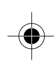


*Statement by Dr. D. Subbarao, Alternate Governor at IMFC, Washington D.C.**

1. The IMFC meets today in extraordinarily complex and challenging times. The financial crisis became full-blown in the second half of 2008, and has morphed through negative feedback to real activity, plunging the global economy into the deepest recession since World War II. What started off as a sub-prime crisis in the US housing mortgage sector has turned successively into a global banking crisis, global financial crisis and now a global economic crisis spreading from the littoral Atlantic regions across the world to Europe, Asia-Pacific, Latin America, and most unfortunately, to Africa. The crisis now threatens the recent gains in human livelihood and well-being. It also challenges many of our fundamental beliefs about economic resilience and financial market stability.

The Global Economy and Financial Markets

2. The most frequently asked question today is whether the worst is behind us. While there are incipient signs of business confidence and consumer spending trying to gain toehold, rising unemployment, high inventories and financial stress weigh heavily on overall demand conditions. In financial markets, although spreads have narrowed from September 2008 levels, they remain elevated while bank credit has declined and other markets remain impaired. The estimates of the expected write-downs by banks on global exposures are rising rapidly. For all financial institutions taken together, the expected write-downs over 2007-10 is estimated at $ 2.8 trillion on US-based assets and $ 1.4 trillion in Europe and Japan. The retrenchment from emerging markets is

* Statement by Dr. D. Subbarao, Governor, Reserve Bank of India on behalf of Mr. Palaniappan Chidambaram, Member, IMFC (representing the Constituency consisting of Bangladesh,Bhutan,India and Sri Lanka), Leader of the Indian Delegation to the International Monetary and Financial Committee, Washington D.C., April 25, 2009.

outpacing the overall de-leveraging that is underway, raising serious concerns about refinancing and even default risks.

3. Global economic activity is expected to contract by an annualised 6 percent in the first quarter of 2009 – the same as in the fourth quarter of 2008. Policy making around the world is in clearly uncharted territory. Governments and central banks across countries have responded to the crisis through big, aggressive and unconventional measures. Emboldened by falling inflation, monetary authorities in advanced countries have cut policy rates to unprecedented lows and when credit markets failed to thaw, central bank balance sheets have been expanded alongside funding and guarantees to financial intermediaries. Fiscal stimuli have been employed in conjunction, with large discretionary impulses boosting automatic stabilisers. Even with current levels of policy intensity the trough of the global recession is not seen until the end of 2009 and could get pushed out further if the policy responses fail to gain traction.

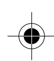
4. While the recession has intensified in the advanced economies, emerging economies have been dented by the collapse in external demand and commodity prices, the tightening constraints on access to external financing and the retrenchment of capital flows. Emerging and developing economies could experience capital outflows of the order of 1 percent of GDP in 2009 with growth expected to slump to 1.5 percent. Their prospects could indeed worsen if external financing constraints tighten further, trade and financial protectionism escalates and stress in domestic financial systems heightens and spreads.

5. Inflation is subsiding across the world with cooling demand and weakening commodity prices; however, this has not translated into gains in purchasing power in the face of high job losses and eroded profit margins for firms. In many emerging economies, this has resulted in overvaluation of currencies, partly reflecting the appreciation in the key reserve currencies. As international reserves have been drawn down to stabilise foreign exchange markets, the cushion against the global crisis has been eroded further.

6. Current estimates of write-downs on toxic assets suffered by banks globally are highly contingent on the hope that the global economic situation does not worsen further. Of the write-downs of $ 3 trillion only a third has been capitalised. Uncertainty about potential losses has kept spreads in financial markets elevated with the securities market still impaired and the credit market yet to thaw. In this context the key challenge is to impart credibility to a restructuring strategy comprising, loss recognition; realistic valuation; cleansing balance sheets; and recapitalisation and distress resolution. These issues need to be speedily addressed so that economic recovery takes root in the mature economies and capital flows to emerging and developing economies are revived.

The Role and Response of the Fund

7. The sharp deterioration in the global economic and financial situation has evoked vanguard national efforts towards crisis resolution on a scale, mix and duration that is perhaps unprecedented in



recent history. With the G20 Leaders' Summits in Washington in November, 2008 and in London earlier this month providing direction, a more comprehensive multilateral response involving a range of institutions, with the Fund in the forefront, has now been crafted.

