



# **International Monetary and Financial Committee**

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**Statement by Mr. Chidambaram**



**Statement by Honourable Finance Minister  
Mr. P. Chidambaram  
Leader of the Indian Delegation to the  
International Monetary and Financial Committee  
Washington D.C, October 11, 2008**

Mr. Chairman

**The Global Economy and the Financial Markets**

1 We are meeting in Washington at a time when the global economy is under unprecedented strain. The financial sector turmoil that originated in the sub-prime mortgage sector in the U.S is now unfolding itself into a full-blown crisis with multidimensional ramifications across many developed economies and spillovers to the rest of the world. Troubled assets are now lodged in the balance sheets of various financial institutions across the world. We are not too sure about the full magnitude of the problem. Despite some incipient signs of cooling, inflationary pressures arising out of elevated food and fuel prices have not fully subsided. The recessionary trend is slowly becoming a reality with the twin threats of the financial markets crisis and consumer anxiety. Clearly, these are troubled times for the world economy. Nevertheless, crises do give us an opportunity to quickly take stock of what went wrong and to act. It provides an impetus to long-awaited reforms in institutions, structures, regulations, procedures and practices.

2 The global financial crisis has impacted the world growth scenario. With the increase in the perceived counter-party risks and the virtual freezing of inter-bank transactions, a strong negative feedback loop from the financial to the real sector has clogged the flow of credit. World output growth is on a steep downward trend. Compared to the 5 percent in 2007, global output growth is forecast to drop to 3.9 percent in 2008 and fall further to 3 per cent in 2009. Emerging market economies will also be affected as their growth slows to 6.9 percent in 2008 and further to 6.1 percent in 2009. The risks for these base line scenarios are clearly tilted downwards. Inflation could, however, moderate mildly due to the recessionary conditions in some parts of the world and some moderation in commodity prices.

3 The crisis has revealed the major weaknesses of structured products and derivatives in the credit market. The need to flush out the troubled assets clogging the smooth flow of

credit in the global banking system has necessitated a process of deleveraging with declining debt-to-assets ratios. This has the potential to engender a credit crunch across the globe. Along side, the financial crisis has triggered serious liquidity problems in the money market with the money market interest rates shooting up. Banks face serious capital constraints, which also could act as major impediment to further credit expansion. If not addressed with speed and determination, the prolonged liquidity concerns could turn into solvency problems, further jeopardizing the stability of the global financial system.

4 The U.S. and a number of developed countries have adopted a number of efforts including some unorthodox measures to combat the fall-out of the crisis. The impact of these measures will, however, depend upon the contextual appropriateness of the packages and the manner in which they are implemented.

5 The current crisis and the attempts at its resolution across the globe have raised a number of concerns. Financial sector supervision in developed countries has invited criticism that risk management and supervisory practices lagged behind the pace of financial market innovations and new business models. The crisis underscores the need for further policy co-ordination among the regulatory and supervisory authorities in systemically important countries and the necessity for them to continually upgrade their skills and the instruments at their disposal. There are also likely to be substantial fiscal costs with attendant implications. Once the immediate concerns are allayed and some calm is restored, we need to reflect on these critical issues and their policy implications.

6 What the crisis has shown is that, in a globalizing world, no country can claim to be completely unaffected. However, emerging market economies (EMEs) have been less affected so far by the crisis. Their relative stability could be reflective of policy improvements, prudent practices, strengthened reserves, and the strong growth performance in recent years. But the EMEs are not islands of tranquility and the crisis could be transmitted to them through multiple channels. External corporate and bank borrowing is becoming scarcer and dearer and housing and real estate markets are slowing down. The current crisis holds important lessons for EMEs which they should factor in as they move forward on financial sector reform.

### **Food and Fuel Price Crisis**

7 Food and fuel price increases continue to haunt the common citizen and policy makers alike world over. Consequently, the policy challenges associated with reducing poverty, ensuring food security, and maintaining macroeconomic stability have been greatly accentuated. Depending on their respective macroeconomic contexts and levels of import dependence, different countries have adopted different responses. The policy tool-box has been varied and includes fiscal, monetary and trade policies.

