International Monetary and Financial Committee

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Statement by Dr. Raghuram Rajan
Alternate Governor, India

On behalf of Bangladesh, Bhutan, India, Sri Lanka

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Alternate Governor for India
(Representing the Constituency consisting of Bangladesh, Bhutan, India and Sri Lanka)
to the
International Monetary and Financial Committee
Washington DC, October 2014

Mr. Chairman,

1. Global growth is recovering, but hesitatingly. Even as the US economy has performed better than expected, the recovery in the Euro area remains extremely fragile. Investment remains weak in many advanced economies (AEs). Low and falling inflation in the Euro area has emerged as a major risk to its economy. Even as the global recovery remains weak, financial stability risks in many AEs raise concerns afresh. These risks are serious, and should they materialize, have the potential to derail the recovery process. There are positive developments also. The fiscal situation in AEs is improving. The public debt to GDP ratios in AEs have stabilized, though they remain at historically high levels.

2. Growth in the emerging market economies (EMEs) has also slowed down, reflecting country specific factors. It is worrying that potential growth in both AEs and EMEs has declined significantly. Thus, the challenge for policymakers in both AEs and EMEs is to put the current global recovery on a sustainable path and to raise the long-term global growth potential.

3. When we met in April 2014, we had agreed that creating a more dynamic, sustainable, balanced, and job-rich global economy remains our paramount goal. We also agreed that we would implement, among others, ambitious structural reforms, promote financial stability, and reinforce cooperation to manage spillovers. More or less a similar view was echoed on several occasions in the past. While a strong and sustainable global recovery has eluded us so far, we face two major challenges. First, financial stability risks have arisen in the wake of prolonged period of low interest rates. Second, uncertainty continues about the smooth exit from the unconventional monetary policies pursued by central banks in AEs. There is, therefore, a need to review the evolving global macroeconomic situation and financial market conditions, and to display policy sensitivity to spillover risks so that the global economy can collectively be placed on a sustainable growth path.

A. The Global Economy and Financial Markets

4. The global recovery continues to be fragile. The US economy is expected to perform well even though growth suffered in Q1 of 2014 due to a harsh winter. For the third year in succession, the US economy is expected to register a growth of around 2 per cent. The unemployment rate has fallen significantly. Growth is being underpinned by accommodative monetary policy, lower fiscal drag and improved financial conditions. However, the euro area continues to raise concerns. Although the fiscal adjustment drag has reduced and lending conditions have improved, weak investment activity continues to weigh heavily on economic

activity. Unemployment continues at an extraordinary high level. Financial fragmentation persists and credit continues to contract. The repairing of balance sheets is still not complete. Even as the Euro area continues to deal with some of the legacy problems, falling inflation has become a big concern. It can delay the extremely fragile recovery due to rise in real interest rates and exacerbate debt sustainability concerns. On the whole, the growth outlook for AEs remains subject to significant downside risks.

5. Growth has also weakened in EMEs, declining in each of the last four years. What is worrying is the significant decline in potential growth in EMEs due mainly to decline in investment. Like in AEs, financial stability risks have increased as reflected in rising asset prices, compressed yields, low volatilities and rising corporate debt.

6. The low rate of interest over a prolonged period of time has had only limited impact on economic activity, as the transmission mechanism remains impaired, and confidence low. However, low interest rates have facilitated excessive risk taking and increased overall risk in the system. It is worrying that financial markets have diverged from fundamentals. More worrying is the fact that they have occurred simultaneously and across the board for asset classes and across countries. The disconnect between financial markets and the real economy is a matter of concern. There is a risk that the normalization of monetary policy by AEs could trigger repricing of risks and lead to turbulence in financial markets, which, in turn, has the potential to derail the global recovery.

Policy Challenges

7. The current macroeconomic situation continues to pose several challenges for policymakers in both AEs and EMEs. Ultra loose monetary policy in AEs has been pursued for long, which has led to under-pricing of risks in financial markets. Under-pricing of financial assets in both AEs and EMEs is likely to be corrected once accommodative monetary policies are reversed. This could lead to turmoil in financial markets and derail the recovery. To sustain the recovery, it is, therefore, important that financial stability risks are addressed in both AEs and EMEs. As accommodative monetary policies are leading more to financial risks than economic risks, the pros of continuing such policies need to be carefully weighed against the cons. However, the process of exit from unconventional monetary policies needs to be predictable and well communicated, and sensitive to developments. Central banks in AEs also need to take into account the spillovers of their policies on other economies. EMEs also need to take measures both to address financial stability risks and the adverse impact that the withdrawal of accommodative monetary policy may have on their financial markets and the real economies. Thus, there is an enhanced need for sensitivity to spillover effects, and to continue work on enhancing multilateral safety nets, as the AEs make the exit from unconventional monetary policies.