Surveillance

8. Core to the very existence of the IMF is its surveillance role - monitoring global, regional and national economies to assess whether countries' policies are consistent not only with their own interest but also with the interest of the international community. The on-going crisis has highlighted the relevance and importance of strengthening and appropriately focusing Fund's surveillance. I reiterate the need for greater focus on systemically important countries - the more systemically important the country the greater should be the rigour of surveillance. In parallel, the gap between multilateral and bilateral surveillance should be bridged. The IMF's surveillance should not add to the obligations of developing countries.

9. While the Fund's traditional emphasis has been on exchange rates, the crisis has pushed macro-financial sector issues onto centre-stage in IMF surveillance. A key aspect is the integration of macroeconomic and financial sector surveillance. The Financial Sector Assessment Programme (FSAP) should be made more focused and forward-looking so that it could be integrated more effectively into bilateral surveillance. National authorities are closer to the terrain realities of their financial sectors and self-assessment of regulatory frameworks based on internationally agreed methodologies should be a priority. As we have learnt, prescription of standards for the financial sector in itself cannot prevent crises. There is a need for on-going review of the standards by international bodies and greater national commitment for implementation. National authorities should also commit to assist each other in enhancing their capacity to strengthen regulatory frameworks and the IMF has a crucial role to play in this coordination.

10. The IMF has recently stepped up its collaboration with the expanded Financial Stability Board on developing a framework on early warnings for identifying and mitigating systemic risks and vulnerabilities. We welcome this collaboration and while recognising the potential utility of the exercise, we look forward to more details, particularly on the methodology. Strengthening information availability is a key pre-requisite. The effectiveness of this collaboration should be regularly reviewed by the IMFC.

Lending Role of the Fund

11. The Fund as a financing institution should have the lending instruments and the financing capacity to address potential borrowing needs. We welcome the proactive and prompt measures taken by the Fund to reform its lending instruments and policies. The introduction of the Flexible Credit Line (FCL) and the high access precautionary stand-by arrangements (HAPAs) are timely, positive steps. The streamlining of modalities for applying Fund conditionality, including greater use

of *ex-ante* conditionality, appropriately balance the financing needs of the membership with safeguards for Fund resources.

12. These reforms could enable the Fund to re-emerge as the financier of choice not only for balance of payments needs and programmes designed for macroeconomic stability and structural adjustment, but for insurance in these uncertain times. Many member countries who were far removed from the epicentre and had no role or responsibility in the making of the crisis have nevertheless been adversely affected by it. The Fund would have to assist them and ensure that the fallout of the crisis in emerging markets and developing countries is contained. We expect that these facilities will be implemented in an appropriately flexible manner. The Fund should work closely with its membership to ensure that support is provided in a timely manner to prevent crises at an early stage. In this context, the initial response to the FCL is heartening.

13. We also welcome the initiative of the Fund to reform the financing instruments for low income countries (LICs) to better reflect their diverse needs and circumstances and heightened exposure to global volatility. Appropriate precautionary arrangements with higher access levels and ex-ante conditionality for strong performers amongst low income countries also warrant consideration. We call for an early completion of this exercise. The doubling of access limits for concessional lending, including the rapid access component of the Exogenous Shocks Facility (ESF), is a good interim measure.

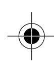
14. We also support the initiatives that are underway to bridge the gaps in trade financing and restore normalcy to markets for trade finance flows and rollovers. We urge the IMF to collaborate with other international financial institutions (IFIs) and bilateral agencies to support a truly multilateral effort. The unimpeded flow of trade financing to low income countries for imports of essential items such as food, fertilizer, fuel and capital goods should also be ensured.

Augmenting the IMF's Resources

15. In response to the increasing demand for Fund financing to manage the crisis the London Summit of G20 Leaders rightly focused on measures to enhance the resources available with the Fund. These decisions should be speedily implemented.

16. The Fund is a quota based organisation and quotas have to be the primary mechanism through which the resource needs of the Fund are ultimately met. This calls for two tasks on the way forward. The first task is to ensure that the April 2008 package of quota and voice reform is ratified at the earliest. The second task is advancing the completion of the 14th General Review of Quotas from January 2013 to January 2011. This quota review should, at the minimum, aim at doubling the quota resources. A time-sliced work plan should be laid down, commencing at the earliest so that the quota review can be completed in the targeted year and a half time frame.

17. Since the process of increasing and allocating quotas could take some time, the Fund is working on securing alternate resources, including borrowing. We



support these efforts but these should be seen as bridging mechanisms until the quota review is complete.

