

Shaktikanta Das: Global risks and policy challenges facing emerging market economies

Speech by Mr Shaktikanta Das, Governor of the Reserve Bank of India, at the event “Governor Talks” on the sidelines of the International Monetary Fund-World Bank Spring Meetings 2019, Washington DC, 12 April 2019.

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Thank you for inviting me to this forum.

I intend to cover some of the global risks and policy challenges from the perspective of emerging market economies (EMEs). We are aware that most EMEs have emerged more resilient than before from a turbulent 2018. For the greater part of 2018, the EMEs faced a wave of global spillover risks leading to capital outflows, currency and asset price volatility and tightened financial conditions. These developments posed risks to growth and inflation. Strong fundamentals, forex reserve buffers, capital in banking systems and prudent macroeconomic policies, however, enabled these economies to absorb global spillovers. Yet, as Agustin Carstens and Hyun Song Shin soberingly point out, “EMEs aren’t out of the woods yet”.¹

Global Risks

Let me highlight three major risks confronting EMEs in 2019.

2. The biggest risk facing these economies is the growing evidence that global growth and trade is weakening. Unsettled trade tensions and developments around Brexit are imparting further downside risks to the outlook. There is considerable uncertainty as to whether this weakness is temporary or the beginning of a recession in advanced economies. This uncertainty also seems to be reflected in several downward revisions to the 2019 global growth forecast by the IMF. Moreover, central banks across the world are stepping back from tightening monetary policy and some of them are promoting easier lending conditions. In some economies, fiscal stimuli are being used to support growth.

3. The second risk is that EMEs remain vulnerable to financial market volatility as the experience of 2018 has shown. The risk of sudden stops and reversals of capital flows has increased. Consequent external financing gaps and currency depreciations could undermine the outlook for growth and macroeconomic stability for these economies, just when global growth had begun to show signs of a synchronised revival a decade after the global financial crisis. Furthermore, adverse financial conditions could aggravate existing stress in the balance sheets of lending institutions in some EMEs and stretch their capital requirements.

4. The third risk to EMEs is the high volatility in international oil prices. For net energy importers like India, the recent firming up of oil prices on production cuts by major suppliers presents risks to current account deficit and inflation. The financialisation of energy markets and changing underlying dynamics in the global oil market are adding an upside risk to prices, though the demand is subdued. While break-even costs for shale production have apparently increased, investors have turned risk averse and are focusing on cash flows and financial returns. This may reduce the flexibility of shale output in filling the shortfalls created by OPEC plus production cuts.

Policy Challenges

So, in this environment, what are the policy challenges faced by EMEs?

5. In the aftermath of the global financial crisis (GFC), several EMEs have embarked upon structural reforms to reorient their economies. In the short-run, however, these reforms inevitably

involve sacrifices, including in terms of losses of growth momentum. Conventionally, these reforms are best undertaken in the expansionary phase of the economic cycle. With growth slowing down in a synchronised manner across borders, the space for undertaking and/or pushing ahead with structural reforms is likely to become severely constricted or even deterred. But the fact remains that we need more structural reforms precisely when the economy is slowing down to ensure durable momentum to growth. This is a point which I would like to stress.

6. As the global economy loses speed and with fiscal space getting squeezed, the focus in EMEs as well as advanced economies is likely to be on monetary policy as the first line of defence. Central banks may once again be expected to assume the mantle of guardians of the world economy. The global financial crisis has, however, exposed several limitations of conventional and unconventional monetary policy tools. In despair, some have turned to the heterodox evolution of ideas that has come to be known as modern monetary theory. While the jury is still out on this idea, I have my own strong reservations on this due to its serious downside risks. In the end, monetary policy must touch the real economy, spur investments, and maintain monetary and financial stability.

