Shaktikanta Das: Fundamental shifts in the global economy - new complexities, challenges and policy options

Keynote address by Mr Shaktikanta Das, Governor of the Reserve Bank of India, at the 59th South East Asian Central Banks (SEACEN) Governors' Conference, Mumbai, 15 February 2024.

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On behalf of the Reserve Bank of India, the current Chair of the SEACEN (South East Asian Central Banks) forum, I extend a warm welcome to Governors of central banks and other delegates to this 59th SEACEN Governors' Conference. The weather in Mumbai during this time of the year is pleasant and I hope you get some time for sightseeing. As everyone in this hall is aware, SEACEN plays a pivotal role in promoting collaboration, knowledge sharing and policy coordination among the member central banks, and thereby contributes significantly to the stability, resilience and sustainable development of the regional and the global economy.

We are gathered here at a critical juncture when the international economic landscape is undergoing profound transformations. The prospects of a soft landing have improved for the global economy, but there are multiple challenges with uncertainties looming on the horizon. The theme of the Conference "Navigating Economic Headwinds and Advancing Financial Inclusion: Perspectives and Challenges" aptly fits into the current policy dilemma that all central banks of the region face today. In these times, prudent macro-financial policies assume even greater importance for all of us to not only navigate through the current turbulence, but also to chart a course towards a more promising future. It is heartening to note that the economies in the region are making notable progress and are positioning themselves for continued advancement in the years ahead. There is a need for deeper integration in this region to stimulate economic growth and foster inclusiveness. I am sure the insightful discussions at this conference will offer some takeaways for our future policy making.

I have chosen the theme "Fundamental Shifts in the Global Economy: New Complexities, Challenges and Policy Options" for my address today. First, I propose to speak about the resilience of the global economy in recent years in marked contrast to the earlier periods of crisis. Thereafter, I propose to outline the emerging trends and shifts that are currently reshaping the global economy irreversibly and posing significant challenges for policymakers. Finally, my effort would be to provide a macroeconomic overview of our region, followed by highlighting some policy choices for the future.

Resilience of the Global Economy

According to the latest projection of the International Monetary Fund (IMF), the global growth is projected at 3.1 percent in 2024 and 3.2 percent in 2025, with forecast for 2024 revised upward by 0.2 percentage point from its October 2023 projection. It is interesting to note that that this time around the global economy has been far more resilient, weathering repeated shocks remarkably well. Even the financial system has broadly withstood the unprecedented monetary tightening across the world. The resilience of emerging market economies (EMEs), in particular, stands out unlike previous episodes of volatility which saw EMEs at the receiving end. EMEs have probably learnt from their past experience and played it well this time. While there is no definitive answer to this so called soft landing as yet, let me outline some possible factors.

First, during the global financial crisis (GFC) and the previous episodes of global turmoil, banking crises were a common feature in which insufficiently capitalised banks were at the core of the crisis. In contrast, this time the EMEs did not face adverse spillover effects from the recent banking sector turmoil in the advanced economies (AEs) in March 2023. This has been possible due to the strengthening of prudential regulation through wider adoption of Basel III norms and improvements in supervisory practices, which has resulted in a much-improved banking and financial system. Second, the improved macroeconomic fundamentals and buffers of the EMEs in recent years provided cushion against global shocks of the last four years. Third, fiscal and monetary stimulus provided during the COVID-19 has not been fully rolled back, especially in AEs. This has so far somewhat restricted the degree of spillovers from policy tightening by the AEs. Fourth, greater diffusion of technology in industry and services has gained traction after the pandemic. This has enhanced productivity in several EMEs and offset the adverse impact on output from factors like monetary tightening. In fact, technology has opened up new vistas of opportunities for EMEs, particularly in the services sector. Fifth, due credit also has to be given to calibrated and clear communication by central banks. Effective communication has now become an even stronger tool than earlier in providing forward guidance and anchoring market expectations.

Changing Landscape of the Global Economy

The pandemic was an unprecedented crisis of epic proportions in terms of loss of life and livelihood. In recent human history, recessions have been caused by swings in agricultural production, sharp jump in oil prices and financial upheavals. The global financial crisis also was a manifestation of the financial excesses growing under the benign neglect of policymakers. In contrast, the pandemic was a health emergency leading to a complete shutdown of economic activity and mobility to save lives against an unknown enemy. Consequently, there was no clear or readymade template for policymakers to follow; instead, they had to innovate and learn on the job in framing appropriate policy responses to minimise the negative impact of the pandemic on the economy and the financial system.