18. We appreciate the bilateral commitments made so for. We believe that the Fund's borrowings should adhere to certain key principles, consistent with the London Summit decisions. First, the Fund's borrowings should not be seen as a substitute for a substantial quota increase. Second, an appropriate mix should be maintained between the quota resources and borrowings of the Fund. Third, Fund borrowings should be based broadly on present quota shares, preferably within a multilateral framework like a modified NAB. Fourth, to provide greater flexibility for member countries to contribute to the Fund's resources, various modalities should be explored, including note purchase mechanisms. Fifth, resources lent to the Fund should be treated as part of the country's international reserves.

19. An early decision on these modalities would enable a quicker mobilisation of the targeted resources from a wider group of members. On our part, India is prepared to take on its share of responsibility to augment the Fund's resources. We would be able to commit on the extent of participation once the modalities are evolved in keeping the principles enunciated.

20. We call for an early and front-loaded allocation of SDRs worth $250 billion which would amount to about three-quarters of the present quota size of the Fund. This would provide developing countries with additional liquidity of about $100 billion, of which $ 19 billion will go to low income countries. There is a need to widen and deepen the market for SDRs through an expansion of the voluntary agreements. An SDR allocation is a reversible measure and the allocation could be re-considered when the global economic situation shows significant improvement.

21. We call on the Fund to finalise the modalities for raising both loan and subsidy resources for concessional assistance to low income countries. A number of available options need to be explored. We support the proposal to utilise the additional income from the investment of the higher proceeds of the agreed gold sale under the New Income Model to expand subsidised lending to low income countries. Members participating in the multilateral borrowing arrangements with the Fund should have the option of earmarking a portion of their lending for assistance to low income countries. Vigorous efforts to increase donor contributions to the subsidy resources should be pursued.

Governance

22. Governance continues to be critical to the legitimacy, credibility and effectiveness of the Fund. The most crucial issue is the continuance of the process of realignment of quotas and voice. The ensuing quota review should ensure that the IMF is comprehensively reformed so that it reflects the changing economic weights in the world economy and is more responsive to future challenges. Emerging and developing economies should have substantially greater voice and representation in the Fund. This principle was reiterated in the Washington Declaration of the G20 Leaders and

endorsed by the London Summit as well. We now expect that the quota review will result in a comprehensive reform of the governance of the Fund.

23. The initiative towards internal governance reform within the Fund is also relevant, although it should follow the quota and voice reform. We now have the Independent Evaluation Office (IEO) report on Corporate Governance, the report of the Trevor Manuel Committee, and the inputs from civil society. We expect that these inputs would be thoroughly analysed and discussed in the Executive Board and appropriate recommendations for action would be made so that the IMFC could become a more effective forum and the Fund is also strengthened.

24. We call for the introduction of an open, merit-based process, irrespective of nationality and geographical preferences, for the selection of the senior management of the Fund. The next Managing Director of the IMF should be selected in this manner.

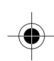
Developments in the Constituency

25. I now turn to developments in my constituency.

India

26. The global financial crisis interrupted India's growth momentum. Since downside risks have materialised, the GDP growth for 2008-09 is now projected to turn out to be in the range of 6.5 to 6.7 per cent after clocking annual growth of 8.9 per cent on an average over the preceding five years (2003-08). Domestic demand, in the form of both private consumption and investment expenditure, has slackened although government final consumption rose on account of discretionary fiscal stimulus measures. The global crisis brought to the fore the strong interactions between funding liquidity and market conditions. Both the Government and the Reserve Bank responded to the challenge of minimising the impact of the crisis on India in a coordinated and consultative manner. The Reserve Bank's policy response was aimed at containing the contagion from the global financial crisis whilemaintaining comfortable domestic and forex liquidity. The Government launched three fiscal stimulus packages which came on top of an already announced expanded safety-net programme for the rural poor, the farm loan waiver package and payout following the Sixth Pay Commission report. The combined impact of these fiscal measures is about 3 per cent of GDP. Through the Reserve Bank's actions, the cumulative amount of primary liquidity potentially available to the financial system is about 7 per cent of GDP. There are several challenges on the way forward : implementing the fiscal stimulus packages, particularly stepping up public investment; revival of private investment demand; unwinding of fiscal stimulus in an orderly manner; maintaining the flow of credit while ensuring credit quality; preserving financial stability along with provision of adequate liquidity; and ensuring an interest rate environment that supports the return of the economy to a high growth path.