8. In the Euro area, while good progress has been made in several areas such as setting up a single supervisory mechanism, some other legacy issues in the Euro area have persisted for too long. Balance sheets continue to be impaired. Notwithstanding some improvement, credit conditions continue to be tight and financial fragmentation persists. This has constrained the investment activity. All these concerns need to be addressed. The Euro area

also needs to take effective measures to address the risk of low and falling prices. We fear that prolonged asset purchases by the ECB could exacerbate financial stability risks. This suggests more weight on structural reforms to enhance competition and productivity, even while allowing some fiscal overshoot for countries that have a clear reform agenda. Long term concerns relating to aging populations and weak productivity also need to be addressed.

9. In many EMEs, the policy space to stimulate the economic activity varies. The macroeconomic policy space, wherever available, needs to be used. The key challenge is to raise the potential growth for which the focus in the emerging markets needs to be on structural reforms. For improving productivity, reforms need to focus on education, skill development, and removing bottlenecks. Investment in infrastructure could also play an important role in the short run and in raising potential growth in the medium term. Countries also need to guard against financial stability risks, limiting dependence on unconventional monetary policies, using macro prudential polices and building resilience.

B. The IMF's Role – Architecture for Global Cooperation

10. I now turn to some of the overarching issues relating to global co-operation that need to be addressed in the context of safeguarding global economic and financial stability in the period ahead.

Quota and Governance Reform

11. The 2010 Quota and Governance Reform has not become effective despite the strong support of the global community. Governance reforms are required to ensure the Fund's credibility, legitimacy and effectiveness. They are also imperative to maintain its relevance. The quota reforms, therefore, need to be completed by the year-end. Should this not materialise, the Fund needs to explore every available option for completing the current round of quota reform process. We call upon all members, particularly those with the crucial voting power, to extend their fullest cooperation and support to the alternative proposals that might be suggested.

Surveillance

12. The recent financial crisis has exposed several weaknesses of the Fund's surveillance. We, therefore, commend the Fund for the recent 2014 Triennial Surveillance Review. We welcome the decision to focus on further integrating multilateral and bilateral surveillance and macro-financial linkages. However, for surveillance to gain traction, it is important that the Fund is evenhanded both in terms of providing inputs and outputs, i.e., policy advice. We will encourage the Fund to play a key role in fostering global cooperation so as to enhance the effectiveness of surveillance. However, changes in the structure and mandate of the Fund should be very carefully weighed.

C. Developments in the Constituency

13. I now turn to developments in my constituency.

Bangladesh

14. Economic activity revived with the return of normalcy after the elections of January 2014. As per preliminary estimates, growth in Fiscal Year (FY) 2014 was 6.1 per cent. Growth is expected to pick up in FY 2015, as domestic demand strengthens, worker remittances go up and public investment increases. Inflation eased to 7 per cent in FY 2014 as non food prices lowered. It is expected to ease further in FY 2015. Though import growth will be higher and export growth is likely to moderate, international reserves are likely to continue building up. During FY 2014, tax revenue was adversely impacted by slower economic activity. However, the government kept current expenditure under control and the fiscal deficit for FY 2014 was contained at 4.2 per cent of GDP, narrowly missing the targeted figure.

15. The fiscal policy stance in FY 2015 will be prudent and the overall fiscal deficit (excluding grants) is targeted at 3.8 per cent of GDP. Public investment, especially in the critical transport and power infrastructure, and social sector spending will receive priority. The monetary stance is focused on bringing average inflation down to 6.5 per cent by the end of FY 2015. There are upside risks to inflation from strong growth in demand and reserve money will be tightened as and when necessary to keep inflation in check.

16. The government has undertaken a number of reform measures across a range of areas including tax legislation and administration, subsidy policies, financial management of State Owned Enterprises (SOEs), public debt and cash flow management, central bank financial reporting, and banking sector supervision. There have been, however, delays in the implementation of a new VAT, a critical element of tax reforms, which was expected to be launched in July 2015. The government remains committed to this reform and is putting in place a new time table for the same. Poverty reduction remains on track with the target of reducing poverty from 31.5 per cent in FY 2010 to 22.5 per cent in FY 2015. Significant progress has been made in improving labor rights and factory standards. In fact, this is a reason why export growth is expected to moderate slightly, as the readymade garment industry adjusts to higher labor and safety standards. Social safety nets for the poor continue receiving special attention of the government.

Bhutan

17. Real GDP growth in Bhutan is expected to have accelerated to 6.0 per cent during 2013-14 from 4.6 per cent in 2012-13. In the preceding two years, growth had decelerated in response to monetary policy and other prudential measures to rein in aggregate demand and external imbalances. The pick-up in economic activity in 2013-14 was led by higher growth in electricity and construction activities on the back of hydro-power activity. The hydropower sector remains a key sector of economic activity – construction and electricity sub-sectors constitute almost one-fourth of GDP. Consumer price inflation (year-on-year) moderated to 8.6 per cent in the second quarter of 2014 from 11.3 per cent in the fourth quarter of 2013, on the back of reduction in both food and non-food inflation. The fiscal deficit is expected to be 4.0 per cent of GDP in 2013-14, marginally lower than that of 4.1

per cent in 2012-13. The current account deficit is estimated at 24.8 per cent of GDP in 2013-14, broadly unchanged from 2012-13, reflecting large imports associated with the construction of hydropower plants. Bhutan's international reserves were USD 979 million (July 2014), equivalent to 22 months of merchandise imports. Financial soundness indicators for Bhutan remain sound, with capital adequacy and liquidity well above the required prudential norms, although the non-performing assets (11.8 per cent) are a policy concern. Going forward, the Royal Monetary Authority of Bhutan (RMA) has indicated that monetary policy will remain tight to counter prospective overheating and pressures on Indian rupee reserves. With the introduction of fiscal measures by the Government, in particular new and increased taxes on the import of vehicles and fuel, the RMA has phased out the temporary credit restrictions imposed on the housing and transport portfolios from September 2014.