When the shadows of the pandemic were receding, geopolitical tensions and supply chain disruptions fuelled new challenges and inflation came back strongly. The resultant regime shift in monetary policy rattled financial market sentiments leading to a period of 'great volatility'. Existing models that were built to explain historical patterns in the data were found wanting in explaining the new realities. These models are now being increasingly challenged by ongoing shocks, geo-economic tensions and supply chain reconfigurations. For instance, models focusing on aggregate analysis fell short to explain what we observed in the aftermath of the pandemic. There was a rotation in demand initially from services to goods and then from goods to services. There was also a period of pent-up and revenge spending. These sectoral imbalances kept the levels of inflation high. The pandemic has indeed highlighted the need for more granular and sectoral analysis. In a sense, paradigm shifts in economic thinking are on the anvil. Let me reflect on some of these issues further.

First, the world after the pandemic has changed fundamentally in terms of shifting labour market dynamics, work processes and technological deepening. Work from home, online education and shopping have received wide acceptance, altering the way we work, learn and live. Technological innovation and digitalisation are permeating through every sector of the economy. Businesses are adapting to these trends for their survival. Frontier technologies like Artificial Intelligence (AI) and Machine Learning (ML) are being used widely to boost productivity. These technologies open new opportunities, but they also present challenges that we need to address.

Second, monetary policy before the pandemic was operating in a low for long regime in its quest for reviving growth while resisting deflationary pressures. This situation changed suddenly and drastically with monetary policy adopting the stance of "higher for longer" rates to fight inflationary pressures, following the war in Ukraine. Such regime shifts in the presence of debt overhang in an environment of high interest rates and low growth raise concerns on macroeconomic stability in many countries. Higher interest rates not only raise the interest servicing burden of heavily indebted countries but also impact the balance sheet of banks and financial institutions, as it was seen during the recent banking sector turmoil in advanced economies. In an extreme sense, high indebtedness of countries may constrain monetary policy due to sharp trade-off between price stability and financial stability.

Third, globalisation had boosted the global economy by enhancing productivity, creating global value chains and free movement of capital and labour across countries. The benefits of globalisation, however, had reached unevenly across countries. Given the recent trends of geo-economic fragmentation, industrial and trade policies worldwide are undergoing a shift. Several economies are now reshoring, nearshoring and friend-shoring [1] their production processes on security and strategic considerations. Consequently, there is growing trade fragmentation, technological decoupling, disrupted capital flows and labour movements. All of these do not portend well for an integrated global market for goods and services.

Fourth, from emerging market economies (EMEs) perspective, disruptions in trade flows in food, energy and critical industrial inputs due to recurring geopolitical flashpoints and disturbances in key trade routes are raising concerns for food security and macroeconomic management. Moreover, in view of the volatility in financial markets and capital flows, these countries remain vulnerable to external shocks. In such an environment, creation of domestic buffers in terms of strategic reserves of critical commodities as well as a strong umbrella of forex reserves become imperative for the EMEs.

Fifth, macroeconomic models used by central banks so far have mainly focused on the demand side of the economy. Enough emphasis was not given on supply side factors. The pandemic, followed by the war, and the resultant supply chain disruptions have brought in a sharp focus on the supply side. Overlapping supply shocks, as we saw recently, led to persistent inflationary pressures even when aggregate demand was not unreasonably high. In this context, the role of governments in managing the supply-side or cost-push pressures on inflation has increasingly gained wider acceptance. Going forward, a better understanding of the supply side of the economy has become very important for conducting monetary policy more effectively.

Against this background, let me now briefly touch upon the macroeconomic settings in our region.

Macroeconomic Overview of the SEACEN Region

The South-East Asian economies have shown remarkable resilience in the face of large global shocks. To a large extent, this can be attributed to improved monetary and macroeconomic policy framework that these countries have adopted in recent years. Growth in this region has remained strong, while inflation has been lower than the OECD average. Economic activity of the region has been supported by resilient services activity across sectors such as retail trade, digital services, e-commerce and tourism. This region remains a model of regional integration with close trade and labour flow linkages. Nevertheless, there is significant untapped potential for further trade integration. I strongly feel that promotion of tourism within the SEACEN countries can further strengthen the economies of the region.

