International Monetary and Financial Committee

Fifteenth Meeting
April 14, 2007

Statement by Mr. Sergei Storchak
Deputy Minister of Finance of the Russian Federation
On behalf of Russian Federation

STATEMENT
by Mr. Sergei Storchak
Deputy Minister of Finance of the Russian Federation
at the Meeting of the International Monetary and Financial Committee
of the Board of Governors of the International Monetary Fund
Washington, D.C., April 14, 2007

1. The Global Economy and Financial Markets

The world economy continues to demonstrate a steady dynamism, even though the latest *World Economic Outlook* (WEO) predicts some slowdown of global growth in 2007 compared to the record year of 2006. We agree with the WEO authors that a moderate decline in oil prices and continued relatively low inflation along with comparatively benign conditions on global financial markets indicate the possibility of a soft landing for the global economy after a period of a rapid growth. While this possibility does indeed exist, there is also a possibility of negative developments. The current favorable period of global economic expansion seems “too good”, which carries the risk of complacency in both expectations and estimates. In this context we consider it appropriate to consider in more detail the global economic and financial risks noted in the WEO.

There remains substantial uncertainty regarding future developments in the **U.S. economy.** Like the WEO, we associate this with the apparent weakening of the U.S. housing market and its potential consequences. The range of possible scenarios stretches from merely a mid-cycle slowdown to recession. The WEO argues in favor of the most favorable scenario, but we see the situation as somewhat more disturbing given that the consequences of the unfolding crisis in the sub-prime mortgage segment are still unclear. Over the last two years the U.S. housing market has been performing as a financial pyramid, where exotic and easily accessible mortgages have been supporting a high level of demand and contributing to increases in house prices. In turn, the possibility of servicing these mortgages was based on the assumption of continued appreciation of house prices. Now that these prices have stopped growing, there has been a sharp increase in the number of foreclosures and the entire scheme has begun to unravel in the opposite direction. For now it is not clear how all this will end, but there is a risk the crisis in the sub-prime segment may spill over to the broader credit market and thereby have an effect on the overall level of demand.

One of the risk factors mentioned in the WEO is **inflationary pressure in the advanced economies**, which may eventually require that short-term interest rates be raised. We find this interpretation of inflationary risks to be ambiguous. Higher interest rates may indeed have a negative impact on demand and thereby lead to a slowing of growth. Low interest rates, however, have their own drawbacks as well, as they pump up global liquidity and create risks in the financial sector. Near-zero interest rates in Japan, for example, have turned that country into a powerful source of global liquidity via the mechanism of the so-called "carry trade," which is a commonly recognized risk factor for global financial markets. It seems to us that for now it is difficult to say which represents the greater risk to the global economy: a premature decline in interest rates (especially in the U.S.), which will lead to a new round of expanding global liquidity, or rate increases needed in order to overcome inflationary pressures.

Oil prices remain a source of risk due to the tight balance between supply and demand. Under these conditions splashes of geopolitical tensions lead to price volatility. Nonetheless, we are convinced that the trend toward price increases observed over the last few years is not associated with breakdowns in supply but rather with the rapid growth of demand, especially on the part of the quickly growing emerging market economies.

Global imbalances have become so customary that they have almost ceased to attract attention. The latest WEO notes that the risks associated with global imbalances are of "low probability but potentially highly disruptive." It is assumed that in the foreseeable future a significant (about 6 percent of GDP) U.S. current account deficit will be maintained and it will be externally financed fairly smoothly. This said, the growing sensitivity of inflows to returns on U.S. assets is, indeed, acknowledged.

We see that thus far global imbalances have not led to any negative consequences for the global economy. We doubt, however, that imbalances may be maintained for a prolonged period of time. Global demand for U.S. debt cannot be sustained indefinitely, especially if there is deterioration in the quality of U.S. assets offered for sale, as has happened, for example, in the case of assets based on exotic mortgage schemes.

The risks associated with the **stability of the global financial system** are potentially the most dangerous and at the same time the least understood. The existing risks have been described repeatedly, including in the latest *Global Financial Stability Report* (GFSR). These risks include the aforementioned global imbalances, and also abundant global liquidity, in part due to carry trade and the swelling of credit as a result of the appearance of new financial instruments and the accumulation of petrodollars. The consequences of an abundance of liquidity are underestimation of risk, price inflation for all types of assets (stocks, bonds, including sovereign bonds, housing, artworks, and other luxury items), and a decline in the quality of a number of debt instruments. The GFSR justifiably notes that sophisticated and liquid financial derivatives may behave unpredictably under stressful market conditions.

The paradoxical nature of the situation is that financial market participants are ignoring all these risks and storm warnings. The two most recent episodes associated with a correction and a sharp increase in volatility on financial markets (May - June 2006 and February - March 2007) turned out to be short-lived, after which risk tolerance and pursuit of any yield-bearing assets reasserted themselves with new force. From this one may conclude that either a golden age of low risk, cheap credit, and unlimited liquidity has established itself in the financial world, or a much more serious correction is about to occur. The Fund's reports mention the existence of a third path – a soft landing – where financial risks are worked out gradually, slowly, and painlessly. Time will demonstrate, however, to what extent such a scenario is realistic.

