Rakesh Mohan: Statement at the IMF – the global economy and financial market issues

Statement by Dr Rakesh Mohan, Honourable Deputy Governor of the Reserve Bank of India and Leader of the Indian Delegation to the International Monetary and Financial Committee, Washington DC, 14 April 2007.

Representing the constituency consisting of Bangladesh, Bhutan, India and Sri Lanka.

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Mr. Chairman,

The global economy and financial markets

The continued expansion in world GDP in 2006, with growth crossing the 5 percent mark, points to the emergence of a new phase – one that is more diversified with most regions posting higher growth than in the previous year. It is heartening to note that the new robust phase is driven by emerging market economies with China and India continuing to contribute substantially to the global growth momentum. Growth rate in the Euro area accelerated and the recovery in Japan was sustained.

The initial assessment in the latest World Economic Outlook (WEO) that global growth could moderate somewhat from 5.4 percent in 2006 to 4.9 percent during 2007 may be all right at the current conjecture. While in the recent past WEO growth forecasts have normally got revised upwards from one round to another, there is little room for complacency as the nature of the risks to the favorable growth outlook during 2007 has not changed, though they appear muted at this stage. At the same time, downside risks to global financial stability have increased and the risks in the US housing market have started to manifest themselves.

The most important factor that has contributed to the reduction of risks is the moderation of oil prices from their peak levels in August 2006. However, with the recent firming up of oil prices again, it is not clear at what level, if at all, oil prices would stabilize. There does not seem to be a fundamental improvement in the supply-demand balance in the oil market. The geopolitical risk has also not diminished. If oil prices continue to remain volatile, they would impart considerable uncertainties to growth prospects, particularly for oil-importing developing countries.

Nonetheless, the reduction in oil prices from their peak levels has had an immediate impact on the inflation outlook. The headline inflation in advanced countries has decreased, and with this, the immediate prospect of monetary tightening has diminished. This has imparted some stability to financial markets. It would, however, be premature to draw firm conclusions about the direction and pace at which monetary policy would move in advanced countries, as core inflation remains at an elevated level. With reported slackening of productivity growth and closing of the output gap, inflationary concerns might still persist in advanced countries. Many emerging markets continue to experience inflationary pressures and have tightened monetary policy. If oil prices turn volatile, inflation concerns may resurface.

Another area of concern is the impact of the US slowdown on the global economy. The current slowdown has been triggered by the adverse development in the subprime segment of the housing sector. Looking at the recent stock market response, it does not seem unlikely that the trouble in the subprime sector could permeate into other segments of the housing sector. In such a scenario, consumption demand, which has been steady thus far, could get affected.

The persistence of global imbalances continues to cause concern. Slowing US growth, coupled with dollar depreciation, is expected to keep the deterioration of current account deficit under check. However, even under the most favourable scenario, the net foreign liabilities position of the US would continue to deteriorate further, raising the prospects of an eventual adjustment.

The increasing integration of China and India into the global production stream has significantly altered the efficiency of the global production process. While exchange rate changes are a part of the process of adjustment, a larger part of adjustment would have to occur through changes in domestic policies of the key global players in such imbalances. This would involve a rebalancing of saving-investment behavior between the US and economies with large surpluses. If the adjustments were to

occur mainly through exchange rate adjustment, it would have wider ramification for global financial stability. The emerging market countries would be particularly vulnerable, as the major share of their external liabilities is in US dollars. While a disorderly unwinding of global imbalances remains a low probability event, concerted efforts by key stakeholders are required to avoid such an occurrence.

While the US growth is expected to slow, stronger fiscal performance should improve the resilience of the economy. In the event of a sharper slowdown, it is important that the slack is taken up by the Euro area and Japan, so that global growth remains buoyant. Growth projections indicate that Euro area growth would revert to its potential level, which remains comparatively low. In order to sustain the current level of performance, the region needs to close the productivity gap with the US by increasing competition and removing labour market distortions. While growth momentum has clearly picked up in Japan, fiscal reforms and supply-side structural reforms are needed to enhance the productivity of the non-tradable sector.

The persistence of terms of trade shock arising out of high fuel and non-fuel commodity prices has benefited a number of countries. While commodity prices are expected to remain buoyant, a faster than anticipated slowdown of the global economy would increase the vulnerabilities, particularly for low-income countries in Africa. Africa has also benefited from debt relief and ongoing efforts at strengthening macroeconomic stability. Growth in emerging Europe has accelerated, but vulnerabilities have increased on account of deteriorating current account balances. While the Middle East enjoys strong growth, expenditure management would be a major challenge as the level of current account surplus for the region is expected to come down with the moderation of oil prices.

In recent years, the benign financial market conditions have been supportive of global growth. The underlying risks in the financial markets have, however, gone up. The markets have also become more discerning. The leveraged position of market entities has increased as reflected in a sharp pick up in leveraged buyouts (LBOs). The activities of hedge funds have also increased. However, with lack of transparency in the operations of hedge funds, a proper assessment of risks becomes arduous. The persistence of carry trade has further accentuated risks in the financial markets.

