# International Monetary and Financial Committee

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**Statement by Dr. Raghuram Rajan,**
**Governor, Reserve Bank of India**

On behalf of Bangladesh, Bhutan, India, Sri Lanka

**Statement by Dr. Raghuram Rajan**
**Alternate Governor for India**
**(Representing the Constituency consisting of Bangladesh, Bhutan, India and Sri Lanka)**
**to the**
**International Monetary and Financial Committee**
**Washington DC, April 2014**

Mr. Chairman,

1. We are meeting at a time when the global economy is showing some signs of a pick-up. Economic activity in the US has expanded better than expected. The Euro area has also begun to show some signs of emerging from recession. On the whole, although economic activity in advanced economies has improved to some extent in comparison with what it was when we last met in October 2013, the recovery is yet to take a firm hold and is vulnerable to several downside risks. Although the fiscal risks are abating, they remain elevated. In advanced economies, recent policy moves have broadly stabilized public debt ratios. However, medium-term prospects still remain uncertain and debt levels remain at historic highs.

2. Growth in emerging market economies (EMEs), which had slowed down, is now picking up. However, it still languishes below the pre-crisis level. Some emerging market economies have also became vulnerable to volatility in capital flows. Therefore, the current global macroeconomic situation continues to pose several challenges to policymakers, both in advanced and emerging market economies.

3. When we met in October 2013 we had agreed to implement more ambitious and coherent policies for strong, sustainable, and balanced growth, while reducing market volatility. We also agreed that the eventual transition toward the normalization of monetary policy in the context of strengthened and sustained growth should be well timed and carefully calibrated. Such action, among others, was expected to help mitigate risks and manage spillovers, including those stemming from increased capital flow volatility. Continuing uncertainty as to whether the central banks in advanced economies will be able to make a smooth exit from the unconventional monetary policies (UMP) has weighed on growth prospects in emerging market economies. Financial market volatility was again observed in global financial markets in January 2014.There is, therefore, a need to review the evolving global macroeconomic situation, for greater monetary policy coordination, and for policies that will put global growth on a strong and sustainable path.

## A. The Global Economy and Financial Markets

4. As mentioned earlier, the global economy is showing some signs of improvement, *albeit* tentative. Economic activity in the US has expanded at a faster pace than was expected in October 2013. Even though the more recent data suggest some slowing of economic activity, on the whole, growth in the US should register a significant improvement in 2014 in comparison with 2013. It is heartening to note that growth in the Euro area has turned positive after witnessing recessionary conditions consecutively in previous two years. Nonetheless, growth in the Euro area is expected to remain sluggish as several fragilities continue to weigh on domestic demand. Even as they continue to face tight external financing conditions, the economic outlook in emerging markets is expected to improve further as they

address domestic constraints. This suggests that, going forward, the resilience of emerging market economies should improve.

5. Exchange markets in some emerging market economies came under renewed pressure in January 2014, following unexpected developments in some emerging markets and worries about more rapid exit from unconventional monetary policies. The market reaction was less severe, though, than when the talk of tapering began in May 2013. Long-term bond yields in advanced economies have declined in the recent period after they had risen sharply on the prospects of tapering. Equity markets in major advanced economies have risen on improving growth prospects. Long-term yields and equity markets in emerging market economies have shown mixed trends in the recent period. While credit conditions in the US have improved, those in the Euro area continue to remain tight. Financial fragmentation in the Euro area also persists. Although financial markets are broadly stable, a sense of uncertainty still prevails over whether central banks in advanced economies will be able to make a smooth exit from the unconventional monetary policies. Market focus has turned from tapering to the timing of the first interest rate hike. More turmoil when the timing of the hike becomes clear cannot be ruled out.

