Statement by

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Global Economic Scenario – The Ongoing Economic Crisis

Our meeting in Istanbul takes place in an atmosphere which is far more hopeful than it was a year ago when the financial and economic crisis had just begun. The crisis has not only been enormous in scale but has generated an extraordinary response from most major economies. The coordination and cooperation we have been able to demonstrate at the political level has generated hope that we can overcome the crisis and turn the corner. The stimulus packages, unprecedented in their size, have had a beneficial impact and we see signs of stability and a general uptrend in many quarters. Industrial production, trade and economic growth have recovered in many countries. Green shoots are discernible over the horizon for many. However, it is important to be cautious at this juncture.

While the optimism is justified, we must realize that the economic crisis has not yet run its full course. The crisis continues and though the acute phase may be over, its adverse impacts are going to linger on for many years to come. While the first order effects were limited to the financial sector and many developing countries remained relatively unscathed, the second order effects on the real sector have had damaging consequences. The loss in industrial production, remittances, trade and consequently, economic growth, has pushed over 90 million people into poverty as per the Bank’s own estimates. It must be remembered that this estimate has been constantly rising and we are not sure that we have reached the upper limit. In the seven years before the crisis, the GDP of the developing countries grew at an average of 6.5 per cent per year. In 2009 it will grow by only 1.5 per cent, implying a fall in real per capita income. Of course, experience varies across countries. Countries in Asia have generally fared much better. Countries in sub-Saharan Africa and in many other regions have been very badly hit.

While developing country governments are trying to battle the crisis through stimulus packages and other relief measures, they face fiscal constraints in maintaining their investments in education, health and infrastructure. The fight against poverty, illiteracy and disease has suffered a serious setback and the timely achievement of MDGs has been jeopardized. As major economies unwind their stimulus packages and bring budgets back into balance, this would reduce stimulus driven growth impulses. It is likely that we will experience a weak recovery which is unevenly distributed, with a continuing severe impact on the poor and marginalized.

Changed External Financing Scenario

An important change that has taken place is the decline in the availability of external financing for developing countries. The crisis has completely transformed the financial landscape. While much of it is for the common good, the implications for developing countries are serious. One long lasting impact of the crisis is that we have probably moved to a new world of higher cost capital for investment in developing countries. Bank consolidation and capital requirements have seen a scaling back in private lending to developing countries. This has been coupled with a dramatic rise in interest rate spreads for
emerging market loans. FDI flows have almost halved and are unlikely to recover to pre-crisis levels for some time. Developing countries are faced with an external financing gap of between $300-600 billion. Foreign exchange reserves have been drawn down to meet some of this gap. The higher cost of capital acts as a drag on growth and could cut growth by 1-2%.

Developing countries are caught in a pincer. At a time when they need additional resources for essential investments in physical and social infrastructure, they are faced with rising investment costs and reduced flows. This is the right opportunity for the World Bank Group to fulfill its mandated role and step in to fill as much of the gap as possible. This should be its finest hour.

And the Bank has certainly risen to the challenge. It has been innovative in creating new instruments, lending windows, fast-track procedures and mobilizing additional resources. We applaud the Bank’s response to the crisis so far. IBRD commitments rose last year by a record 144% to $33 billion, a historic high for any single year. We are heartened that they are going to be even higher this year. The President has repeatedly asserted the readiness of the Bank to help countries tide over the crisis. IFC has been particularly innovative in rising to the challenge and also needs our appreciation. The steps taken so far and more in the pipeline will certainly mitigate some of the adverse effects of the crisis. However, much more needs to be done.

**Capital Adequacy**

The demand for World Bank assistance is a pointer to the future and we need to draw the right conclusions. What we are experiencing is not a one-time jump in demand for Bank assistance but rather, a change in the long term trend. It is true that a few years ago, the Bank was faced with declining demand for assistance. This was in the context of an external sector where credit was cheap and easy to get and where FDI flows were rising rapidly. It was natural that Bank assistance was relatively less attractive.

