GS World

Explaining the Asian rate cuts wave

Writer- Ramkishen S. Rajan (Professor at the Lee Kuan Yew School of Public Policy, National University of Singapore)

This article is related to General Studies-Paper III (Indian Economy)

Indian Express

3 Aug, 2019

"Policy makers across Asia should ensure enough ammunition to manage a prolonged economic downturn."

` The latest International Monetary Fund (IMF)-World Economic Outlook update in July 2019 has confirmed a growing belief that global growth has decelerated and dark clouds seem to be looming in the near term. Specifically, the IMF has downgraded global growth multiple times since October 2018 and now projects it to be 3.2% compared to 3.6% in 2018.

The China factor

While the deceleration in economic activity is broad-based among both the advanced and developing economies, particular attention should be paid to China. The country has faced strong headwinds to growth both because of the ongoing supply-side reforms, including dealing with financial risks (reining in of shadow banking and hidden debt of local governments), as well as the negative effects of escalating tariffs and their consequent impact on its exports and investment. It is noteworthy that China is one of the few major economies that is expected to continue to decelerate into 2020 (along with Japan which is faced with acutely unfavourable demographics and seems unable to escape persistent deflationary pressures).

As corporates look to reconfigure their China-centric supply chains (both in response to the ongoing policy uncertainties and rising protectionist sentiments), many export-dependent Asian economies that are a part of the intricate production networks have also inevitably been hard hit. While there have been some short-term beneficiaries of the export and trade diversion from China to countries such as Vietnam, the global external demand slowdown has more than outweighed these gains. For instance, given Singapore's small size and acute openness, it has often acted as a recession barometer for the rest of Asia. Latest data show that exports from the city state have collapsed and the Singapore economy is expected to face stagnation in 2019 on the back of a sharp slowdown in the manufacturing sector. This does not bode well for other trade-dependent economies in the region.

Asian banks to the rescue?

In response to the global economic slowdown as well as generally subdued inflationary pressures, many Asian central banks (India, China, Indonesia, Malaysia, the Philippines, South Korea) have begun to ease monetary policy. However, this generalised loosening has happened largely following the recent signals from the U.S. Fed that it is set to embark on a new round of rate cuts in response to the slowdown in the United States and the rest of the world. In fact, in his congressional testimony on July 10, 2019, chairman Jerome Powell emphasised the slowdown in global growth as the main reason for the Fed moving towards a more accommodative stance, leading some to suggest that he has become

GS World Committed To Excellence

the "world's central banker".

The recent wave of rate cuts in Asia is consistent with research which suggests that emerging economies tend to be cautious about lowering interest rates when the base country (usually the U.S.) does not do so as they are concerned about potential capital flight and sharp currency depreciations which in turn could have negative repercussions on domestic firms and other entities with unhedged external borrowings in foreign currencies. However, when interest rates in the base country decline, while emerging economies may experience massive surges in capital inflows if they stand pat on interest rates, they can maintain monetary policy autonomy via a combination of sterilised foreign exchange intervention (leading to sustained reserve accumulation) as well as tightening of capital controls and/or use of macro prudential policies (MaPs).

Alternatively, if the emerging economies are themselves faced with an economic slowdown, they are comfortable lowering their interest rates along with the base country, as is the case currently in Asia. This said, it is wise for Asian policy makers to ensure that they have enough ammunition to manage a prolonged downturn given that 2020 is "precarious" with many downside risks, as the IMF's chief economist, Gita Gopinath, put it.

RBI's monetary policy stance

Where does all of this leave India? On the one hand, since India has not been well-integrated with the Asian and global supply chains, it has not been as impacted directly by the China-U.S. trade war. On the other hand, given existing acute domestic bottlenecks, policy missteps and ongoing structural challenges, India has not been able to reap significant benefits as an alternative production and export platform to China.

On the back of a prolonged downturn in the capex cycle, the IMF has downgraded projected growth for India to 7% in 2019. This is broadly in line with the forecasted range by the Reserve Bank of India (RBI). While this growth is admirable relative to other major countries, it is well below the country's likely potential growth of 7.5% and 8%.

In view of this "growth recession" and subdued inflation, along with a lack of fiscal space, and with the government having been distracted by the general election, the RBI moved much earlier than most of its Asian counterparts in taking steps to lower interest rates, having cut rate multiple times by 25 basis points since October 2018 to a nine-year low in nominal terms. The concerns here however have been threefold.

