Statement by Governor Dr. Y.V. Reddy at IMFC Meeting*

The Global Economy and Financial Markets

Outlook, Risks and Policy Responses

There have been several welcome developments in the global environment since we met in last April. To our relief, several uncertainties relating to Iraq war, impact of SARS and volatility in oil prices have turned out to be short-term and transitory in nature. Hostilities in Iraq have ended earlier than expected. Reflecting the cessation of hostilities, oil prices reverted back to lower levels although they have rebounded somewhat thereafter. The impact of SARS has also been successfully contained. Financial markets, which were in a state of flux, especially equity markets, have also rebounded in many countries. Interest rates in several countries have continued to decline to historically low levels. With the receding global risks, financing conditions for the emerging markets have eased considerably and spreads for many countries have declined significantly. Despite these favourable developments, the world economic outlook continues to be fragile and weighed down by downside risks. Labour market conditions continue to be soft. Data on industrial production and trade growth indicate marked slowdown. Rise in oil prices in the recent weeks is also worrisome. Investment activity in major industrial countries is yet to show a decisive turnaround, although it is heartening to note that signs of pick-up in growth in the US are discernible, of late.

During our last meeting in Washington, it was expected that the global recovery could resume in the second-half of the year if the war in Iraq was short. While the growth performance of the Asian region, the Middle East, CIS countries, the African countries and the Latin American countries has shown resilience, in view of the lack of sustained recovery in the industrialised countries, several new uncertainties have arisen. It is not clear as to what extent the US dollar would depreciate and how the global economy would adjust to that. It is difficult to say as to how and when global macroeconomic imbalances would get corrected. Low inflation combined with weak global recovery has increased the risk of deflation in several industrial countries.

While faster global recovery may be the immediate global concern, there is also a need to address the structural issues so as to place the global recovery on a sustainable path. In spite of large cross currency movements, misalignments continue to persist in the face of the continued global imbalances. In this context, further easing of monetary policy and stronger structural reforms in the euro area have assumed critical importance. Despite the limits set by the Growth and Stability pact on the permissible extent of fiscal expansion, cyclical expansion may be fully allowed, at least, to neutralise the impact of shortfall in revenue realisation in the face of an economic slowdown. If the sources of global growth are not diversified across regions and if countries continue to rely on the US demand to increase their exports and thereby grow faster, the case for US depreciation would become stronger. Rebalancing of growth dependence, therefore, would be critical to contain volatility in key exchange rates.

Several emerging market economies have been contending with the challenge arising from current account surpluses and pressures on the exchange rate to appreciate. Large reserve accumulation by some Asian emerging market economies, in a way, reflects their lack of confidence in the international financial architecture. The improved reserve position of emerging market economies will surely provide “self insurance”, giving the necessary flexibility for exchange rate management. As the duration of the global slowdown becomes more prolonged, fiscal and public debt problem of many countries could intensify further. Fiscal adjustment, though necessary, would have to be weighed carefully and is best calibrated with the pace of global recovery.

Against the backdrop of several adverse developments including severe drought, uncertain global environment and considerable hardening of oil prices, the Indian economy performed reasonably well during 2002-03. The growth rate of the Indian economy at 4.3 per cent, though lower than expected, was one of the highest in the world. This indicates the growing resilience acquired by the Indian economy over the years. With a good monsoon so far this year, a strong recovery in agricultural output is expected. The output for the industrial sector is expected to be reinforced by the renewal of agricultural activity, the abiding strength of export growth and the improved environment for new investments as indicated by a surge in the production of capital goods and non-oil imports. Overall, the economy is expected to perform much better in the current year. The growth process would be facilitated by benign inflationary conditions, adequate liquidity coupled with soft interest rates and strong external sector. As a result of various structural reforms, the Indian financial system is increasingly becoming more sound, stable and efficient. The overall policy environment has fostered macroeconomic stability, and generated optimism regarding the medium-term. The main challenge in macroeconomic management today is reducing the high fiscal deficit and an improvement in the quality of fiscal adjustment. The recent enactment of the Fiscal Responsibility and Budget Management (FRBM) Act is a step in this direction, which will put in place the institutional structure for greater transparency in fiscal operations as well as a phased decline in the Central Government’s borrowings. This will “crowd in” private sector investments for the achievement of self-sustaining, accelerated growth.

Sri Lanka has entered into a new phase of social and economic revival with the return of peace and a wave of new economic reforms. Progress is being made towards consolidation of macro economic stability and acceleration of economic growth. Such policies are being complemented under the Fund/Bank supported PRGF/EFF and PRSC programs. The economy of Sri Lanka is expected to grow by 6 per cent this year and inflation is on a declining trend. External reserve position has also improved. Economic prospects having improved significantly, investor confidence has been growing.