However, the external financial sector has changed substantially to conclude that the trend has changed. The new world of higher cost capital for investment in developing countries would mean that they would now need a reliable lender who would be able to provide adequate financial resources at a stable, cheaper rate. This is precisely the role for which the Bank was set up. Therefore, it is our firm conviction that demand for World Bank assistance would continue to rise for many years to come. We need to plan for that scenario rather than hope that the situation will revert to pre-crisis levels. The financial world has changed and the Bank needs to change its lending projections to meet the new demands on its resources.

Facts speak for themselves. The demand for IBRD loans has been far in excess of projections made even a year ago. The President had asserted that it would lend $100 billion over three years. However, demand seems to be outstripping IBRD’s financial capacity rapidly. By IBRD’s own estimates, under a conservative “Expected Scenario”, total commitments would cross $136 bn in four years. In a prolonged recession, demand could go higher. Actual figures seem to be inching even higher than expected. Therefore, IBRD needs to plan for at least the expected scenario.

The other aspect is the steady state lending level IBRD should aim for in a post-crisis situation. Given the changed external financial realities, the external financing gap for developing countries will continue to be high, even after the crisis. Governments will continue to face deficits, infrastructure projects that have been delayed would need to be completed and social sector investments would need to be maintained. These factors will ensure that there is substantial demand for World Bank Group services for many years to come. The drivers identified in the paper give rise to the same conclusion. Hence, IBRD should plan for a lending level which is significantly higher than the pre-crisis levels. Against an annual average lending of $12-13 billion in pre-crisis years, we believe that IBRD should target between $15-20 bn per annum.
This is a challenge and an opportunity for the Bank. The Bank should contribute to the solution – but needs to be strong enough to contribute. A weakened Bank would not be able to be part of the solution. We are concerned that the current capital position of the Bank may not be able to sustain this level of lending. We feel that there is a strong case for a capital increase at IBRD and the case could not be better made in the document. There is an equity gap facing IBRD. Some measures have already been taken to bridge the gap. Borrowers have already shared the burden by bearing a loan price increase. It would be unfair and self – defeating to ask them to bear more through another loan price increase. It is time for shareholders to do their bit by supporting a capital increase. This needs to be tied up with Voice reform as well.

The way we see it, the choice before us is simple – do we want the Bank to continue to play a lead role in eradicating poverty and fostering development globally, or do we want it to slide into irrelevance and be marginalized. The relevance of the Bank’s mandate is as real as it was in the 1950s, 60s and 70s, in fact, more so. The Bank has come to occupy a unique position in the multilateral system. It has become the repository of an exceptional and irreplaceable collection of knowledge, data and expertise in development. Today, in the midst of perhaps the worst crisis since the Bank’s inception, its storehouse of knowledge and resources is desperately needed. We have to strengthen the hands of the Bank if we are to remain sincere in our commitment to eradicating poverty. And to those who see an IBRD-IDA trade-off, they may note that 70% of the world’s poor live in middle income countries which are IBRD clients. It is these countries which will provide the next growth impetus. The least we can do at this stage is to agree to supporting a capital increase for IBRD. Let not future generations say that we failed when had chance to make a difference.

IFC’s position is no better. It is already in a capital constrained situation, unable to counter the decline in private capital flows. Although IFC has been innovative in raising resources, innovation has its limits. We need a strong IFC in the years to come to fill the fall in private flows. Projections show that even at a modest growth rate, IFC will need capital. Let us also agree to support a capital increase for IFC.

Voice & Participation

Voice and participation of DTCs in the governance of the Bank is important from many perspectives. DTCs are the customers of the Bank. The Bank’s entire effort to eliminate poverty is played out in DTCs. As partners in the process, they need to have adequate voice in the way this institution is run. This will make the Bank a more responsive, credible and relevant organization which is truly a development cooperative. It is only through this transformation that it can continue to play a vital developmental role.

Further, the changing dynamism of the global economy and the evolving weights of developing economies need to be reflected in the governance structure of the World Bank. Today, a significant portion of incremental global economic growth is being contributed by developing countries who can be important drivers of global economic growth in future. This fact needs to be recognized. This is also necessary if they have to see a role for the Bank in addressing new challenges in climate change, energy and food.