2. Strengthening Surveillance

We do not object to amending the 1977 Decision on Surveillance Over Exchange Rate Policies to make the new text reflect the modern concept of surveillance objectives and practices. Any such revision should not, however, create new obligations for Fund members. In addition, we believe that the revised text should also include multilateral surveillance so that all types of surveillance are covered in a single document. Revision of the 1977 Decision will help clarify the system of strategic priorities in surveillance. Furthermore, the triennial reviews of the Fund's surveillance activities also allow for timely adjustment of surveillance objectives. Under these conditions the creation of one more surveillance mandate (a remit) is unnecessary insofar as it gives rise to more questions than it answers.

We are not yet ready to assess the results of the first round of multilateral consultations on the subject of global imbalances. We also have doubts about the proposal to hold a new round of consultations aimed at studying the impact of financial globalization on economic growth and financial stability. First, we do not understand why only a small group of countries should participate in discussions on such an important topic. Second, that subject is already the focus of attention of a number of international fora. If additional work is needed in this area, then it should be directed at coordinating the efforts that are already underway and defining more clearly the role of the IMF.

We support concrete measures to integrate the analysis of capital markets and financial sector developments into the list of issues being discussed during Article IV consultations. Implementation of that initiative will, however, require significant additional resources and, accordingly, relevant decisions on the Fund's budget and financing.

At the same time, we are disappointed with the so-called streamlined Article IV consultations, whereby country reports are so curtailed that the IMF becomes unable to adequately fulfill its surveillance mandate, particularly with respect to those countries that are undergoing radical changes and are in need of a comprehensive dialog with the Fund.

We consider the strengthening of regional surveillance to be one of the Fund's most successful initiatives, including the preparation of regional economic reports. One more very important initiative would be the publication of Fund materials in the languages other than English, which would make the Fund's work accessible to a far wider audience.

3. Other Elements of the IMF's Medium-Term Strategy

a. Securing Sustainable Financing of the Fund

We are grateful to Mr. Crockett and his colleagues for their substantive report and their sensible proposals for putting the Fund's finances on a sustainable footing. We are willing to discuss these proposals and we call upon the Fund's management and the Executive Board to intensify their efforts in this area. A prolonged period of uncertainty concerning the ways of financing the Fund's expenditures is having a negative effect on the

IMF staff morale and also is hampering the recruitment of highly-qualified staff. Therefore any delay in addressing this issue is not in the interests of the Fund.

b. IMF Quotas and Voice

We have been following closely discussions on quotas at the Executive Board. The stakes here are very high, given that the Fund's legitimacy in the eyes of the international community will depend on the final decision on this issue. Unfortunately, the discussions that have taken place thus far centered on a formula that possesses all the same shortcomings as the old set of five formulas. I would like to remind all participants in the discussion that sooner or later the Fund will have to explain to the international community the new rules for determining quotas. And how can such a formula be explained? Why use exactly those variables? Why use those specific weights? How to prove that this is not a manipulation? This is why we continue to believe that we do not need any formula and that the most simple and transparent way of quota calculation would be on the basis of the blended GDP indicator incorporating GDP measurements at both PPP and market exchange rates.

c. Role of the IMF in Emerging Market Economies

In recent years the emerging market economies have undergone great changes. They have been implementing much more sound macroeconomic policy and have achieved great success in their development. Moreover, many of them have taken advantage of favorable external environment to reduce public debt and accumulate foreign exchange reserves. Nonetheless, some of these countries are interested in obtaining access to Fund resources as a source of liquidity in unforeseen circumstances. We see the proposal to create a new facility – the Reserve Augmentation Line (RAL) – as a way of meeting that interest. The new facility will address the shortcomings of the earlier Contingency Credit Line (CCL), which was supposed to address approximately the same set of objectives but was never requested. The key element here will be provision for automatic access to Fund resources over a sufficiently long period of time. Nonetheless, only time will tell if there will be demand for this new instrument.

d. Role of the IMF in Low-Income Countries

In its work with low-income countries, over the last decade the Fund has increasingly been drawn into activities that in essence represent development finance. In other words, the Fund has been engaged in the provision of concessional long-term credits, which does not in any way correspond to its mandate to ensure financial stability. Currently this practice is increasingly subject to criticism. In particular, the report of the international group headed by Mr. Malan on collaboration between the IMF and the World Bank proposes that the Fund stop providing development finance and concentrate on issues of current macroeconomic management and ensuring financial stability in low-income countries. We have always supported this approach. We also believe that the Fund should continue to work on improving its methodology for analyzing debt sustainability and disseminate its results to all creditors in order to prevent low-income countries from the repeated accumulation of excessive debt.

e. Report on IMF-World Bank Collaboration

We would like to express our gratitude to Mr. Malan and his colleagues for their substantive report, in which we found many useful recommendations for strengthening IMF-World Bank collaboration. We agree with the need to monitor the quality of collaboration at the level of the executive boards and we call upon the management of the IMF and the World Bank to prepare specific proposals for implementing the recommendations of the report. In autumn we could approve a new conceptual framework for collaboration between the Bretton Woods Institutions.