8 As far as food prices are concerned, the fall in world cereal production, low food stock levels and crop diversion for the bio-fuel sector seem to have played a major role. Fertilizer prices have nearly tripled and transport costs doubled over a two year period. While supply uncertainties and higher demand could have been, in part, responsible for the higher fuel and food prices, the role of speculation and financialization of commodities should engage the attention of policy makers.

9 Notwithstanding the recent softening of global food and commodity prices, we cannot afford to let down the guard on inflation. Concerted policy efforts to minimize the operation of speculative factors in food and fuel price increases and financialization of commodities are essential. The IMF through its financing instruments should also attempt to cushion the impact on the worst affected countries and support them in adjusting to the changed global economic scenario.

### **Role of the IMF**

10 The twin crises – in the financial markets and the commodity price increases – bring to the fore the role of the Fund. Efforts at crisis resolution have been taken up at the national, regional and the multi-lateral levels. However, the Fund's role, particularly in the financial crisis, has been perceived as peripheral.

11 The Fund's initial estimate of the financial system's losses at one trillion dollars has turned out to be accurate and perhaps an underestimate. But the moot question is, could the Fund have played a bigger role in analyzing and mitigating the crisis or even anticipating and preventing it? More importantly, what further role can the Fund play?

12 The key appeal of the Fund and its legitimacy are derived from the universality of its membership. The Fund should be unambiguously tasked with the mandate of providing the global public good of financial stability. As the crisis gets manifested in various corners of the globe, efforts are on under the aegis of different bodies – some regional and others which are restricted in their membership and with a somewhat limited mandate – in solving a crisis of global proportions. While we welcome such efforts, it is time that such fragmented efforts are organized and orchestrated on a global scale and the IMF may be best suited to play the role of the conductor.

13 As a first step, the Fund's response should be refocusing and strengthening the Fund's traditional surveillance and lending functions.

### *Surveillance*

14 Surveillance - oversight of policies and economic development at the global, regional and country level - is the core mandate of the Fund. Surveillance is not a static concept and historically this core function of the Fund has evolved to keep pace with the spirit of the times. There was a concern whether Fund surveillance has kept pace in the present financial crisis.

15 The recently concluded Triennial Surveillance Review has raised a number of important questions. Was the emphasis on exchange rates in surveillance misplaced and led to the Fund missing out on the early warning signs of the financial crisis? What would be the future role of Fund surveillance in the developed countries where, given the nature of the international capital market, the Fund would have at best a limited role as a lender? More fundamentally, what will be the priority assigned to “financial stability” surveillance?

16 Exchange rates are important in Fund's surveillance but financial sector stability, the orderly flow of capital, and the linkages between the real economy and the financial sector are equally critical if not more important issues. Moving forward I urge the Fund to adopt a more wholesome, balanced and priority-driven approach to surveillance.

17 I reiterate the need for greater focus on systemically important countries, since developments in such countries tend to impact all other countries, particularly smaller ones.

***Lending Role of the Fund***

18 The Fund, as a financing institution, should have the lending instruments and the financing capacity to address potential borrowing needs. The reduction in the Fund's overall lending operations provides the backdrop for a review of its financing role. The decline in the demand for Fund credit was in part due to the positive global and country-specific developments. However, as the global situation takes a turn for the worse, the fact that very few member-countries have as yet approached the Fund points to the inadequacy and unattractiveness of the Fund's financing toolkit.

19 The key issue now is not of increasing the Fund's lending but one of staying relevant to its membership. The reasons for the unattractiveness of Fund instruments need to be addressed. A frank discussion and openness to new ideas would best serve the task of updating the Fund's lending toolkit.

20 First, there has to be a clear division of labour between the Fund and other international financial institutions (IFIs). The Fund has traditionally been the financier of choice for balance of payments needs and programmes designed for macro-economic stability and structural adjustment. It is now apparent that other IFIs are also lending for very similar needs. It would be desirable to avoid such overlaps in financing mandates.

21 The issue of stigma attached to Fund lending has to be tackled to reduce recourse to alternatives. Stigma could be mitigated by the IMF developing a deeper and more open relationship with its member-countries. Countries have to be encouraged to approach the Fund in the incipient stages of a crisis.

