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INTERNATIONAL FINANCE CORPORATION
INTERNATIONAL DEVELOPMENT ASSOCIATION
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Statement by the Hon. **ALEKSEI KUDRIN**,
Governor of the Bank and the Fund for the **RUSSIAN FEDERATION**,
at the Joint Annual Discussion

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1. The Global Economy and Financial Markets

We welcome the continuing strong growth of the global economy but, at the same time, we note increasing uncertainty. On one hand, the relatively high growth rates in the environment of subdued inflation is the evidence of the enhanced resilience of the global economy, even at a time of soaring oil prices. On the other hand, the continuation of the current trends is leading to a further deepening of global current account imbalances against a backdrop of remaining wide growth divergences across regions. One cannot help but be concerned that further development of the global economy on the basis of the prevailing patterns is increasing the risk of a disruptive adjustment.

Much that has transpired recently in the global economy and on the financial markets is difficult to explain. In a high-demand environment, long-term interest rates remain at record low levels. Exchange rates have recently been changing in the direction opposite to the one, which is necessary for a gradual easing of global imbalances. Over a number of years, accommodative monetary policy and the associated increase in liquidity have not led to higher prices of goods and services, but rather to significantly higher asset prices, including housing. The only macroeconomic indicator that is behaving in an explicable manner is the world price of oil, whose ascent reflects mostly a substantial increase in demand in the face of limited possibilities for raising supply. Under these circumstances the price of oil is becoming the main indicator of overheating of the global economy.

Today the global economy is far less sensitive to changes in oil prices than it was during the oil crises of the 1970s and 1980s. However, further increase in oil prices could lead to a considerable deceleration of global growth. In this connection much is being said about the need for increased investment in oil exploration, extraction, and refining in order to significantly boost future supplies of petroleum products to consumers. While we do not dispute the importance of the above-mentioned measures, we note, however, that there exist substantial opportunities for stabilizing the oil market through raising its efficiency, including on the basis of increasing its transparency. Additional measures can also be adopted to reduce demand. In particular, possibilities include decreasing or eliminating subsidies for consumption of petroleum products, and increasing their taxation in countries where the level of consumption is especially high.

We welcome new IMF research on global imbalances which has allowed to make a number of interesting conclusions.

First, the greatest impact on the easing of global imbalances over the short-term may come from the depreciation of the U.S. dollar relative to Asian currencies, while over the medium-term it may come from a substantial reduction in the U.S. budget deficit. Moreover, the impact of structural reforms in Europe and Japan on adjustment of global imbalances is found to be rather limited over the entire period of analysis. Such assessments permit to rank the individual components of the cooperative strategy by their importance and thus pay more attention to those components that may have the greatest impact.

Second, the analysis of the dynamics of global savings and investments demonstrates that current account imbalances are a mirror reflection of the gaps between savings and investments across different regions. Thus, there is a correspondence between the sharp drop in savings in the U.S. beginning in the late 1990s and the trend toward decreased investments in East Asian countries (other than China) observed in the same period. Therefore, the traditional recommendation to increase U.S. savings is supplemented by a new proposal to raise investments in Asian countries (other than China) and in oil exporting countries. It is recommended that the latter, in particular, spend a larger part of their growing revenue from oil exports on increasing their investments, and that they boost expenditures in areas where social returns are high. It appears, however, that the optimum balance between saving and spending of oil revenue should be determined by the economy's absorption capacity, as well as by a clearer understanding of the degree, to which the observed increase in oil prices is a permanent rather than a temporary phenomenon.

Returning to the issue of global imbalances, we would like to note that one obstacle to the implementation of the cooperative strategy for addressing them is associated with the need for all contributors to this strategy to accept certain short-term losses, for example, in growth rates. The voters and business communities should consent to these losses for the sake of the long-term benefits not so much for their own countries but for the global economy as a whole, which makes such a strategy difficult to implement from a political standpoint. This situation once again demonstrates the increasing tension between the growing integration of the global economy and the continuation of economic management at the national level.

The situation on the world financial markets continues to be benign in the sense that low interest rates and decreasing credit risk premia are providing a beneficial financing environment for the official sector, corporations, and households. Cheap financing, however, leads to the underestimation of risks and the accumulation of excessive debt, a situation that may subsequently turn into a financial crisis. The Fund's *Global Financial Stability Report* underscores the duality of the prevailing situation, and suggests that the same developments occurring on the financial markets simultaneously can be favorable over the short-term but also be connected with the growing vulnerability of the global economy over the medium-term. It seems to us that such an assessment of the current situation is somewhat complacent in light of the steadily growing risks of a disruptive adjustment on the financial markets.

2. IMF Objectives and Medium-Term Strategy

The development of the Fund's medium-term strategy continues to be one of the priorities for the institution. In this regard we welcome the IMF Managing Director's new report on this issue and endorse most of his proposals.

Globalization can be viewed as the main factor in determining the Fund's objectives for the future and may serve as a basis for the elaboration of the Fund's medium-term strategy. Globalization is associated not only with new opportunities but also new risks. Therefore, the Fund's activity should be oriented towards helping its member countries avail themselves of the new opportunities, on one hand, while preparing themselves for the new risks, on the other.

We agree that it is necessary to place more emphasis on the research of the long-term consequences of globalization. We believe that such research would be of great value, especially if it includes alternative scenarios for the development of the international financial system.

In addition, it is necessary to conduct a deeper analysis of the financial markets, *inter alia* the financial markets of individual countries. The objective is to include sections on the development of the financial markets in the majority of Article IV reports. This will require inclusion of financial sector experts into the Fund's country missions.

We also have no objection to the proposal for a more active participation of the Fund's country missions in public discussions on economic policy in member countries. In Russia, press conferences held by the head of the Fund's mission on the outcome of economic policy consultations have already become standard practice. Such press conferences always attract great interest and are reported widely in Russia's mass media.