With financial globalisation, the exposure of emerging markets to risky financial assets in mature markets has increased. Similarly, the risk appetite of institutional investors has also increased in search of higher yields. This is reflected in the compression of spreads for emerging market financing which cannot be fully justified by improved fundamentals. Overall, as highlighted in the Global Financial Stability Report, the financial risks have increased. In the event of a loss of risk appetite and consequent unwinding of leveraged positions, there could be serious adverse effects in emerging markets.

With financial globalisation, international financial markets have become more exposed to risks arising from large cross border inflows by foreign institutional investors seeking to benefit from higher yield in emerging market economies. With strong capital flows, many emerging market and developing countries face the challenge of sustaining stable macroeconomic and financial conditions. The authorities have to engage in activities such as sterilisation and tightening of policy to contain volatility in financial markets arising from large capital flows. However, the experience in this regard raises its own difficulties. For instance, monetary tightening through a rise in interest rates could lead to further capital inflows, requiring larger sterilised operations. Thus, the authorities in their countries are facing challenges that are arising from large cross border flows and financial market volatility that is related to possible inappropriate risk pricing by international investors.

In sum, while I see good prospects for the global economy, there are a number of risks emanating from the behaviour of oil prices, adverse developments in the US housing market, persistence of global imbalances, large leveraged positions in financial markets, and possible emergence of inflationary pressures. In addition, there is also the threat of protectionist pressures with adverse consequences on global growth. The evolving situation needs to be carefully watched and policy makers should be ready to respond to emerging challenges promptly and effectively.

Reshaping of surveillance

Surveillance is the key responsibility of the Fund. We have noted the ongoing work in this important area. We would be supportive of efforts that would enhance the relevance of surveillance and increase its effectiveness. The basic approach and principles for moving ahead have been laid down by the Managing Director clearly and succinctly: (i) the revised Decision should muster the broadest possible support; (ii) it should not in any manner, overt or covert, introduce new obligations; and (iii) it should

not move towards a more compliance-based approach. I am confident that, if we approach the issue with these principles in mind, it would assuage many apprehensions of members.

In the context of the review of the 1977 Decision, my understanding is that the Decision derives its legal basis from Article IV Section 3(b) on surveillance over members' exchange arrangements. The adoption of new principles that are being currently debated must be limited to the subject matter of surveillance over exchange rates. We would be uneasy to see the insertion of any new principles that qualify domestic policies with peripheral consequences on exchange rate management. While it is open to the Fund to suggest "factors" or "points for consideration" relating to what constitutes sound monetary, fiscal or financial sector policies, it must be clearly understood that such guidelines qualify the Fund's oversight over members' domestic policies under Article IV Section 3(a). They cannot and should not be regarded as principles qualifying firm surveillance over exchange rates under Article IV Section 3(b).

As regards exchange rate surveillance, the proposed draft new principles seem to go beyond the intent of Article IV in so far as formally taking on board the concept of "fundamental exchange rate misalignment". In view of conceptual and methodological uncertainties, it would not be appropriate to embed the term, "exchange rate misalignment" in a formal Decision. The fact that alternative approaches produce widely divergent estimates of "exchange rate misalignment", it would not be appropriate to anchor policy advice on such exchange rate assessments. Moreover, given the sensitivity of exchange rates for emerging markets, it would be desirable in the spirit of the Fund's role as a confidential advisor to keep the exchange rate assessment internal.

The discussion on remit, independence and accountability framework has two important elements: (i) to improve focus of surveillance with greater prioritization, and (ii) to improve the methodology to assess the effectiveness of surveillance. We are very much for strengthening the methodological aspects of surveillance reviews and prioritization. However, it needs careful consideration whether there would be any value addition in introducing a new policy statement devoted to this purpose alone. Another approach could be to prioritise surveillance objectives through the triennial surveillance reviews. I am sure the Board would consider the pros and cons of both approaches and come up with proposals, with wider acceptance.

I welcome the emphasis on the core areas of the Fund's mandate in bilateral surveillance. It is important to aim at better integration between multilateral and bilateral surveillance with a greater focus on cross-country spillovers. There is also a need for an evenhanded approach in order to build confidence among both borrowers and lenders, which is critical for the effectiveness of surveillance.

Quotas and voice

I note the discussions in the Board on this most critical area of governance of the Fund. After the first round of ad hoc quota increases, it is important that the international community shows the resolve to move forward with the second round in a time-bound manner. The commitment in this regard is embedded unambiguously in the Singapore Resolution. The main objective should be to realign the quota formula to meet the current global reality. The fundamental reform has to come by giving greater share to the under-represented countries while that of the over-represented countries would need to come down.

The challenge today is to achieve this reform through a new, simple, transparent and linear quota formula. We believe that this is possible if we work towards a new quota formula that seeks to achieve two outcomes. First, such a formula must result in the rebalancing of quota shares in keeping with the economic changes that have taken place globally. Second, and equally important, is the objective that quota shares of low-income countries are protected to the fullest extent possible. We find that these twin outcomes can only be met if, in the hypothetical new formula, GDP is computed entirely on purchasing power parity (PPP) basis. No halfway house of blending GDP at market exchange rates with GDP on PPP would meet these twin objectives. Furthermore, the "openness" variable in the calculation of quotas needs a close scrutiny in the context of countries having a common currency. We are of the view that our proposal for comprehensive reforms alone will result in adequate, equitable and appropriate representation for developing countries. Such a broader representation of the developing countries would enhance the acceptability, ownership and effectiveness of the Fund's programmes and policies.

