Y V Reddy: The global economy and financial markets - sustaining the recovery

Statement by Dr Y V Reddy, Governor of the Reserve Bank of India and Leader of the Indian delegation on behalf of Bangladesh, Bhutan, India and Sri Lanka, to the International Monetary and Financial Committee (IMFC), Washington, DC, 24 April 2004.

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Mr. Chairman

The global economic environment has improved significantly since we met last September in Dubai when the outlook for the global economy was weighed down by some uncertainties and risks. The recent strengthening of the global recovery process has been led by buoyant growth in emerging Asia, especially China and India and, of course by a robust turnaround in the US. Incipient recovery appears to have set in in the Euro area while the economic activity in Japan has exceeded expectations. The resurgent growth in many emerging market economies (EMEs) is now accompanied by significant resilience and EMEs are now positively contributing to the world growth. The determinants of global growth and the policy requirements for sustaining the present momentum, both at regional and multilateral levels, need to be evaluated in the light of this beginning of a significant rebalancing of economic strengths and activity.

The improved global recovery has been accompanied by a strong acceleration in world merchandise trade, particularly from emerging Asia, Japan and Euro Area. With renewed improvement in sentiment, investment has also picked-up in most regions, which should in the normal course augur well for sustaining the recovery process. Reflecting improved investment opportunities and receding systemic risks, capital flows to emerging markets have also improved. At the same time, the risk of deflation in several industrial countries has begun to subside with growing recovery and rising commodity prices. Risks have been mitigated by improved liability management through readjustment of maturity structure of external debt, build up of foreign exchange reserves, and improved credit quality. The domestic bond market has also received added fillip in many countries. International financial markets have remained orderly and buoyant. While resilience against shocks in EMEs has strengthened, it is still an open question whether the anecdotal “herding behaviour” of investors is tempered by the “maturation process” of the investing community across the globe**.** This factor continues to be a critical issue for policy-makers in EMEs.

Although overall global growth prospects have improved markedly, uncertainties still remain. Significant challenges and risks which still persist include possibilities of disruptive global currency adjustments, continued structural problems and hardening of interest rates. The impact of currency and interest rate movements needs to be carefully assessed on the balance sheets of households, corporates and financial institutions. While the adjustment of the US dollar has been orderly so far, there is a need to be vigilant about inflation and interest rate risks that could be generated in the process of correction of the high order of current external imbalances.

To sustain the recovery process and to correct the global imbalances in an orderly manner, there is an imperative need for a coordinated and cooperative approach. Key elements of this coordinated approach should include different policy responses in different countries/regions. In the US, there is need to curb household and government borrowings and strengthen national savings. However, US policies would need to delicately balance a gradual withdrawal of fiscal stimulus without hurting the recovery and, at the same time, without disruptive adjustment of the US dollar. The Euro area, which continues to depend largely on external demand, needs to pursue some structural reforms, especially labour policies, to boost domestic demand and broad-base the recovery. Japan needs to continue to take some concrete measures to strengthen its financial system, restructure the corporate sector, and reduce large fiscal imbalances. There is a growing perception that flexibility in exchange rate policies in emerging market economies in Asia is worth considering on pragmatic grounds but as appropriate to each country’s circumstances. As the recovery gains further momentum, interest rates which are at historically lows, may have a tendency to firm up. The transition to higher interest rates would have to be managed carefully, particularly in countries with high household indebtedness and exposure to housing and mortgage markets.

There is need for bold leadership in resolving some of the issues confronting the international community. Despite the fact that past episodes of crises have exposed various deficiencies of the international financial system, progress towards developing a sound system has been slow. Accumulation of foreign exchange reserves by several Asian countries seems to be not only linked to the exchange rate policies and the related trade as well as employment implications but also, to the lack of confidence of these countries in the existing architecture. Concrete steps need to be initiated in right earnest to redesign the international financial architecture. There is also a need to move swiftly in reviving trade talks. The protectionist postures by industrialised countries need to be shed, particularly in agriculture and textiles sectors, especially when developing countries have started, at last, to get out of their protectionist mindsets. Developing countries are increasingly realising that trade is, after all, not a zero sum game but a win-win proposition for both the trading partners. In this context, as presented eloquently by most eminent policy-makers in industrialized countries, the recent protectionist measures by some countries against business process outsourcing misses out not only the efficiency gains from such outsourcing but also the employment gains from resources saved in the process and deployed in other employment generating sectors.

