MACROECONOMIC CHALLENGES

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Good Morning friends !

I would like to talk on the Macroeconomic Challenges in Emerging Asia. The emerging Asia referring to China, India, Hong Kong SAR, Korea, Singapore, Taiwan, Indonesia, Malaysia, the Philippines and Thailand accounts for around 45 per cent of world population and around 11 per cent of world GDP, though in PPP terms the share of GDP is about 27 per cent. However, in recent years, given the strong growth, the emerging Asia has contributed almost one-half of the global growth in GDP. In emerging Asia, the annual growth in GDP of 8.4 per cent and 8.3 per cent during 2004 and 2005, respectively, was impressive considering that the growth in the world economy during the corresponding period was 5.3 per cent and 4.8 per cent, respectively. According to the IMF, this growth momentum in Emerging Asia is expected to continue in 2006 as well and real GDP in the region is projected to expand by 8.3 per cent and 8.2percent by 2007, while the global growth is placed at 4.8 per cent for the year 2006.

According to the data published in the World Development Indicators of the World Bank, India ranks fourth next only to the USA, China and Japan in terms of size of the economies measured on the basis of Purchasing Power Parity (PPP). It is interesting that in terms of PPP, three out of the four largest economies of the world are in Asia.

INDIA – A CASE STUDY

I would like to take you through a case study of India to give a more focussed perspective.

Highlights of India's Performance

While the change in India in the past five years seems dramatic, indeed, it is not discontinuous. First, India as a nation has been diligently working over half a century to realize the dreams at the time of its independence. Second, the domestic deregulation of 1980s and economic liberalisation of 1990s helped acceleration of growth. Third, perhaps, the world is appreciating India and its progress better now than before.

The three salient features in India's economic performance over the period 1980-2000, as mentioned by several analysts, have been a high growth of output per capita, surpassed only by China and East Asian countries; a very stable output per capita, surpassing that of even China and East Asia; and the growth is sourced by an increase in total factor productivity, thereby having positive implications of an enduring nature of the process, rather than being driven only by better returns on capital.

The Indian economy appears to be shifting to higher levels of growth trajectory in more recent years with the average annual growth of real GDP increasing to 6.3 per cent during 1992-93 to 2005-06 from 5.8 per cent in the 1980s. Again, lately, the economy is perhaps picking up an accelerated growth momentum, with an average GDP growth at around 8 per cent per annum during the last three years. It is equally notable that the inflation conditions have moderated to around 5 per cent, decelerating significantly from relatively higher levels in the earlier periods.

The strengthening of economic activity in the recent years has been supported by persistent increase in gross domestic investment rates from 23.0 per cent of GDP in 2001-02 to 30.1 per cent in 2004-05 coupled with more efficient use of capital. Gross domestic saving rate has also improved from 26.5 per cent to 29.1 per cent during the same period. The saving-investment balance in India is in a desirable range thereby contributing to global stability also.
India's foreign exchange reserves currently exceed its external debt, thereby reflecting improved solvency of the economy.

Apart from its leading edge in the software services, India is also becoming a major hub for manufacturing and export of manufactured products. The Indian information technology industry is becoming increasingly global through cross-border acquisitions, on-shore contract wins and organic growth in other low-cost locations. This has been complemented by global majors continuing to significantly improve their off-shore delivery capabilities in India. Indian firms are also acquiring manufacturing firms abroad to leverage comparative advantage of foreign locations, using synergies between the parent company and the company under acquisition and having production facilities near the major markets also.

A number of downside risks loom over the global economy that have implications for the medium-term prospects of countries like India for which the channels of global integration are getting stronger over time. The key global risks for emerging economies are potential escalation and volatility in international crude prices, a disorderly unwinding of the macroeconomic imbalances of the major economies and a hardening of international interest rates. Though characterised by significant downside risks, over the medium term, the prospects for the global economy are by and large positive.

FINANCIAL STABILITY & MONETARY POLICY RESPONSE

Financial stability considerations may require the use of interest rate tool, in conjunction with other prudential measures. Some times, there could be even a trade-off between raising the short-term interest rate and tightening of prudential norms if risks are perceived to originate from certain segments of the market. The highly leveraged lending operations in the backdrop of asset price bubbles, might require adjustments in margins and risk-based capital requirements.

Coming to the specific issues, since the focus of monetary policy is on influencing the ‘aggregate demand’, at the macro level, the aggregates represent an amalgamation of different forces in operation at the micro level, sometimes moving in different directions. For instance, when the general price level increases, there could be sectors where prices are coming down; the same is the case with employment, consumption, production and investment. Therefore, the micro foundations of macroeconomic analysis would not mean a one-to-one correspondence between the two. This relationship is somewhat nebulous but very important and should be viewed seriously with its significance as well as inherent limitations in mind.

Reforms in the Monetary Policy Framework

Twin objectives of "maintaining price stability" and "ensuring availability of adequate credit to productive sectors of the economy to support growth" continue to govern the stance of monetary policy, though the relative emphasis on these objectives has varied depending on the importance of maintaining an appropriate balance.

India has moved from direct instruments (such as, administered interest rates, reserve requirements, selective credit control) to indirect instruments (such as, open market operations, purchase and repurchase of government securities) for the conduct of monetary policy.

Turning to an assessment of monetary policy, it would be reasonable to assert that monetary policy has been largely successful in meeting its key objectives in the post-reforms period. Just as the late 1990s witnessed a fall in inflation worldwide, so too has India. Inflation has averaged close to five per cent per annum in the decade gone by, notably lower than that of eight per cent in the previous four decades.