The approval of the PRGF for SDR 347 million for Bangladesh in June 2003 is a satisfying event this year. The country is expected to improve upon its already better economic performance, continue strengthening of external sector and make further progress towards structural reforms particularly addressed to poverty alleviation. The country has developed a competent and laudable economic management. The Fund guidance on reforms in a number of areas has been extremely valuable.

It is refreshing to see increasing recognition being paid to the non-quantifiable but a critical factor to the Bhutanese development goals *viz.*, Gross National Happiness (GNH). Factoring GNH, at least implicitly, as an objective of IFIs, could be explored.

Importance of the Doha Development Agenda

As one of the founding members of the GATT (1947) and the WTO (1995), India remains firmly committed towards the multilateral approach to trade relations. India is committed to ensure that the sectors in which developing countries enjoy a comparative advantage are adequately opened up to international trade. The November 2001 declaration of the Fourth Ministerial Conference in Doha, Qatar, provides the mandate for negotiations on a range of subjects. The progress so far has been reviewed at the recently concluded fifth Ministerial Conference in Cancun, Mexico. The conference reflected the diversity of views and positions, particularly in relation to agricultural subsidies and the Singapore issues.

We believe that once the concerns of the developing countries are adequately reflected in the discussions, it will pave the way for rapid development in multilateral trading environment. In the context of developed countries there is a need for reduction of high tariff and subsidies to agriculture, providing effective market access, facilitating trade in services, and, whenever necessary, giving effect to the clauses extending "Special and Differential treatment" to developing countries in the implementation of these WTO Agreements. There is little doubt that potential gains from free and equitable multilateral trading system far outweighs the costs, and, therefore, it is of utmost importance that the international community endeavour to reach a mutually agreed agenda within the WTO framework.

Strengthening IMF Surveillance and Promoting International Financial Stability

Enhancing economic performance, resilience to crises and financial stability through IMF surveillance

A major initiative towards preventing crisis has been enhancing the effectiveness of surveillance, and incorporation of a fresh perspective to the Fund's analysis and policy recommendations. Considerable work has already been done with a view to preventing crisis, including the emphasis on public and external debt sustainability assessment, analyses based on financial soundness indicators (also known as Macro-Prudential Indicators) and balance-sheet weaknesses, preparation of ROSCs and reporting of political economic issues in the staff report. However, several more steps are required to improve the efficacy of the surveillance mechanism. First, the vulnerability assessment exercise for the emerging market economies needs to be improved. Secondly, early warning system models today are far from perfect and suffer from high false-to-signal ratios.

As regards strengthening of surveillance, we have come to a stage when we have all the tools available, but there are still doubts about their effectiveness for a variety of reasons. We should recognise that origins of crises in the past were also in the industrial countries and advanced financial centers leading to sudden capital flow reversals. While markets have started to learn to discriminate among countries, there is still a long way to go. Therefore, in surveillance, the Fund has a significant role in building confidence of both borrowers and lenders, which is important for an orderly market behavior. We are indeed happy to note that the Management has proposed an even handed approach to the Fund's surveillance in this regard. Secondly, the fundamental question relating to Fund's surveillance is what purpose it serves and to whom it is meant for. The objective is no doubt to identify vulnerabilities and pre-empt crises from occurring or minimising severity of such crises, when they occur. Some clarity and transparency about the target of surveillance would be in order. In this respect, the Fund has to take a view on whether the Fund's assessment is meant for national governments in its role as a confidential advisor, or for the market players who in any case rely on alternative avenues for assessing publicly available information. It needs to be mentioned that immediate market reactions to sensitive information may have serious implications on members' efforts to address a problem in hand or their plans for addressing an impending crisis. Our view is that the Fund should preserve its role as a confidential adviser and the Fund's assessment should be to help national authorities in reducing the recognition lag and recommending measures that could help in containing vulnerability. However, we are not opposing the dissemination of relevant information giving due consideration to the specific circumstances that members and the Fund are dealing with.