Coming to countries in my constituency, I would like to mention that their performance has been a matter of satisfaction. The Indian economy has moved on to a high growth path. The GDP growth of India during 2003-04 is expected to be over 8 percent. Following good monsoons, the agriculture growth has rebounded and is expected to be over 10 per cent. Industrial sector continues to remain buoyant. The corporate restructuring undertaken in recent years and further opening up of the external sector have started to yield dividends through higher productivity and better balance sheet management. Various indicators suggest that the investment climate during the year has improved considerably. Infrastructure has been accorded renewed priority. India’s external sector continues to be a source of strength. In particular, exports witnessed robust growth despite not so favourable an external environment. Growing export of services and remittances have helped maintain a marginal surplus in the current account in spite of a growing trade deficit. Reflecting the improved fundamentals, capital inflows have been buoyant, but manageable for the conduct of monetary policy. The health of the financial sector has also been improving. Improved risk management measures have enabled an absolute reduction in the non-performing assets of the public sector banks for the first time since the initiation of reforms. Financial markets in general and the equity markets in particular have demonstrated robust performance. Notwithstanding some pressure on prices at the beginning of the year, inflation continues to be under control. The main challenge of macroeconomic management today continues to be fiscal consolidation. However, there are definitive signs of progress towards deficit reduction. The fiscal deficit of the central government as a proportion of GDP has also declined considerably. Revenues are buoyant, the disinvestment programme has picked up speed, and expenditure control and management measures are firmly in place. The Fiscal Responsibility and Budget Management Acts, operating at the Centre and several States can be expected to deliver solid progress on the fiscal consolidation front.

Sri Lanka has made further progress in 2003 towards economic stability and recovery with the continuation of sound macroeconomic policies and structural reforms in the context of the continuing ceasefire, and improvements in the global economic environment. The international community has extended support for the government’s economic progress and peace process. There were elections in early April and a new government is in place. The Sri Lankan authorities are committed to making further progress on the peace front, growth and poverty reduction and to sustain macroeconomic stability.The new government will continue discussions with the Fund on the Poverty Reduction and Growth Facility/Extended Fund Facility (PRGF/EFF) arrangement.

Bangladesh has continued steadfast implementation of reform measures under the PRGF program with a view to moving the economy to a higher and sustainable growth path. Substantial progress has been made in implementing an ambitious agenda of reform measures. A composite strategy is being pursued to mitigate the risks arising from the scheduled phasing out of MFA quotas at end-2004. Some differences, which are inevitable in a democracy, should not make the international community feel that the country’s commitment to economic reforms is lagging. Bangladesh values the financial and technical assistance from the international community.

Bhutan continues to experience strong macroeconomic performance with a robust real GDP growth and subdued inflation. Keeping in view the strategy to benefit from integration with the rest of the world and through membership of multilateral bodies including the World Trade Organization (WTO), Bhutan is undertaking important structural reforms and strengthening the institutional framework.

Crisis prevention and IMF surveillance across the membership: priorities, tools and modalities

We welcome the initiatives taken by the IMF to strengthen the overall framework of bilateral and multilateral surveillance. The recent initiatives undertaken by the Fund including the proposal to integrate the 'balance sheet approach' into Fund operations, the proposal to redesign the framework for debt sustainability in low-income countries and the recent decision to further strengthen data provision under IMF's Article VIII Section 5, reflects the Fund's commitment towards adopting an effective framework for vulnerability assessment. While the above measures will help member countries to strengthen their statistical systems and for the Fund to enhance the value of country-specific information system, it is essential to emphasize that the cooperative and voluntary nature of data provisioning as laid down under the Article needs to be preserved.

For strengthening surveillance, we welcome the thorough analysis of its various dimensions proposed for the next biennial review, including an impact analysis in select countries*.* We welcome a separate study on impact analysis*.* There is an increasing feeling that the framework of surveillance should be more focused in terms of its objectives and targets. While strengthening vulnerability assessment is an important element of the surveillance process, the fundamental objective of surveillance is to review and analyse macroeconomic policies for ensuring the soundness and stability of the domestic as well as the international monetary and payment system.