India

18. Economic activity in India is beginning to look up. The Reserve Bank of India projects the growth rate to improve from 4.7 per cent in 2013-14 to 5.5 per cent in 2014-15. Business and consumer confidence is fast improving after the new government was formed in May 2014. Economic outlook beyond this year looks still better. Structural constraints are being addressed expeditiously. A large number of stalled projects have already been cleared, and are gradually beginning to pick up pace. It is expected that investment activity will soon pick up. Retail inflation is also trending down. Inflation, which was 11.2 per cent in November 2013, declined to 7.8 per cent in August 2014. In terms of the glide path envisaged by the Reserve Bank of India, retail inflation is projected to decline to 6 per cent by January 2016.

19. India's twin deficits, viz., the fiscal deficit and the current account deficit, which made the economy vulnerable in 2013, have improved significantly. The gross fiscal deficit is budgeted to decline from 4.5 per cent in 2013-14 to 4.1 in 2014-15. India's current account deficit (CAD)-GDP ratio has also declined from 4.7 per cent in 2012-13 to 1.7 per cent in 2013-14. In Q1 of 2014-15, the CAD-GDP ratio stood at 1.7 per cent as compared to 4.8 per cent in the corresponding quarter of 2013-14. The recent fall in oil prices, if sustained, will help narrow the deficit further. India has also been receiving large portfolio flows. Consequently, India's foreign exchange reserves have increased significantly.

20. Even as the macroeconomic situation has improved, the Indian economy faces some challenges. A major challenge continues to be to bring down inflation to a more tolerable level. Another challenge is to revive investment activity in the short run and to raise the long-term growth potential through structural reforms.

Sri Lanka

21. The Sri Lankan economy grew by 7.7 per cent in the first half of 2014 compared to 6.4 per cent in the same period of the previous year. Improvements in both domestic and external demand helped in achieving this growth momentum. The industry sector grew at an impressive rate of 12.4 per cent largely supported by the construction and manufacturing sub-sectors. The services sector grew by 6.1 per cent with a significant contribution coming from

the wholesale and retail trade and tourism. Affected by unfavorable weather conditions, the agriculture sector grew only moderately. The growth momentum is expected to continue in the second half recording a growth of 7.8 per cent for 2014. Inflation continues to remain subdued. The year-on-year inflation decelerated to 3.5 per cent in September 2014 from 4.7 per cent in December 2013. Considering the benign inflation and inflation expectations and slowing private sector credit growth, the central bank eased its monetary policy stance in 2014 to support economic activity. The budget deficit during the first half of 2014 declined to 3.7 per cent of the GDP from 4.3 per cent in the corresponding period of 2013. The authorities are confident in attaining the targeted deficit of 5.2 per cent of GDP in 2014 despite revenue generation remaining a challenge. The external sector resilience improved further in 2014. The export earnings grew by a healthy rate of 16.8 per cent while imports declined marginally during the first half of the year resulting in a substantial improvement in the trade account. The trade in services also showed a steady growth during this period largely benefitting from the improved performance in travel, tourism and transportation. With these developments and steadily increasing remittances, the current account deficit is expected to improve to around 2.1 per cent of GDP in 2014. Reflecting increased FDIs, portfolio investments and inflows to the Government, the BOP is expected to generate a surplus of USD 1.8 billion in 2014. The gross international reserves of the country increased to USD 9 billion, equivalent to 6.1 months of imports as at end August 2014. The Sri Lankan rupee remained largely stable during the first eight months of the year reflecting a slight appreciation of 0.43 per cent against the US dollar. Sri Lanka's financial sector remains well capitalized, healthy and profitable. A proactive consolidation process of financial institutions through mergers and acquisitions is in progress to further strengthen the financial system.

Conclusion

22. The global economic situation continues to disappoint. Even as the global economic recovery is yet to take a firm hold, rising financial stability risks raise serious concerns. These risks, if they materialize, could derail the fragile recovery. There is, therefore, a need to guard against such risks. A major challenge facing the global economy continues to be the uncertainty on whether AEs will be able to make a smooth exit from the unconventional monetary policies. An exit from the unconventional monetary policies - as and when it takes place - has the potential to impact the EMEs. While EMEs have prepared for the exit, given the widespread froth in asset prices, volatility cannot be ruled out. There is, therefore, a need for the central banks in AEs to be sensitive to the spillovers from exit on other countries. We also need to strengthen multilateral safety nets, even while ensuring dialogue and cooperation among the policymakers of AEs and emerging and developing economies.