The Role of the CCL and precautionary arrangements in Crisis Prevention

The Contingent Credit Line (CCL) was expected to play a critical role to serve as a precautionary line of defense, reducing vulnerability and bolstering investor confidence in eligible emerging market economies. Unlike other existing Fund facilities, the objective behind CCL was to prevent crises by making available adequate liquidity upfront to a member with sound fundamentals so as to deal with the pressure of contagion. CCL, however, has not been used by any member so far because of a number of concerns, including: (a) the entry problem – *i.e.* the fear that access under CCL would convey a negative signal to the market, (b) the exit problem- *i.e.* the uncertainty about the withdrawal of eligibility, (c) insufficient automaticity, and (d) stringent pre-qualifying norms. The very fact that no country has so far requested the Fund for using CCL resources suggest that it did not serve the intended purpose and it should be allowed to expire in November 2003. While we support the option of allowing the facility to expire, however, if there is a distinct possibility of evolving workable strategies in the near future, we are willing to go along with a consensus for further review.

The existing precautionary arrangements could be suitably modified so as to enhance the capacity of the members to prevent capital account crises. We suggest that since the objective behind a modified precautionary arrangement is to prevent a capital account crisis, the access limit under the first purchase must be large (*i.e.* a top-down staircase pattern of disbursement rather than the present bottom-up staircase pattern) and the performance criteria must be relevant to deal with a capital account crisis (implying less emphasis on conventional performance targets and complete avoidance of the sawtooth problem). Since the IMF would endorse the policy framework of a country before entering into a precautionary arrangement, repeated programme interruption and subsequent granting of waivers would need be avoided. Overemphasis on "safeguarding Fund resources" would reduce the effectiveness of a precautionary arrangement by subjecting the programme to performance criteria that would not be critical to deal with the capital account crisis.

Progress with Crisis Resolution Initiatives

Efforts are also underway to develop Collective Action Clauses (CACs) to augment a market-led process for restructuring of sovereign bonds. It is heartening to note that rapid progress has been made in promoting the inclusion of CACs in international sovereign bond issuances.

We welcome the positive developments relating to the development of a voluntary Code of Conduct to deal with debt restructuring . We urge that the Code should be developed in full and voluntary agreement of creditors and debtors and neither a mechanistic nor a prescriptive or standardised approach should be followed.

In recent years, increasing attention has been accorded towards development and implementation of standards and codes to strengthen the international financial architecture. The IMF and the World Bank have taken the initiative to monitor and assess member countries' financial sectors as also their observance of standards and codes through Reports on the Observance of Standards and Codes (ROSCs). In future, ROSCs will help national authorities develop their own reform plans, assess compliance with international standards and codes, and serve, if published, as a signal of their policies' enhanced transparency. They will also provide helpful inputs for IMF surveillance and technical assistance.

Accelerating Poverty Reduction and Strengthening Sustainable Economic Growth in Low income countries

Millennium Development Goals, the Monterrey Consensus, and progress with the PRSP approach: the role of the IMF

Monterrey has generated consensus on the issues that need to be addressed to effectively alleviate poverty. This consensus needs to be transformed into concrete action urgently. A comprehensive and transparent system to monitor progress towards fulfilling the Millennium Development Goals (MDGs) of poverty reduction, sustained economic growth, and promotion of sustainable development would need to be developed. The IMF has attempted to achieve this through two programmes- the PRSP and the HIPC initiative. The PRSP has been instrumental in addressing medium term policy reforms to promote broad-based growth and reduce poverty. The initial experience with PRSP approach underlined the need for (i) improving public expenditure management (PEM) systems, (ii) building capacities for monitoring and evaluation, and (iii) strengthening and institutionalising participatory processes. There is a need for working with other donors for improving the effectiveness of aid in these countries. A strengthened PRSP approach will certainly emerge as the crucial link between national public accounts, donor support, development outcomes needed to meet the MDGs, the operational basis for Fund concessional lending and for debt relief under the Enhanced Heavily Indebted Poor Country (HIPC) Initiative.

While an important constraint in improving low-income countries' economic growth is inadequacy of finance, this problem could be mitigated by ensuring their access to the private capital also. Institutional change along with appropriate economic policies are most critical. Strong institutions could provide necessary support that cuts across level of economic development, country grouping, and geographical and historical endowments. However, there are genuine uncertainties surrounding as to what constitute an appropriate institutional reform agenda. Keeping in view the country-specific imperatives, it is felt that case-by-case study could be the preferred approach to initiate institutional reforms. This would allow appropriate innovation and adaptation to suit the local conditions.

Minimising Vulnerability to Exogenous Shocks

The role of Fund Assistance for countries facing exogenous shocks can hardly be overemphasised, given the fact that these shocks can have negative impact on developing countries' growth, macroeconomic stability, debt sustainability and poverty ratios. The impressive gains made by developing countries in recent years can be considerably eroded when they face such exogenous shocks. It is a welcome step on part of the Fund to include a systematic focus in Surveillance and fund assistance programmes towards tackling the adverse effects of exogenous shocks, with a view to reducing response delays. Also welcome is the recent initiatives to strengthen existing instruments with the Fund, e.g., Emergency Natural Disaster Assistance, Compensatory Financing Facility (CFF), Stand by credit tranches, and augmentation of PRGF programmes.