The increasing complexity of financial markets have rendered the existing instruments of surveillance such as Article IV consultations*,* Financial Sector Assessment Program/Financial System Stability Assessment (FSAP/FSSA), and Reports on Observance of Standards and Codes (ROSCs) less effective than what was assumed so far, in identifying and preventing crises. In this context, there may be a need to reach an appropriate framework of vulnerability assessment based on high frequency data, duly taking into account data availability and methodological details*.* Second, integrating the use of high frequency data into the IMF surveillance process would also require a successful identification of more stable methodological apparatus as compared to the ones that are presently available. Third, the Fund may require rebalancing its objective of vulnerability assessments with respect to developed countries *vis-à-vis* developing countries, given the increasing empirical evidence that the primary maladjustments that lead to crises have sometimes emanated from developed financial markets. Finally and perhaps of paramount importance, we would like to stress that increased transparency resulting from assessments of a member country's incipient vulnerabilities may, in turn, exacerbate a crisis even when such a country does not face any liquidity problems and its macroeconomic conditions are stable. Thus, there is need to reconsider the issue of the optimal degree of transparency in such vulnerability assessments.

Enhancing IMF support to low-income members: instruments and financing; IMF - World Bank collaboration; and promoting debt sustainability

The official development assistance (ODA) by to developing countries falls significantly short of the committed target of 0.7 per cent of their gross national product (GNP). Further, a large part of the actual increase has been directed not to financing the incremental cost of Millennium Development Goals (MDGs) but enlarging the scope of debt forgiveness or aiding the war on terror, thus crowding out development aid. Net official flows to developing countries have in fact declined. There is also no clear picture emerging that donors have moved towards targeting aid better for countries with better policies and institutions, and away from imposing excessive transaction costs on recipients, thereby impairing efficiency.

The efforts put by the IMF together with the World Bank towards poverty reduction, debt sustainability and achieving Millennium Development Goals (MDGs) are commendable. We appreciate the emphasis on efficient use of available resources, providing cushions for exogenous shocks, expanding the institutional capacity, managing additional resources, and chalking out pragmatic and effective debt restructuring mechanism. The recent studies on different aspects of financing should help to improve the flow of funds to Low Income Countries (LICs) and also strengthen their capacity to withstand exogenous shocks and service their debt without jeopardizing their economic growth. We agree that the focus for future Fund engagement with LICs should include (a) an assessment of policies, (b) dealing with shocks, (c) technical assistance, (d) donor support coordination, and (e) debt sustainability analysis for donors.

Given the likely scenario of reduced annual lending capacity under the self-sustained PRGF programme from 2006, there exists a need for additional resources. To ensure efficient use of available resources, concessional arrangements should be made more effective without going for substantial changes in existing arrangements. We support greater selectivity in use of PRGF resources and tapering of access norms for successive arrangements. On the proposed amendments in instruments and financing for PRGF, the efforts for clarifying blend criteria, formalizing the low access PRGF arrangements are welcome. Greater clarity in the principles of PRGF augmentation for addressing exogenous shocks and the need for Fund engagement with emergency post-conflict countries are also necessary.We are not in favour of duplicating surveillance in the form of Enhanced Monitoring Policy (EMP). The drawing up of an explicit exit strategy and introduction of differentiated rate of charge for prolonged users as a signaling device appear necessary. Moreover, a staff monitored programme, preferably after the second/third PRGF arrangement, may ensure improved ownership. Considering the required efforts to be put up by the LICs in balancing their needs for resources and ability to service their debt, we are in favour of developing an operational framework for debt sustainability and promoting LICs' economic growth.

While it is widely recognised that rising exports could effectively reduce debt service burden, for the LICs the quantum of exports has fallen short of the desired target. In this context, there is a need to focus on remittances as a supplementary source of resources to mitigate debt service burden. However, while trade in commodities has expanded over the years, and cross border capital flows exploded, growth in mobility of labour has not been encouraging. Moreover, the demographic transition in advanced economies with a declining proportion of the population in the working-age adds urgency to the consideration of the issue of cross border mobility of labor. The International Financial Institutions (IFIs) can play a crucial role in developing a harmonised framework for enhancing cross-border labour movement and channeling of remittances.