This twin outcome approach requires a sense of pragmatism and spirit of compromise on the part of all member countries. However, we are dismayed that, contrary to this approach, some proposals are

being made that detract from the spirit and purpose of the reform process. It is being proposed that the reform objectives could be met in a number of ways. In our view, the promise of a number of ways is a teasing illusion. There is only one way and that is to construct a formula that realigns actual quotas in line with current global economic realities. Another suggestion has been to benchmark the revision to the current *calculated* quotas rather than the *actual* quotas. What the outside world and we understand by IMF reforms is an outcome that seeks to realign *actual* quotas in line with current global economic realities. We need to resist all attempts to obfuscate this intent.

Emerging market economies and crisis prevention

The resilience of emerging market economies has increased with sustained reforms and strong policy frameworks. Most of the emerging market economies have built self-insurance and enjoy greater market confidence. At the same time, these economies face several policy challenges from time to time, emanating from exogenous changes in global capital flows. The Fund, therefore, needs to reorient its interface with these countries to suit their specific requirements and strengthen its toolkit to address typical financing needs of emerging markets.

In this context, I note the ongoing discussions on the design of a new liquidity instrument. We see merit in a new liquidity instrument of a contingent nature that could strengthen the Fund's crisis prevention efforts. It is important that the new instrument is created after careful analysis of the proposed qualification criteria and other modalities so that potential member countries become convinced about its possible usage.

Role in low income countries

The Fund should continue to remain fully engaged in the multilateral effort to help its low-income member countries achieve the Millennium Development Goals (MDGs) and address the issues of ensuring debt sustainability with supportive policies. The recommendations of the Report of the Independent Evaluation Office on the role of the Fund in Sub-Saharan Africa and the recommendations of the Malan Committee Report on Fund-Bank Collaboration provide scope for a more effective role of the Fund in low-income countries.

Managing an effective institution

I welcome the Report by the Committee of Eminent Persons on the Sustainable Financing of the Fund. The Report is timely and provides a robust framework for addressing the weaknesses in the current financing model. Further deliberations on the Report need to be conducted in conjunction with the expenditure framework. Some of the recommendations of the Committee, including the proposals to invest out of quotas and the part sale of gold are far reaching, and would require careful consideration. The proposal for charging for Technical Assistance would discourage its use in several needy countries and we therefore, do not support it. We look forward to working toward an efficient, equitable and sustainable income model for the Fund that aligns with its medium-term strategy.

Developments in the constituency

Let me now turn briefly to some key aspects of developments in my constituency. In **India**, the growth rate of GDP has exceeded 9 percent during the last two years, and the prospects for 2007-08 continue to be favorable. The savings and investment rates have risen significantly, reinforcing the prospects of sustained high growth. Business confidence remains high. Some inflationary pressures have emerged, reflecting both demand factors and supply side constraints. We have already taken a number of measures on the fiscal, monetary and supply sides, which are expected to keep the inflation rate at around the acceptable range of around 5.5 percent for 2006-07. The current account situation is manageable, underpinned by robust exports and invisible receipts, and capital flows. The fiscal performance for 2006-07 improved over the previous year and the Budget for 2007-08 aims to continue on the path of fiscal consolidation consistent with the objective of Fiscal Responsibility legislation. We remain committed to economic reforms, fiscal prudence and monetary stability.

The **Bangladesh** economy continues to maintain steady growth and moderate inflation while making significant progress in reducing poverty and meeting the Millennium Development Goals (MDGs).

Bangladesh can be singled out as one of the Fund's success stories under the Poverty Reduction and Growth Facility (PRGF) program. There has been discernible improvement in the business environment as reflected in the sustained flow of Foreign Direct Investment (FDI). The authorities' stewardship of fiscal and monetary policies has been broadly appropriate, as reflected in the falling overall fiscal deficit as well as the size of the current account deficit.

Sri Lanka's economy registered a GDP growth of over 7 percent in 2006, on top of the 6 per cent growth in 2005. The outlook for 2007 remains strong. Unemployment has declined to 6.5 per cent. Monetary policy has been tightened to curb inflationary pressures. Despite expenditure on Tsunami reconstruction, the fiscal deficit has been contained. The balance of payments remain in surplus. The government has spelled out its economic policy framework in "Mahinda Chintana – Vision for a New Sri Lanka – A Ten Year Horizon 2006-2016", designed to create a vibrant and stable economy, with broad based participation and equitable distribution of benefits to all segments of the population.

The **Bhutanese** economy is poised to take off on a more sustainable basis with the commissioning of the Tala hydroelectric project. As Tala came on stream in July 2006, GDP is expected to increase by nearly 14 percent in 2006-07. The current account is expected to improve further and public debt is likely to drop significantly. Monetary policy remains appropriate to contain potential inflationary pressures.