Finally, we support the proposal to expand research on a set of issues concerning capital account liberalization. We note that the number of countries embarking on capital account liberalization is constantly increasing. In this respect, it is very important that the Fund has the ability to provide high-quality technical assistance to such countries since the alternative for them would be to learn from their own mistakes.

3. Strengthening IMF Support for Low-Income Countries

We call on all Fund and Bank members to support the G-8 proposal for a full cancellation of the debt owed to international financial institutions by the countries-beneficiaries of the HIPC Initiative. For many of them this will substantially ease the burden of servicing their external debt, which will help them free up additional resources for development purposes.

We believe that the implementation of the G-8 proposal will not undermine the Fund's and Bank's overall financial integrity. At the same time, given the decline in resources that will be available to these organizations for financing low-income countries, their ability to continue their mission in those countries will depend on the donors' ability to deliver on their commitments to finance the initiative. We are prepared to work on this issue and hope that all the necessary measures will be taken to ensure adequate financing of the Fund's and Bank's operations in low-income countries.

We believe that to be eligible for debt cancellation under the G-8 proposal, countries that have reached the completion point under the HIPC Initiative should continue to fully service their debt up until the cancellation point, and avoid serious lapses in economic policy management and the quality of governance. At the same time, we think that there is no need to introduce additional conditionality since this would complicate the implementation of the initiative.

It is unlikely that those countries that are going to benefit from debt cancellation will refrain from future borrowing from the international financial institutions. In this connection, it is important to ensure that the precedent being created will not be repeated. In order to prevent the emergence of a "lend and forgive" cycle, the Fund and the Bank should devote special attention to monitoring debt sustainability indicators in low-income countries.

4. Aid Financing and Aid Effectiveness

Improving the quality of aid could raise the effectiveness of development assistance even at constant aid levels. It is clear however that the existing structure of aid flows is not optimal, and its continued replication would not bring us nearer to achieving the MDGs.

At the same time we would like to caution against a simplistic view of what would constitute an improvement in the structure of aid. For example, we believe it would not be useful to equate it with an increasing share of budget support. Direct budget support is only justified when we can be sure that recipient countries have adequate capacity to use these resources effectively, in terms of both sound public resource management and maintaining reasonable macroeconomic framework. An important aspect of this decision is the distribution of aid flows between investment and consumption as well as between productive and social sectors.

We welcome the progress achieved in developing new mechanisms of aid mobilization, in particular in the area of vaccines. We are however cautious with respect to such proposals as introducing airline ticket surcharge in some countries. At the same time we would like to point out that any such proposal would be much more effective if it played the dual role of mobilizing resources for aid and rectifying structural imbalances in international trade that prevent the developing countries from taking full advantage of the international division of labor. In this context it could be useful to discuss the feasibility of linking additional voluntary contributions to development assistance to the level of agricultural subsidies in industrialized countries.

Focusing on tangible and measurable results is a major instrument of enhancing aid effectiveness. We welcome the Bank's efforts in this area. However, given the complexity of this issue, the Bank must make sure that these efforts do not lead to additional bureaucratic procedures, delays in project preparation or any other negative developments that could undermine the recent trend of containing the costs of doing business with international development institutions.

As regards the problem of donor coordination, we believe that the best way of overcoming it would be to channel an increased share of external aid through multilateral agencies, such as IDA.

PRGF programs continue to be the backbone of IMF assistance to the poorest countries. At the same time we hope that over the time more and more of these countries will be able to do without IMF financing, and with this view we support the new Policy Support Instrument.

5. Strengthening the Development Partnership and Financing for Achieving the MDGs: an Africa Action Plan

We welcome the fact that the international community is paying increasing attention to the task of development in Africa, and we also share the general concern that Africa is off track to achieve the Millennium Development goals. In this connection we strongly support World Bank's Africa Action Plan that forms an integral part of recent international initiatives to spur development in this region.

We note with much satisfaction the recent shift of emphasis towards greater reliance on economic growth as the main engine of lifting these countries out of poverty, a change in attitude that Russia has been advocating for some time. We believe it is time to identify development paradigms that could realistically put Africa on a better growth trajectory. Successful examples in South-East Asia and Latin America suggest that such paradigms should be based on building a socially oriented industrial society with massive job creation. Needless to say, increased labor productivity should be the cornerstone of this model. In this respect it is particularly instructive to reflect that labor productivity in Africa has been falling for the last 50 years.

Against this background we particularly welcome the renewal of attention to investments in infrastructure, a topic that has been neglected by the multinational institutions for too long. We are happy to see that the Plan envisages doubling infrastructure investment in Africa, which can form an important step on the road towards self-reliant growth. In practical terms this would mean investing up to 20 billion dollars a year in African infrastructure projects, up from the current level of about 10 billion a year. We hope that the bulk of the promised increase in aid to Africa will go towards improving the continent's productive potential, because otherwise we risk wasting this historic opportunity.

6. Infrastructure and the World Bank

We are particularly gratified to see World Bank's efforts in the area of infrastructure financing. It seems that only recently the primacy of infrastructure financing for development seemed debatable; yet today, this idea once again enjoys global support. One important example of this shift is that Africa Action Plan gives priority to infrastructure financing.

The Bank could make important progress in the area of infrastructure financing by focusing its efforts on developing mechanism for sub-sovereign support without the sovereign guarantee. Clearly, instruments of such support should be used sparingly, only where institutional and macroeconomic conditions are adequate. This sub-sovereign support could be particularly useful for large countries in their efforts to improve fiscal federalism, and could fit well with the ongoing global trend towards urbanization and growing role of major urban conglomerations in sustaining economic growth.