Progress with crisis resolution initiatives

Designing a globally accepted institutional framework has been the core issue for achieving "private sector involvement" in crises resolution. The introduction of 'Collective Action Clauses (CACs)' in sovereign bonds is increasingly being recognized as a tool that would help mitigate the problems associated with the free rider and holdout litigation involved in debt restructuring exercises. In this context, we welcome the recent inclusion of CACs in many of the sovereign debt issues which has not resulted in any additional premium. The role of the IMF and other for***a*** such as the G-10 in popularising the concept has been commendable. The efforts to develop a 'Code of Conduct' by initiatives from G-20, in addressing the coordination problems that arise in a restructuring exercise is valuable and proactive. However, a prescriptive or standardized approach should not be followed in the formulation of the Code and the role of the IFIs should be limited to providing overall support to the development of such a code. Finally, we welcome the adoption of the Evian Approach by the Paris Club for redressing debt sustainability concerns of the non-HIPC countries.

Combating money laundering and financing of terrorism

We reiterate that India vehemently opposes all forms of terrorism. We also restate our commitment to fight against the abuses of the financial system, including money laundering and terrorism financing. In India, a comprehensive Prevention of Money Laundering Act has been passed to deal with money laundering and financing of terrorism.

We commend the Fund/Bank staff on the overall success of the pilot program and also welcome the participation by the Financial Action Task Force (FATF) and the FATF Style Regional Bodies (FSRB) in the pilot progrm. The primary objective of the Pilot program has been achieved through the deepening of international attention to Anti-Money Laundering/Countering the Financing of Terrorism (AML/CFT) issues. However, on AML/CFT issues, the Fund should remain within its mandate as laid out in its Articles of Agreement, without getting involved in law enforcement or non-macroeconomic issues. Proliferation of areas beyond its core competence may dilute the Fund's efficiency in its core area of functioning. Such an involvement may also not augur well for the co-operative principles that must underpin IFIs' engagement in this area***.*** It may be desirable to maintain the current policy of limiting the IMF/Bank involvement to responsibilities for assessment. For rest of the work, the independent AML experts should be financed from external resources.

IMF quotas, voice and representation

The problem of a democratic deficit and transparency in IMF's governance is well-recognized. The public discussion about the process of appointing a new Managing Director has again brought this issue into sharp focus. A number of measures have been suggested to strengthen voice and representation of the developing countries. We are supportive of the proposals to provide increased administrative and technological support to multi member constituencies to increase their effectiveness. We are also open to considering additional chairs to make the two very large African constituencies more manageable. However, we have concerns that the Boards may become unwieldy, unless immediate consideration is given to merging or reducing the number of chairs allotted to countries that are one monetary union and/or one trading bloc.

We reiterate that these measures are not a substitute to real reforms, i.e., structural changes in the Board and reform of quota formulas and voting rights. It is worthwhile recalling that similar discussions last year culminated merely in some additional posts being created in the two largest constituencies.

For real and substantive reform, a package of measures must be adopted simultaneously, and the central issue, namely distribution of voting rights and representation of member countries on the Executive Board, addressed squarely. We appreciate the enormous complexities involved in such an exercise, but the current state of impasse on this owes a great deal to the reluctance of the major shareholders to give up their present disproportionate strengths.

The present quotas, based on a flawed formula with variables and weights chosen to produce a pre-determined result, do not reflect positions that are truly representative of many countries' profile in the world economy. A new formula based on a transparent and objective set of criteria is needed. In order to be truly representative of the size of economy and capacity to contribute to Fund resources, the chosen formula should assign maximum weights to GDP and reserves, and GDP should be computed on Purchasing Power Parity (PPP) terms. This could be accompanied by increasing the share of basic votes which have declined from 12.1 percent of the total at the time of Fund's inception, to just 2.1 percent. It may also be worthwhile to review the requirement of supermajority for important decisions. In conclusion, we would like to emphasize the need for a comprehensive approach, as piecemeal measures implemented singly will have only a marginal overall impact for developing countries as a whole.

Activities of the Independent Evaluation Office (IEO)

The Independent Evaluation Office (IEO) set up in July 2001 continues to play an important role. The IEO has come out with final reports on three topics and are in the process of completing another three studies. All the three reports released so far have been well received. They have provided an objective assessment of arguably some of the most controversial and contentious issues relating to the functioning of the Fund. The IEO has lived up to the expectation.

Thank you.