22 Appropriate instruments have to be developed incorporating features that would appeal to different types of member-countries. We welcome the work already done on making the Exogenous Shocks Facility easier to access. However, this alone may not be adequate to meet the needs of low income countries, and the array of lending instruments available for them and the manner in which they are delivered needs a further review. The usefulness of a contingent credit line as an instrument of crisis prevention tailored for emerging market economies undertaking reforms has been well recognized and work on this aspect needs to be expedited.

23 A review of the Fund's lending function should also take note of the resource position of the Fund. Since the Eleventh Review of quotas in 1998 there has been no general increase in quotas. Although the Fund does not face an immediate liquidity issue, possible future needs have to be kept in mind.

### **Governance**

24 The issue of governance continues to be critical to the legitimacy, credibility and effectiveness of the Fund. At a fundamental level the most crucial issue is the continuance of the process of realignment of quotas and voice. The initiative towards internal governance reform within the Fund is also very important. We support the proposed three-pronged process – work based on the Independent Evaluation Office (IEO) report; the recommendations expected from the Trevor Manuel Committee of Eminent Persons; and the inputs from civil society. It may be recalled that the institution of the IEO was set up to improve governance, provide independent feedback to the Executive Board in its oversight responsibilities and to enhance the learning culture of the IMF. Hence it is important that IEO's reports are given due importance and the follow up is meticulous.

### **Developments in the Constituency**

25 Let me now turn briefly to some key aspects of developments in my constituency. With a real GDP growth at 9.0 per cent during 2007-08, the **Indian** economy continued to perform well. This was, in fact, the third year in succession when the Indian economy achieved a growth rate of 9 per cent and above. Headline inflation, however, has increased significantly since early 2008, partly reflecting supply-side pressures on key agricultural commodities, increase in iron and steel prices in line with international prices, and pass-through (though partial) of international crude oil prices to domestic prices as well as continued high domestic demand. India's balance of payments remained comfortable with the current account deficit at 1.5 per cent of GDP in 2007-08. Large net capital flows, which were significantly higher than the current account deficit, led to an accretion of foreign exchange reserves, placing continued pressure on monetary management. Our current challenges are to rein in inflation without hurting the growth momentum, preserve financial stability and move more vigorously on fiscal consolidation.

26 Following a 6.8 percent growth in 2007, **Sri Lanka**'s economy posted a growth of 6.6 percent in the first half of 2008, despite many challenges, both external and domestic and this year's annual growth is estimated to be around 7 percent. The growth has been very much broad based and equally distributed as all three sectors have grown on average by over 6 percent. Unemployment remains all time low at 5.1 percent. Inflation that rose to a high level has come down quite significantly during the last three months responding to the tight monetary policy stance adopted by the authorities. High fiscal deficit too will fall below seven percent in 2008. Public Debt to GDP ratio, which remained high over 100 percent a few years ago, has fallen sharply and by end 2008, this ratio is projected to be around 78 percent. Despite widening Current Account deficit due to increased cost of food and oil imports overall Balance of Payments remained favourable with a surplus of US\$500 million by mid 2008.

27 Despite natural disasters and high global food and fuel prices, **Bangladesh** economy has shown remarkable signs of resilience. The real GDP growth rate for the financial year 2007-08 (i.e., July 2007 to June 2008) is estimated at 6.2 percent, which is slightly lower than the 6.4 percent achieved in 2006-07. Growth has picked up during the latter half of 2007-08, supported by a bumper agricultural harvest, escalating garment exports and very strong remittances. The current floods are transient in nature and are not expected to pose any serious threat to disrupt the macroeconomic fundamentals of the economy. Consequent to the elevated food and energy prices globally as well as internal shocks, Bangladesh witnessed a high inflationary trajectory in recent times. The authorities adopted a combination of supply management and monetary and fiscal policies to rein in inflation. The fiscal position was supported by a significant improvement in revenue collections, which helped offset increased subsidies and outlays on safety nets.

28 In **Bhutan**, the historic political transformation to a parliamentary democracy in March, 2007 provides the backdrop for the implementation of the development agenda. Under the 10<sup>th</sup> Plan, development spending is expected to double with a focus on poverty reduction through industrial development, balanced regional growth and infrastructure investment. Real GDP growth for 2007/08 is estimated at 23.6 per cent reflecting the recent doubling of hydro power generation capacity with the coming on stream of the Tala hydro project. Inflation, which tracks price developments in the main trade partner, India, is a challenge.