27. Going forward, the fiscal and monetary stimulus measures initiated during 2008-09 coupled with lower commodity prices will cushion the downturn by stabilising



domestic economic activity. On balance, with the assumption of normal monsoon, real GDP growth for 2009-10 is placed at around 6.0 per cent. Inflation, as measured by variations in WPI, is projected to be around 4.0 by end March, 2010. Consumer price inflation too is declining, *albeit* less sharply. Notwithstanding several challenges, the Indian economy remains resilient with well functioning markets and sound financial institutions. The macro-economic management has helped in maintaining lower volatility in both financial and real sectors in India relative to several other advanced and emerging market economies.

Sri Lanka

28. The Sri Lankan economy was resilient in the face of unfavourable external conditions and registered growth of 6.0 per cent in 2008. High oil and import commodity prices threatened macroeconomic stability resulting in a sharply widening current account deficit and rapidly rising inflation. The global financial turmoil triggered a reversal of capital inflows causing a depletion of reserves and substantial imbalances in the external sector. Despite these challenging circumstances, prudent macroeconomic policies supported the growth momentum while headline inflation dropped to 5.2 per cent in March 2009 from a high of 28.2 per cent in July 2008. The fiscal deficit has remained at a reasonably low level and public debt relative to GDP has been on the decline for the fourth consecutive year. Unemployment has dropped to a historic low of 5.2 per cent while poverty has been falling for the last several years and is currently around 15.0 per cent. Against the back drop of a deteriorating global outlook, growth is expected to drop sharply but would remain around 4.0 per cent in 2009, bolstered by prudent macroeconomic policies and expansion of the domestic economy particularly in the eastern and northern provinces of the country. As normalcy returns, optimism about a resumption of the high growth trajectory and a step-up in the developmental process is gaining ground.

Bangladesh

29. Bangladesh's economy has stood up well in the face of the surge in international food and commodity prices in the first half of 2008 and the outbreak of the global crisis since September 2008. Real GDP growth is expected to remain strong in 2008-09 (July-June) at around 6.0 per cent, benefiting from a favourable agricultural performance and the fall in food, fuel and commodity prices in the second half of the year. As a result and reinforced by a combination of supply management and monetary-fiscal policies, inflation fell on a year-on-year basis to 6.1 per cent in January 2009 from 11.4 per cent a year ago. Public finances have come under some strain with growth in tax revenues falling short of target which is being offset by reduced expenditure due to sluggish demand and lower Annual Development Plan utilisation. With the deepening global downturn affecting major export markets, Bangladesh's balance of payments has come under some pressure, aggravated by some slowing down of remittances although they continue to hold up well. Gross international reserves stood at US $ 5.9 billion at the end

of February 2009, close to three months of imports. Bangladesh has also welcomed the decisions of the G 20 to deal with the current crisis within a multilateral framework while shunning trade protectionism and competitive devaluations. Bangladesh is striving to weather the crisis with a modest stimulus package aimed at boosting domestic demand with investment in rural, agricultural and infrastructure sectors, propping up the export sectors, buttressing food and social security measures and undertaking additional employment programmes.

Bhutan

30. In Bhutan, 2008 was a year of momentous historical significance when the country transitioned into a constitutional monarchy with new democratic institutions. This provides the backdrop for the implementation of the development agenda. Financing for the 10th Plan, which aims to double development spending with a focus on poverty reduction through industrial development, balanced regional growth and infrastructure investment has been tied up. Real GDP growth in 2007/08 was 21.4 per cent reflecting the doubling of hydro power generation capacity with the coming on stream of the Tala hydro project. GDP growth rate is expected to return to a trend level of 5.6 per cent in 2008-09. Regional integration through enhanced trade relationships with neighbouring countries, especially India and Bangladesh are helping growth and diversification. On the external sector, while reserves of convertible currency are comfortable, rupee reserves require careful management to meet the needs for imports.

Concluding Remarks

31. The crisis has put to test the collective leadership of the world and the competence and relevance of multilateral institutions. We are grappling with a crisis that has afflicted the entire world whether at the core or in the periphery. Much depends on a quick and internationally coordinated approach to a daunting, but not an insurmountable, challenge. The IMF is central to this endeavour and all of us have a stake in the role of the Fund in orchestrating the road to recovery. The Fund's capacity to deliver is ultimately connected to how much and how soon we empower it with resources, better governance, greater accountability and a redefined mandate that keeps pace with the requirements of the changing world. Within the IMF too, a radical shift in approach, culture and strategy is urgently warranted so that it divests itself of its past and much of the fallibility that goes with it. The world we will emerge into after the crisis will in all likelihood not be the same again, and the challenge is to re-fashion the IMF so that it becomes more relevant, useful and effective in the future.