It was with these elements in mind that we embarked on the Voice reform process in 2002 at Monterey. It gathered pace after we agreed in Spring 2008 on “the importance of enhancing voice and participation for all developing and transition countries in the World Bank Group.”

A year ago, we agreed on two phases of Voice reform. Phase 1 was agreed as the first step of an ongoing reform process and which was to be implemented immediately. The other was a commitment to conduct a shareholding review for realigning Bank shareholding. The first step enhanced the voice of Sub Saharan
Africa and gave greater representation to smaller members. But the shift in vote share to DTCs was a miniscule 1.4%. It is time for us now to deliver on the promise of Phase 2.

The economic crisis has only accelerated the need to reform the governance structure of the Bank. As inter-dependencies between countries have become self-evident, as the impact of the crisis on poor countries has deepened, as the need to work collectively and cooperatively to find solutions has increased, the need for Voice reform has become more urgent. We responded to the call of G-20 London Summit by accelerating the completion of Phase 2 by a year to Spring 2010.

We need to now deliver on the promise of Phase 2. What then is the expectation. The expectation is a significant shift in voting power to DTCs. A significant shift is one which alters the dynamics of governance. This is possible only if DTCs achieve parity which requires a shift of 6% in voting power. That would truly be transformational. The shift can happen at one go or in stages. But we must reach an agreement now on the quantum of shift in Phase 2 and then work out the mechanics of achieving that shift. At the end of the day, it is on the size of the vote share shift that the rest of the world will judge the success of the Voice reform process. An agreement today will enable our representatives to finalise the details of the realignment.

As for the realignment, it should be based on criteria that are specific to the mandate of the Bank. Economic weight must be the primary criterion in any methodology. We are clear that we cannot agree to any linkage with IMF quotas or outcomes. The reasons are simple. Firstly, we agreed to have a Bank specific formula. Therefore, IMF quotas do not reflect our widely differing mandates. The G-20 Pittsburgh Summit has also “stressed the importance of adopting a dynamic formula at the World Bank which primarily reflects countries’ evolving economic weight and the World Bank’s development mission”. Secondly, IMF quotas are the result of a formula which has many variables which are of no relevance to the Bank’s activities – foreign exchange reserves, current payments/ receipts and variability. Thirdly, we have moved away from parallelism with the IMF two decades ago. That was necessary. We should not attempt to restore it. Lastly, there is a practical issue as well. IMF has just begun a quota realignment process which will end in 2011. We cannot have as a basis an IMF quota share which is itself going to change in a year’s time. Therefore, we should put an end to all discussion on using IMF quotas in the Bank’s Voice reform process.

We should focus on GDP and its blends as the basis for measuring economic weight. The IMF has used a 60:40 GDP Market Rate – PPP blend in the context of its own work. That is not replicable for the Bank. For the Bank, where the focus is on economic development and poverty eradication, we believe that GDP at PPP is the most relevant measure for capturing the effect of Bank’s activities. We feel that any blend should be overwhelmingly weighted in favour of GDP-PPP.

We also feel that other criteria are subsidiary and the primary outcome of realignment should result from economic weight criteria. Therefore, any boosters for IDA should be used to reallocate shares among Developed Countries without affecting DTC vote share. If borrower contributions are to be taken into account, we need a differentiated approach. Boosters could also be used for anomalous outcomes.

As we see it, Phase 1 and Phase 2 are two steps in the same process. In an ideal world, all the decisions should have been taken at one go. However, in order to ensure that the benefits of the Voice reform process to smaller countries and to Sub Saharan Africa are not delayed, we collectively agreed to fast tracking some steps under Phase 1. We now need to focus on the remaining unresolved issue, i.e., share realignment in favour of DTCs. We would like to make it clear that issues settled in Phase 1 should not be reopened. However, we feel that the gains of Phase 1 should be preserved. This may require measures to ring-fence the vote share of small countries. We can look at alternative ways of doing so.
We need an ambitious outcome from the Voice reform process. By doing so, we will strengthen the Bank as a whole and make it an important multilateral instrument for winning the war against poverty, illiteracy, hunger and disease.