**Policy Challenges**

6. The current global macroeconomic situation continues to pose serious challenges to policymakers, both in advanced and emerging market economies. As growth picks up in advanced economies, monetary policy will be normalized. However, a smooth exit from the unconventional monetary policies will continue to pose challenges. The pace of normalization would need to be carefully calibrated keeping in view not only the growth prospects in advanced economies, but also any likely spillovers to the emerging market economies and their impact on the global economy. Unexpectedly rapid normalization of monetary policy in advanced economies will lead to volatility in global financial markets and its consequent impact on capital flows to emerging market economies. Even a well communicated exit can lead to unpredictable reaction in financial markets with spillovers to EMEs, which will then have feedback effects on advanced economies. It is, therefore, necessary to initiate some concrete steps to ensure effective multilateral cooperation.

7. Emerging market economies also need to recognize and prepare for the changing global environment. With improving growth prospects and, hence, returns in advanced economies, along with withdrawal of liquidity, the search for yield in EMEs will reduce. Even if the exit is smooth, external financing conditions will become tighter and interest rates will rise as monetary stimulus is withdrawn. Emerging market economies, therefore, need to manage domestic liquidity to ensure that credit flows are not hampered. On the positive side, improving growth prospects in advanced economies should encourage exports from the emerging markets. However, should the exit from unconventional monetary policies turn out to be bumpy, they will have to contend with volatile capital flows, as a result of which various segments of financial markets may come under severe pressure. Emerging market economies, therefore, need to address domestic vulnerabilities, strengthen fundamentals, build up reserves and prepare contingency plans to deal with any evolving situation. To improve the potential output, emerging market economies need to focus on structural reforms and encourage investment, especially in infrastructure. In the changed global environment, macroeconomic and/or policy framework weaknesses may prove very costly and hence need to be addressed expeditiously.

8. Notwithstanding some improvement in the Euro area in the recent period, several fragilities persist such as still impaired bank and corporate balance sheets, continuing credit contraction and financial fragmentation. Policymakers in the Euro area, therefore, need to address these fragilities to sustain the recovery. They also need to take steps to complete the banking union. Inflation in the Euro area has remained below the European Central Bank's target for some time now. The Euro area, therefore, needs to ensure that inflation expectations do not become unhinged, which could lead to a slowdown in domestic demand.

9. In an integrated world, where there are spillovers of policies followed by countries, it is necessary that there is an effective mechanism to ensure cooperation among countries at an international level. The Fund, with its almost universal membership, is in a unique position to ensure multilateral policy dialogue and cooperation on key policy challenges facing the global economy. The Fund, therefore, needs to work out concrete plans as to how best such co-operation could be achieved.

**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. We are greatly disappointed that the 2010 Quota and Governance Reform has not become effective in spite of the strong support of the global community for the reform. More worryingly, with the most recent developments, it is now not at all clear as to when the 2010 quota reform can become effective.

12. Governance reforms are required to ensure the Fund's credibility, legitimacy and effectiveness. They are also most imperative to maintain its relevance. They, therefore, should not be deferred. We should explore every available option for completing the current round of the quota reform process. We call upon all members, particularly those with the crucial voting power, to extend their fullest cooperation and support the alternative proposals that might be suggested. We also call upon the Fund management to make the 2010 quota and governance reform its top priority.

**C. Developments in the Constituency**

13. I now turn to developments in my constituency.

**Bangladesh**

14. The Bangladesh economy continues to exhibit robust real GDP growth (average GDP growth for the last ten years is 6.23 percent). During the first half of the current fiscal (FY14), economic activity was affected by unrest and uncertainty in the run up to the January 2014 general elections. However, GDP growth is again gathering momentum: rising trends of manufacturing output and export growth along with increased production of major crops are expected to help sustain adequate industrial and agricultural growth in FY14 and beyond. Besides, resilient domestic demand, a vibrant rural economy and rebound in global growth will bolster the service sector's growth dynamism. At the same time, a relatively stable

political environment and ongoing structural and institutional reforms in the fiscal, monetary and financial arena accompanied by a continued growth-supportive fiscal stance are likely to boost private investment. Although food inflation has spiked up in recent months due to disruptions in supply, non-food inflation has declined steadily. On the whole, pragmatic fiscal policy along with moderately restrained monetary stance and currency appreciation resulted in a headline inflation of 7.4 percent in February 2014.