Challenges posed by large capital inflows

It is pertinent to note that inflation could be contained since the mid-1990s, despite challenges posed by large capital flows. Total foreign investment flows (direct and portfolio) increased from US$ 111 million in 1990-91 to US$ 17,496 million in 2005-06 (April-February). Over the same period, current account deficits remained modest – averaging one per cent of GDP since 1991-92 and in fact recorded small surpluses during 2001-04.

In the current account, the growth of software exports and, more recently, of business process outsourcing, has increased the share of service exports on a continuing basis. Even more significant is the growth in remittances from non-resident Indians (NRIs), now amounting to about 3 per cent of GDP. On the capital account, unlike other emerging markets, portfolio flows have far exceeded foreign direct investment in India in recent years. Coupled with other capital flows consisting of official and commercial debt, NRI deposits, and other banking capital, net capital flows now amount to about 4.4 per cent of GDP.

DEREGULATION & RECONSTRUCTION

With increased deregulation of financial markets and increased integration of the global economy, the 1990s were turbulent for global financial markets: 63 countries suffered from systemic banking crises in that decade, much higher than 45 in the 1980s. Among countries that experienced such crises, the direct cost of reconstructing the financial system was typically very high: for example, recapitalisation of banks had cost 55 per cent of GDP in Argentina, 42 per cent in Thailand, 35 per cent in Korea and 10 per cent in Turkey. There were high indirect costs of lost opportunities and slow economic growth in addition (McKinsey & Co., 2005). The cost of recapitalisation of public sector banks at less than 1 per cent of GDP is therefore low in comparison. Whereas we can be legitimately gratified with this performance record, we now need to focus on the new issues that need to be addressed for the next phase of financial development.

That current annual GDP growth of around 8 per cent can be achieved in India at an about 30 per cent rate of gross domestic investment suggests that the economy is functioning quite efficiently. As the Indian economy continues on such a growth path and attempts to accelerate it, new demands are being placed on the financial system.

RESPONSE TO INFLATION

Apart from the legitimate concern regarding growth as a key objective, there are other factors that suggest that inflation targeting may not be appropriate for India. First, unlike many other developing countries we have had a record of moderate inflation, with double-digit inflation being the exception, and which is largely socially unacceptable. Second, adoption of inflation targeting requires the existence of an efficient monetary transmission mechanism through the operation of efficient financial markets and absence of interest rate distortions.

Though interest rate deregulation has largely been accomplished, some administered interest rates still persist. Third, inflationary pressures still often emanate from significant supply shocks related to the effect of the monsoon on agriculture, where monetary policy action may have little role. Finally, in an economy as large as that of India, with various regional differences, and continued existence of market imperfections in factor and product markets between regions, the choice of a universally acceptable measure of inflation is also difficult.

ASSET PRICE MOVEMENTS

A contemporary issue is the appropriate response of monetary policy to sharp asset price movements that may accompany high corporate growth. In an era of price stability and well-anchored inflation expectations, imbalances in the economy need not show up immediately in overt inflation. For instance, unsustainable asset prices artificially boost accounting profits of corporates and thereby mitigate the need for price increases; similarly, large financial gains by employees can partly substitute for higher wage claims. In an upturn of the business cycle, self-reinforcing processes develop, characterised by rising asset prices and loosening external financial constraints. 'Irrational exuberance' can drive asset prices to unrealistic levels, even as the prices of currently traded goods and services exhibit few signs of inflation. These forces operate in reverse in the contraction phase. In the upswing of the business cycle, financial imbalances, therefore, get built-up. In view of these developments, it is felt that credit and monetary aggregates need to be monitored closely since sharp growth in these aggregates is a useful indicator of future instability.

In India, like other countries, we have also seen large rallies in asset prices. Concomitantly, credit to the private sector has exhibited sharp growth in the past two years – averaging almost 30 per cent per annum. While the credit growth has been broad-based, credit to the retail sector is emerging as a new avenue of deployment for the banking sector led by individual housing loans. To illustrate, the share of housing in incremental bank credit has increased from 2.9 per cent in 1995-96 to 11.1 per cent in 2004-05, while the share of industry went down from 64.9 per cent in 1995-96 to 25.6 per cent in 2004-05. Data for retail credit is not available prior to 1998-99; its share too has increased from 19.4 per cent in 1998-99 to 24.3 per cent in 2004-05.

Nonetheless, in the light of high credit growth, there is a need to ensure that asset quality is maintained. While policy rates have indeed been raised, they have been mainly aimed at reining in inflation expectations in view of continuing pressures from high and volatile crude oil prices. Therefore, while ensuring that credit demand for the productive sectors of the economy is met, the Reserve Bank has resorted to prudential measures in order to engineer a 'calibrated' deceleration in the overall growth of credit to the commercial sector. Accordingly, the Reserve Bank has raised risk weights on loans to these sectors. It also more than doubled provisioning requirements on standard loans for the specific sectors from 0.4 per cent to 1.0 per cent. Thus, the basic objective has been to ensure that the growth process is facilitated while ensuring price and financial stability in the economy.

WATCHFUL APPROACH

It is in this context, and consistent with the multiple indicator approach adopted by the Reserve Bank, that monetary policy in India has consistently emphasised the need to be watchful about indications of rising aggregate demand embedded in consumer and business confidence, asset prices, corporate performance, the sizeable growth of reserve money and money supply, the rising trade and current account deficits and, in particular, the quality of credit growth. In retrospect, this risk sensitive approach has served us well in containing aggregate demand pressures and second round effects to an extent. It has also ensured that constant vigil is maintained on threats to financial stability through a period when inflation was on the upturn and asset prices, especially in housing and real estate, are emerging as a challenge to monetary authorities worldwide. Significantly, it has also reinforced the growth momentum in the economy. It is noteworthy that the cyclical expansion in bank credit has extended over an unprecedented 30 months without encountering any destabilising volatility but this situation warrants enhanced vigilance.

THANK YOU