Duvvuri Subbarao: The IMF and latest economic developments in the Indian Subcontinent

Statement by Mr Duvvuri Subbarao, Governor of the Reserve Bank of India, as leader of the Indian Delegation to the International Monetary and Financial Committee (IMFC), International Monetary Fund, Washington DC, 16 April 2011.

Statement on behalf of Mr Pranab Mukherjee, Finance Minister of India and Member IMFC representing the Constituency consisting of Bangladesh, Bhutan, India and Sri Lanka.

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Mr. Chairman,

1. There have been significant developments in the global economy since we met in the fall of 2010. The IMF too has moved on several fronts under its mandate which has strengthened its position in a changing world. There are several key questions confronting us today: Is the recovery assured in the face of still turbulent financial conditions and upward pressures on commodity prices? How resilient is the international monetary system to future shocks? Will the ongoing reforms empower the IMF and make it more effective in anchoring global monetary and financial stability?

The global economy and financial markets

2. A variety of risks, including political and social turmoil in parts of the world combined with natural disasters, have made the global recovery vulnerable. Financial conditions have turned volatile and uncertain, with risks of adverse feedback loops into the global economy. Recurring sovereign debt fears have affected market confidence. In the crisis-affected economies, financial systems are yet to be fully repaired. While the sense of crisis has waned, new challenges have surfaced.

3. The global recovery may be jeopardized by a sustained rise in oil prices. Apart from the inflationary pressures confronting particularly the emerging and developing countries, there is the danger of a slowdown in the global economy unless oil prices moderate from current levels. Furthermore, since the summer of 2010, several natural calamities and consequent food supply constraints have collided with the post-crisis resurgence of demand. World food prices have surged considerably due to concerns about low future supplies because of bad weather and low inventories, raising concerns about food security. Speculative movements in commodity derivative markets are also causing volatility in prices.

Global challenges and the role of the IMF

4. The overarching problems confronting the international monetary system stem from weaknesses in detecting and communicating early warnings of impending crises and management of global liquidity. This calls for fundamental reform of the international monetary system. It is also important to evolve a mechanism to address the challenges of stemming volatile capital flows and to strengthen multilateral adjustment mechanisms to deal with imbalances and sources of instability.

IMF surveillance

5. The surveillance function is critical to the IMF's overall mandate. By focusing on vulnerabilities and detecting the onset of crises, it assumes a vital, preemptive role in preserving global and national stability. Effective implementation at both multilateral and bilateral levels is the key to providing surveillance with incisiveness and traction. We believe

that this can be achieved within the ambit of the existing provisions of the Articles of Agreement. If, however, there is a consensus that there are gaps in the legal mandate that hinder effective implementation, an amendment to the Articles is the optimal approach. Ensuring consistency and comprehensiveness across the various levels of surveillance is important, as is the candour and evenhandedness of the IMF – that systemic risks are pointed out irrespective of where they may originate. We need to stress that multilateral surveillance by the IMF should not lose sight of sovereign debt concerns of developed countries by adopting tighter screening criteria for developing countries that have actually seen fiscal improvement relative to the advanced economies.

Managing capital flows

6. As the recovery of emerging and developing countries has gained momentum, capital flows have surged back to near pre-crisis levels. These flows have exhibited considerable volatility, imparting macroeconomic instability in the event of sudden stops and reversals, eroding competitiveness and complicating the setting of macroeconomic policies. Policy prescriptions with respect to capital flows should be even-handed. So far as lumpy and volatile flows are a spillover from policy choices of advanced economies, managing capital flows should not be treated as an exclusive problem of emerging market economies and the burden of adjustment should be shared. How this burden will be shared raises both intellectual and practical challenges.

7. As regards multilateral strategies to managing capital flows, it is difficult to follow an approach that seeks to establish, standardize, prioritize or restrict the range of policy responses of the member countries that are facing large surges in volatile capital inflows. Based on their experience, policymakers must have flexibility and discretion to adopt policies that they consider appropriate to mitigate risks through macroeconomic, prudential and capital account management policies without a sense of stigma attached to particular instruments. Given the state of knowledge on these issues, it will be premature to consider amending the Articles to either give the IMF jurisdiction over capital account policies of member countries or to impose an obligation on members on this count.