We believe that there is a clear need to establish a broad menu of instruments, and apply the appropriate instrument depending on the nature of the shock, based on country-specific requirements. Sufficient flexibility is needed on part of multilateral agencies to meet the financing and adjustment needs of low income countries affected by exogenous shocks. Enhanced financing may be warranted depending on the intensity of shocks.

Progress with the HIPC Initiative

The HIPC initiative has existed for some time, with the prime motive of alleviating the unsustainable external debt burden of low income countries. Despite a commendable coordinated programme of various multilateral/ bilateral creditors, HIPC initiatives faced difficulties due to inadequacy of resource, global economic slowdown, delay in implementation of policy reforms in highly indebted countries, and litigations by non-participating creditors for recovery of dues. There is a critical need for recognising country specific constraints and work out an agenda for reducing the debt burden of HIPC countries. However, debt restructuring in these countries must look beyond outright write-off of debt and explore innovative measures such as debt-equity swaps, use of export proceeds to donor countries to retire debt, and stepping up investment opportunities in these countries.

Progress Reports

IMF Quotas and Governance

Recent measures to increase administrative and technical support to the Executive Directors of the developing and transition countries are welcome. However, the present quota formulas do not reflect a position that is truly representative of a country's profile in the world economy. Despite increasing recognition of this fact, the consensus to bring about the required reform continues to elude us. We, therefore, believe that the responsibility rests primarily with the developed countries who, as the majority shareholders, must demonstrate the will to reform the international financial architecture in line with the changed realities.

The quota review exercise in future should ensure adequate, equitable and appropriate representation of developing countries. Such a broader representation of the developing countries would enhance the acceptability, ownership and effectiveness of the IMF's programs and policies. While arriving at the quotas, the GDP must be computed on a PPP basis, as this is a more representative measure to define the relative position of a country in the world economy. Lack of data availability has often been cited as one of the significant hurdles to the adoption of the PPP based approach. We suggest that the Fund should work on how this deficiency could be satisfactorily addressed.

Combating Money Laundering and Financing of Terrorism

The Indian government vehemently opposes all forms of terrorism and all activities abetting it. We fully endorse the UN Security Council's Resolutions on combating the financing of terrorism (CFT). We restate our commitment to fight against the abuses of the financial system, including money laundering and terrorism financing. In India, we have already enacted a comprehensive Prevention of Money Laundering Act and there exists adequate legal and institutional framework to address ML&FT. We commend the Fund, the Bank, as well as all member countries, for the adoption of a comprehensive single assessment methodology for AML/CFT. Cooperation among FATF, IMF, World Bank and other multilateral institutions will ultimately lead to more efficient use of resources and a better co-ordination of the policies, taking into account country-specific problems for combating this menace.

While we would like to await the full report of the pilot program for detailed evaluation and discussion of the future road map, we have noted the observations made in the MD's report that the assessments completed or underway reveal not only a great deal of priority attached to meeting international standards by authorities but also a wide range of compliance levels.

In the countries in my constituency, adequate legal and institutional frameworks to address the money laundering and financing of terrorism are in place. In India, this has been further strengthened by enacting a comprehensive Prevention of Money Laundering Act. This Act had factored in the relevant portions of the FATF-40 recommendations. India, an active member of the APG (a FATF-style Regional Body), has completed and sent in FATF's Self-Assessment Exercise on the Eight Special Recommendations. Membership of FATF is in an advanced stage of processing with the FATF Secretariat. In order to strengthen international cooperation, exchange of information and outreach, India is also in the process of upgrading its Economic Intelligence Bureau into a full-fledged FIU. We had attended the last two plenary sessions of the Egmont Group with Observer status.

Independent Evaluation Office

The establishment of an Independent Evaluation Office (IEO) in July 2001 by the IMF marks an important step towards enhancing the transparency of activities and economic policy formulations. IEO has produced extremely insightful reports on the IMF's role in the recent capital account crises and fiscal adjustment in Fund supported programs, providing objective assessments of arguably some of the most controversial and contentious issues related to the functioning of the Fund. We are impressed by the iterative process by which the IEO continues to improve upon the quality of its work, and the Fund, particularly the Managing Director is responding to suggestions and benefiting from them.

*** Delivered as an Alternate Governor of the International Monetary Fund (IMF) to the International Monetary and Financial Committee Meeting at Dubai, United Arab Emirates on September 21, 2003.**