15. On the fiscal front, the slowing down of economic activity amidst political uncertainty and lower import growth, have contributed to lower than targeted tax revenue so far. These effects, however, are expected to unwind gradually with various reforms being pursued by the government in a bid to increase revenue mobilization. Besides, the effect of revenue shortfall has been offset by better control on expenditure which is helping the country to stay largely on track to meet the fiscal target of an overall budget deficit (excluding grant) of 4.6 percent for FY14. Bangladesh Bank has been maintaining a moderately restrained monetary approach to safeguard macroeconomic stability and keep inflation in check, while allowing adequate space for private sector credit growth. It is also looking for sound implementation of macro-prudential policies based on a formal framework and adequate legal backing with a view to strengthening the resilience of the financial sector to any kind of unfavorable development. On the external side, despite a challenging global environment, export growth has remained resilient, mostly on account of strong performance of the readymade garment sector. Remittance growth has turned negative recently reflecting mainly a temporary decline in worker remittances from the Mideast countries. The exchange rate remains stable with foreign exchange reserves hovering around US$ 19 billion (US$ 19.0 billion as on 19 March, 2014) which is sufficient to cover more than five months of imports.

**Bhutan**

16. Real GDP growth in Bhutan slowed during 2012-13 to 4.6 percent from 8.6 percent during the previous year, as the authorities continued to implement monetary policy, currency and prudential measures to rein in aggregate demand and tackle external sector imbalances. Amongst the major sectors, ‘community, social and personal’, ‘financial and insurance’, and ‘mining/quarrying and electricity’ recorded negative growth, while the sectors ‘hotel and restaurants’, trade, manufacturing and agriculture experienced higher growth during the year. Bhutan’s unemployment rate dropped from 3.1 percent in 2011 to 2.1 percent in 2012. Per capita income reached USD 2,585 in 2012. Consumer price inflation increased to 11.3 percent in the fourth quarter of 2013, up from 9.5 percent a year ago, largely due to upward pressures in food-related prices. The fiscal deficit remained modest and decreased slightly from 1.2 percent of GDP in 2011-12 to 1 percent of GDP in 2012-13.

17. Reflecting the slowdown in credit and temporary restrictions on selected imports following the Indian Rupee shortage in 2012, there was an improvement in the trade deficit. Nevertheless, the current account deficit widened to 25 percent of GDP in 2012-13 from 23 percent of GDP in 2011-12 due to reduced inflows in budgetary grants. At end-2013, Bhutan’s international reserves were USD 935 million, sufficient to finance 13.4 months of total merchandise imports and approximately 25 months of essential imports. The Royal Monetary Authority (RMA) has liquidated short-term Rupee debt and authorities continue to be vigilant on external sector developments. The Royal Government of Bhutan plans to introduce new taxation measures and other fiscal reforms this year to address supply-side constraints. To promote lending to productive and priority economic sectors, the Government has introduced an Economic Stimulus Plan to be implemented from 2014. Financial

soundness indicators for Bhutan remain sound, with capital adequacy well above the required prudential norms. The RMA continues to maintain a tight monetary policy stance and has launched new initiatives and macro prudential policies to strengthen financial sector regulation and supervision under the scope of a Financial Sector Development Strategy. Going forward, the Bhutanese authorities expect economic activity to remain robust and real GDP growth is estimated to be 7 percent in 2013/14 driven by developments in the hydropower sector.

**India**

18. India's economic growth is estimated at 4.9 per cent in 2013-14 as compared with the growth of 4.5 per cent recorded in 2012-13. The near term outlook beyond the current year, however, is expected to improve on account of several factors. Many of the structural constraints are being actively addressed. The Cabinet Committee on Investment (CCI), set up to expedite project implementation, has facilitated around 300 projects amounting to over US$ 106.9 billion. Most of the liquidity tightening measures taken during July-August 2013 in the wake of financial markets turbulence have been rolled back. All these developments should have a positive impact on the near term outlook. The Reserve Bank of India has projected growth in a range of 5 to 6 per cent in 2014-15. Retail inflation, measured by the consumer price index (CPI), moderated for the third consecutive month in February 2014 to 8.1 per cent from 11.2 per cent in November 2013.