Turning to the Indian economy, India has successfully navigated through multiple challenges and emerged as the fastest growing large economy. Prudent monetary and fiscal policies have paved the path for India's success in sailing through these rough waters. The Reserve Bank projects the Indian economy to grow by 7.0 per cent during 2024-25, marking the fourth successive year of growth at or above 7 per cent. Inflation has moderated from the highs of the summer of 2022. Recurring food price shocks and renewed flash points on the geo-political front, however, pose challenges to the ongoing disinflation process. We remain vigilant to navigate through the last mile of disinflation as it is often the most difficult part of the journey. We firmly recognise that stable and low inflation will provide the necessary bedrock for sustainable economic growth.

India's coordinated policy response in the face of a series of adverse shocks can be a good template for the future. While monetary policy worked on anchoring inflation expectations and quelling demand-pull pressures, supply side interventions by the government alleviated supply-side pressures and moderated cost-push inflation. Effective fiscal-monetary coordination was at the core of India's success.

I would now like to turn to some possible policy choices for the future course of the global economy, as new realities take shape in the years to come.

Policy Choices Going Ahead

First, we need to chalk out an effective strategy for global cooperation and coordination to deal with multiple challenges afflicting the global economy. Multilateralism must be re-energised. In this regard, agreements on a "critical minerals corridor" and a "food corridor" for safeguarding food security are necessary. Such arrangements have to be fair and equitable.

Second, there is a need to develop cooperation in areas of common interest and urgent needs such as climate change where no country can devise strategies on its own.

Smooth and orderly green transition is necessary to avoid disruptions to economic activity and loss of growth potential. While the investment needs for smooth green transition are large, the actual financial flows to green projects are highly skewed and are, by and large, concentrated in advanced economies. As a result, there is a need to enhance green capital flows to EMEs. At the same time, we have to be mindful of potential financial stability implications of green transition.

Third, improving infrastructure remains key to long-term growth. While investment in hard infrastructure (roads, ports, airports, electricity, water) is important, there has to be equal emphasis on creating soft infrastructure (education, health, legal, financial, institutional). Skill enhancement and increasing female labour force participation are key to enhancing effective labour supply and potential growth of the region.

Fourth, India's experience has shown how Digital Public Infrastructure (DPI) can be utilised for advancing financial inclusion and productivity gains through cost reductions. Our sustained engagement in the India Stack and the Unified Payments Interface (UPI), especially during the pandemic and thereafter, has given us the confidence that digital public infrastructure can become a critical part of global public good when scaled up beyond national boundaries. The linkage of Indian UPI and the fast payment systems of a few other countries drives home the potential of the UPI to become an international model for cross-border payments.

Fifth, new technological developments like artificial intelligence (AI) and machine learning (ML) can bring about significant improvements in efficiency and productivity of businesses. Necessary safeguards, however, need to be put in place to prevent the misuse of technology. In particular, global financial market regulators need to be vigilant about the possible misuse of AI and ML in perpetrating financial fraudulence.

Conclusion

The global economy stands at crossroads. Challenges remain in plenty, but new opportunities are also knocking at the door. Together, the course we take from here will decide our destiny in times to come. We need policies that are attuned to the new realities of the global economy. In an uncertain world, central banks need to be proactive to better serve the objectives of price and financial stability.

In this environment, collaboration is not an option but a necessity. We need greater resolve and coordination to make significant progress in dealing with global challenges. SEACEN, as a platform for central banks of the region, serves as a valuable forum for sharing insights and fostering cooperation in several areas for enhanced progress and prosperity. The cooperation among countries should give due consideration to the principles of comparative advantage and resource endowments so that each one of us benefits. Let us take our deliberations to the next level to achieve well-being of our people and our economies.

Thank You, Namaskar.

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[1] The term "reshoring" refers to a country's transfer of (part of the) global supply chain back home (or geographically closer to home the case of "nearshoring"). "Friend-

shoring" limits supply-chain networks and the sourcing of inputs to countries allied with the home country and trusted partners with aligned strategic and political preferences.