7. I do, however, feel that the time has come to think out of the box, including by challenging the conventional wisdom. Let me try and somewhat shock you with one such thought experiment. Typically, modern central banks with interest rates as their main instrument move in baby steps – 25 basis points or multiples thereof – and announce a stance of tightening, neutrality or accommodation to guide the markets and the public on the likely future course of policy. One thought that comes to my mind is that if the unit of 25 basis points is not sacrosanct and just a convention, monetary policy can be well served by calibrating the size of the policy rate to the dynamics of the situation and the size of the change itself can convey the stance of policy. For instance, if easing of monetary policy is required but the central bank prefers to be cautious in its accommodation, a 10 basis points reduction in the policy rate would perhaps communicate the intent of authorities more clearly than two separate moves – one on the policy rate, wasting 15 basis points of valuable rate action to rounding off, and the other on the stance, which in a sense, binds future policy action to a pre-committed direction. Likewise, in a situation in which the central bank prefers to be accommodative but not overly so, it could announce a cut in the policy rate by 35 basis points if it has judged that the standard 25 basis points is too little, but its multiple, i.e., 50 basis points is too much. This approach can also be useful when the central bank is on a tightening mode and potentially help avoid policy turnaround from forward guidance via stance too far into the future, which in a highly volatile global scenario, may not even be a year. I am articulating this idea not necessarily in search of a theory but in search of traction with domain experts and more particularly, with practitioner central bankers who face these dilemmas in their day-to-day lives.

8. At another level, a formidable challenge that EMEs will continue to face is the management of global spillovers. We live in a world of mobile capital flows where consequences of their arrivals, sudden stops and reversals are to be borne nationally. Against this backdrop, a truly global financial safety net remains elusive. The strengthening of resources of the IMF gets pushed out into time whenever we come together for Spring or Annual meetings. Under these conditions, EMEs which are typically at the receiving end when global spillovers flare up, have no recourse but to build their own forex reserve buffers. Paradoxically, the accumulation of reserves has become stigmatised, including with labels such as “currency manipulation”. As I see it, we may be unintentionally setting the stage for several EME currencies to break out and challenge the hegemony of the dominant reserve currencies. There is a need for greater understanding on both sides. In the meantime, so far as the Reserve Bank of India is concerned, we will continue to play by the extant rules of the game.

9. Central banks have to interact closely with financial markets for transmission of monetary policy impulses. In this context, ensuring a sound and efficient payment and settlement system is

a pre-requisite. Taking cognisance of exponential growth of digitisation and online commerce in India, policy efforts have been directed in recent years to put in place a state of the art national payments infrastructure and technology platform. This has changed the retail payments scenario of the country. Regulation and development of our payment system envisages the objectives of safety, security, convenience, accessibility, and leveraging technological solutions to enable faster processing. In order to ensure an orderly development of FinTechs and streamline their influence into the financial system, we are now working on guidelines to introduce a 'regulatory sandbox/innovation hub' within a well-defined space and duration to experiment with FinTech solutions.

10. In this high flux and uncertain environment, EMEs could perhaps be better off by stepping up cooperation on all fronts, while recognising multi-polarity. One area of cooperation could be to put in place an institutional mechanism which balances the concerns of both oil exporting and importing countries to ensure stability in energy prices. EMEs also need to explore alternatives to reduce dependence on conventional energy sources, and give greater focus on renewables and energy efficiency. The International Solar Alliance, with its headquarters in New Delhi, is a vivid example. It seeks to provide a dedicated platform for cooperation among financial and solar resource rich countries so that the global community benefits from the use of solar energy.

11. In closing, let me say a few words about India. Real GDP growth is expected to clock 7.2 per cent during 2019–20, the fastest among large economies of the world, growing by an average rate of around 7.5 per cent in recent years. Inflation has remained below target, averaging 3.6 per cent for the period under the inflation targeting framework so far (since October 2016 up to February 2019); the current account deficit is expected to be around 2.5 per cent of GDP in 2018–19; and the gross fiscal deficit has adhered to budgetary targets.

12. Looking ahead, our priority is to remain watchful and take coordinated action to revive growth and maintain macroeconomic, financial and price stability.

Thank you.

¹ Foreign Affairs, March 15, 2019.