19. The Indian economy has undergone significant macro adjustment during last six months. The Government is committed to the path of fiscal consolidation. Various measures taken to address the twin deficits, viz. fiscal deficit and current account deficit, are bearing fruit. The gross fiscal deficit is projected to be contained at 4.6 per cent in 2013-14 as against the target of 4.8 per cent. It has been budgeted at a further reduced level of 4.1 per cent for 2014-15. India's current account deficit, which was 4.8 per cent of GDP in 2012-13, is expected to be around 2.0 per cent of GDP in 2013-14. Outflows by foreign institutional investors, especially from the debt segment, during May-July 2013 led to volatility in India's forex markets. Significantly, India has received net equity portfolio flows in every month since September 2013 and net debt portfolio flows since December 2013. India has also been able to build up its reserves despite net portfolio outflows during May-August. India's foreign exchange reserves rose to around US$ 304 billion as at end-March 2014. Reflecting the improved fundamentals, the Indian economy was not impacted by the renewed turmoil in international financial markets in January 2014. India's equity markets have also firmed up significantly in the recent period.

20. Notwithstanding the recent significant improvement, we are quite conscious of the challenges facing the Indian economy. A major challenge is to bring down inflation to a more tolerable level. Another major challenge is to revive investment activity and put the Indian economy back on a high growth path.

**Sri Lanka**

21. The Sri Lankan economy grew by an impressive 7.3 percent in 2013 compared with 6.4 percent in 2012. The industry and the services sectors expanded at healthy rates while the agriculture sector growth continued to remain subdued. Per capita income grew by 12.2 percent to US dollars 3,280 in 2013. In spite of significant upward adjustments to domestic energy prices, prudent monetary management and improved domestic food supplies helped in

containing inflation. The year-on-year headline inflation, which continued to remain at a single digit for the fifth consecutive year, declined to 4.7 percent by end 2013 from 9.8 percent in January 2013, while the core inflation moderated to its lowest level of 2.1 percent. Monetary expansion decelerated towards the targeted level in 2013, reflecting lagged effects of tight monetary policy and a steep decline in gold backed loans to the private sector by commercial banks. These developments enabled the Central Bank to ease its monetary policy further during the year to support growth. During the year, the policy interest rate was reduced by 200 basis points and the Statutory Reserve Requirement (SRR) was reduced by 2 percentage points.

22. The gradual recovery in external demand supported a significant improvement in the external sector. The current account deficit decreased to 3.9 percent of GDP in 2013 from 6.7 percent in the previous year, with improved export performance, continued high growth in tourism and remittances. Capital inflows, including FDIs and portfolio investments, remained strong leading to a surplus in the balance of payments. International reserves increased to US$ 7.5 billion, equivalent to 5 months of imports by end 2013 compared to 4.3 months at end 2012. With these developments, exchange rate remained largely stable, depreciating only by 2.7 percent against the US dollar, while appreciating against several other major currencies. The government's continued commitment for fiscal consolidation helped further in reducing the fiscal deficit to 5.9 percent of GDP in 2013, mainly through expenditure containment policies. Supported by strengthened bank oversight and regulations, the financial sector remained sound and resilient despite increased volatility and uncertainties in the global financial markets.

**Conclusion**

23. The global economy is entering a critical transitional phase towards a recovery from an extended global slowdown. With the prospect of improved growth in advanced economies, the expected exit from UMP by central banks in advanced economies would pose problems for the global recovery, if not managed carefully. If exit is not carefully calibrated, there will be adverse consequences in financial markets with spillovers to emerging market economies. Since emerging market economies continue to be the main drivers of global growth, any adverse impact on growth in emerging markets will have feedback effects on the growth of advanced economies, which could threaten the still-fragile global recovery. With the withdrawal of UMP, financial conditions will inevitably become tighter and real interest rates will rise. Emerging market economies will have to tailor their domestic and external policies to cope with these changing external financing conditions. It is, therefore, imperative that policymakers in both advanced and emerging market economies work closely. The IMF can play a critical role in ensuring international cooperation.