely and prompt manner to evolving circumstances. We are committed to deeper and stronger fiscal correction and consolidation set by the Fiscal Responsibility and Budget Management Rules which auger well for macroeconomic stability.

18. **Bangladesh** maintained the growth momentum of over 6 percent in 2005. The current account of balance of payments posted a modest deficit of 1 percent of GDP despite the surge in international oil prices and strong import growth, It has been particularly reassuring that exports of ready made garments increased by 37 percent in 2005. The economic outlook for 2006 continues to remain positive. The positive per capita growth performance, aided by the beneficial impact of NGO social programs and broad-based micro-credit programs, have led to a significant fall in poverty levels. The authorities are focusing on the implementation of the remaining structural reforms.

19. **Sri Lanka's** economy has been performing strongly, despite the adverse effects of the tsunami. While GDP increased by 6 per cent in 2005, inflation has been brought down to single digits by March 2006. The balance of payments is in surplus and efforts are being made to contain the fiscal deficit. The economic vision of the government, as articulated by

the newly elected President in November 2005, is to promote a national economy in which the private and public sectors would co-exist in a complementary manner in a market friendly environment. A strong commitment is made for rapid and equitable development of all regions and to realize the MDGs.

20. **Bhutan's** pursuit of home-grown development strategy is yielding good results. While the economy registered a robust growth of 7 percent and low inflation of 5 -5.5 percent in 2005-06, the outlook for 2006-07 is even more promising with an expected growth rate of 18 percent. The fiscal position could turn to a small surplus and increased power exports are expected to reduce the current account deficit to under 3 percent of GDP.