The IMF's resources

8. We welcome the ratification of the April 2008 quota reforms. The next step in this process should be the speedy ratification and implementation of the 2010 quota and governance reforms. A comprehensive review of the quota formula should be completed by January 2013 to set the stage for the 15th General Review of Quotas by January 2014 which will carry forward the modest progress made so far in enhancing the representation of dynamic emerging and developing countries in the IMF to meaningfully reflect the changing global economic realities. We must make our best efforts to complete the 2010 reform before the 2012 Annual Meetings.

9. We welcome the expanded and amended New Arrangements to Borrow (NAB) which became effective from March 11, 2011. The activation of the NAB should be regarded as a bridge between current expectations and the availability of higher quota resources under the 14th General Review. Subsequently, NAB should be scaled down so as to preserve the quota-based character of the IMF as an institution that is accountable to its membership.

Reserve adequacy

10. In our view, the insurance that reserves provide against sudden stops in growth due to capital drying up far outweigh the opportunity costs. Reserve accumulation by countries is an important part of the global safety net, particularly when the reserve accumulation takes place in the context of current account deficits.

11. Any assessment of reserve adequacy needs to be informed by underlying country-specific conditions, rigorous analytical and empirical foundations and judgments based on practical experience. There should be due consideration to macroeconomic and prudential frameworks and policies, as well as alternative forms of contingent financing, country insurance, and overall assets and liabilities that may not be easily captured in any formula for reserve adequacy. For emerging economies facing volatile surges of capital flows, consideration needs to go even beyond to a broad range of scenarios relating to potential drains on reserves, including a sudden stop of new financing, withdrawal of foreign portfolio investments, capital flight, and current account vulnerabilities. Further, the question of reserve adequacy cannot be resolved without addressing the broader issue of scarcity of safe reserve assets.

Currency internationalization and the role of the SDR

12. In principle, it is desirable to develop a multi-currency system with several currencies operating as broad substitutes and reflecting changing economic weights and global realities. In this context, we note that there have been recent efforts by the IMF to promote the use of SDR as a potential reserve asset for the evolving international monetary system. For the SDR to take on this significant role, several prerequisites have to be in place. The SDR has to be accepted as a liability of the IMF, has to be automatically acceptable as a medium of payment in cross-border transactions, be freely tradable and its price has to be determined by forces of demand and supply. As the SDR does not satisfy these conditions, it cannot be a reserve currency in the international payment system. In principle, one needs a global central bank to issue SDRs which take the characteristic of unit of global payment and settlement system. Thus, we see the move to multicurrency world as a gradual evolution. Another dimension of this issue is to change the composition of the SDR basket. Going by the recent initiatives, if at all there is a move to alter the composition of the SDR basket, we could consider including currencies of those dynamically emerging market economies that satisfy the existing inclusion criteria: in particular, a fully convertible capital account and a market determined exchange rate.

Developments in the constituency

13. I now turn to developments in my constituency.

Bangladesh

14. Bangladesh is steadily moving towards a higher growth trajectory that is largely inclusive, environment-friendly and well supported by continued high performance in the agriculture sector. External sector viability has benefited from export growth estimated at 30 percent and the strength of inward remittances. Concerted efforts to address the shortage of power have improved the investment climate. However, inflation remains high, with pressures from global prices of fuel, food and fertilizers interacting with enhanced internal demand. Revenue mobilization has risen by 28 percent till February 2011 strengthening fiscal sustainability. The budget deficit is expected to remain below 4.5 percent of GDP thereby aiding overall macroeconomic stability. As import demand picks up on the back of domestic demand, some strains could build on the balance of payments, although the level of foreign exchange reserves would remain sufficient at the level of over four months of imports. Accordingly, monetary policy is being tightened with the exchange rate being allowed to depreciate and cushion the balance of payments. Over the medium term, the progressive removal of constraints on investment, domestic and foreign, particularly in the context of private and public sector partnerships in large infrastructure projects would enable Bangladesh to embark upon double digit growth with stability.

Bhutan

15. Bhutan's growth momentum has been strong, underpinned by the prudent and skillful macroeconomic management. Real GDP growth accelerated to nearly 8 per cent in 2009–10, helped by robust growth in hydropower, construction and services sectors. However, inflation reached 9 per cent at end-2010. The current account deficit has increased to about 13 per cent of GDP due to strong imports in the hydropower sector, but the overall balance of payments has remained in surplus due to sizeable grants and loans disbursements. The reserve position has improved and remains comfortable. Credit has grown rapidly, mainly driven by housing and construction sectors as well as personal loans. Bhutan's financial sector coped with the global financial crisis well and financial stability indicators are comfortable.

India

16. The Indian economy, on the back of improved agricultural output, strong private consumption, robust investment, and a pick-up in exports, has rebounded strongly with a GDP growth of 8.6 per cent in 2010–11. However, inflation has emerged as a major concern. Headline inflation has remained firm despite some moderation in food inflation as generalised price pressures have emerged with rising inputs costs feeding into manufactured products inflation. The hardening of global commodity prices, particularly oil prices have further accelerated inflation. A sequenced withdrawal of monetary accommodation is helping to contain inflationary pressures and anchor inflationary expectations which remained at elevated levels for a large part of 2010–11, largely driven by fuel and food prices. The calibrated fiscal consolidation that resumed in 2010–11 is being carried forward into the medium-term, thus alleviating some pressures on aggregate demand. The budgetary initiatives in 2011–12 indicate further progress towards it, while giving due importance to the objectives of removing structural constraints, promoting infrastructure investment and strengthening the earlier policy initiatives towards inclusive growth. However, a potential increase in the subsidies on petroleum products and fertilizers as a result of high crude prices could put pressure on expenditure. Managing capital flows so as to dampen potential threats to macroeconomic and financial stability is a continuous challenge. Despite some tightness in money markets, financial conditions have been orderly with a pick-up in credit growth, vibrant equity market activity and a stable foreign exchange market. Medium-term prospects continue to be positive. Downside risks emanate mainly from continuing uncertainty about energy and commodity prices which may vitiate the investment climate, posing a threat to the current growth trajectory. Notwithstanding the risks, the Indian economy is poised to sustain the growth momentum.

Sri Lanka

17. Emerging out of three decades of civil conflict and the downturn brought on by the global crisis, the economy of Sri Lanka has resumed strong growth in an environment of macroeconomic and financial stability. Real GDP grew by 8.0 per cent in 2010, establishing a higher growth path underpinned by the peaceful domestic environment, improved investor confidence, strengthening macroeconomic fundamentals and the gradual recovery of the global economy. Ebbing inflation and a benign inflation outlook has enabled the continuation of an accommodative monetary policy stance with moderation of interest rates in all market segments supporting economic activity. The recent floods have caused some damage to agricultural production which has spiked headline inflation in the past few months higher than expected earlier. However, core inflation declined and currently remains low at single digit level. An encouraging improvement in the overall fiscal situation was witnessed in 2010 with the recovery in government revenue supported by the expansion of economic activity, the containment of recurrent expenditure, as well as the addressing of certain persistent structural issues in the tax system. The budget deficit was contained within the target of 8.0 per cent of GDP in 2010, down from 9.9 per cent in 2009, and the commitment to fiscal

consolidation will ensure further reduction of the budget deficit to 6.8 per cent in 2011 and to below 5 per cent in the medium term. The external sector, which made a remarkable turnaround since the second quarter of 2009, has continued to improve. Both exports and imports recovered strongly, while increased earnings from the tourism industry and higher inward remittances offset the widening trade deficit, limiting the external current account deficit. Increased capital and financial flows resulted in the balance of payments (BOP) recording a surplus in 2010, strengthening external reserves of the country. Supported by the favourable macroeconomic environment and a sound regulatory and supervisory framework, the financial sector improved and system stability strengthened in 2010 as reflected in all prudential indicators. Banks' credit flows significantly recovered, profitability improved, capital adequacy further increased above the threshold and the ratio of non-performing loans declined, while provisions for loan losses increased. Going forward, external shocks due to higher food and energy prices in the global market pose some risks to the balance of payments and inflation outlook.

Concluding remarks

18. While the trough of the crisis definitely appears to be behind us and there are signs that the recovery is consolidating, new challenges facing the global economy render it vulnerable. We have to remain vigilant and be prepared to deal with all threats, old and new, as we repair and rebuild. The global problems we are facing today are complex and not amenable to easy solutions. Many of them require significant and often painful adjustments at the national level, and in a world divided by nation-states, there is no natural constituency for the global economy. At the same time, the global crisis has shown that the global economy as an entity is more important than ever. Given the deepening integration of countries into the global economic and financial system, uncoordinated responses will lead to worse outcomes for everyone. We should cooperate not only to firmly exit from the crisis, but also to ensure that in resolving this crisis, we do not sow the seeds of the next one. The IMF has to continue to weave together the fabric of international cooperation. This is in the common interest of all. We must ensure that the IMF is adequately prepared for this role so that it remains relevant, legitimate and effective.