One, despite the rapid interest rate cuts, India's real interest rates are still higher than most other countries, though it remains unclear what the neutral real interest rate consistent with India's potential output actually is. The statement by RBI Governor Shaktikanta Das following the June 2019 interest rate cut that the RBI's policy stance "has again changed… from 'neutral' to 'accommodative'" presumably suggests that he views current real interest rates to be below equilibrium. This is rather odd in view of the fact that real rates have actually risen in recent times.

Two, more than most other countries in the region, an ongoing concern for India is that interest rate policy transmission to bank rates tends to be rather slow and limited. This is likely due to a combination of factors: the banking system has been faced with a deterioration in asset quality and remains saddled with bad debts; there has been and anaemic deposit growth; and there is limited scope to reduce deposit rates.

Three, despite the interest rate cuts, India's real effective exchange rate (REER) has actually appreciated somewhat (around 7%) since October 2018, consistent with the fact that real interest rates have not declined. This lack of price competitiveness boost is especially of concern given that external demand is expected to remain subdued and uncertain and other regional currencies may themselves face depreciations pressures following the dovish policy stances by their central banks which could possibly translate to further REER appreciation in the rupee.

GS World Committed To Excellence

Sovereign bond issue

Going forward, if India is to succeed in its ambition of becoming a $5-trillion economy by 2024-25, there can be no substitute for undertaking the necessary structural reforms needed to jump-start private investments and longer-term growth. However, in the short term, in all likelihood, monetary policy will have to remain accommodative (more so than what it is currently) and much greater attention will be needed to be paid on how to revive public capex without raising the cost of capital further.

In the face of constraints in raising revenues in a slowing economy, the government's preferred solution seems to be to issue overseas sovereign bonds rather than streamline subsidies and revenue expenditures. The proposed $10 billion sovereign issuance is manageable vis-à-vis the countries stock of forex reserves, while India's sovereign external debt (as share of GDP) is modest at present. However, increases in external borrowings add an additional element of risk to the economy. Such a move also likely complicates monetary policy further, as any adverse exchange rate movements will lead to a ballooning of interest payments on government debt which is already eating up around a quarter of budgetary spending. It is not clear that the current policy mix is ideal for India.

GS World Team...

India's growth rate

According to the IMF

- Recently the International Monetary Fund-IMF updated the World Economic Outlook and cut India's growth rate by 0.3% in this update.
- This shows lower than expected domestic demand. The main reason for reducing the growth rate of India is the poor condition of demand.
- In April 2019, IMF had projected India's growth rate to be 7.3% but now it has predicted India's growth rate to be 7% in 2019-20.
- Apart from this, in the report of World Economic Outlook in July, India's growth rate estimate for the year 2020-21 has been reduced to 7.2% from 7.5% previously estimated.
- According to the report, India's economy will grow at a rate of 7%, which can reach upto 7.2% in 2020.
- The decline of 0.3 percentage point for both years indicates lower domestic demand than expected.
- The estimated growth of 7.2% for the year 2020-21 is 0.5% less than the forecast made in October, 2018 and January 2019.
- Apart from this, the IMF has also cut the estimate of world GDP growth by 0.1%. The new estimates for the year 2019 and 2020 are 3.2% and 3.5% respectively.
- The growth estimates of emerging markets and developing economies have also been reduced by 0.3% for the year 2019 and 0.1% for the year 2020. The revised estimates for these two years are 4.1% and 4.7% respectively.

According to credit rating agency Crisil

- Crisil has reduced its estimate of the country's economic growth rate by 0.20 percent to 6.9 percent in the current financial year.
- Ratings agency has reduced the GDP estimation due to the risks such as dull global growth and weak monsoon.
- In June, the Reserve Bank of India reduced the economic growth projections for 2019-20 from 7.2 percent to 7 percent.
- The bank took this step in view of slowdown in domestic activities and the global trade war.
- Crisil said in the report that the first half of the current financial year will remain sluggish, while favorable monetary conditions and consumption growth are

expected to support the second half.

- It has been said in the report that the Indian economy will be affected by the events in the country and the world. In such a scenario, the country's GDP growth is estimated to be 0.20 percent below the earlier estimate of 6.9 percent.
- The report noted that the Indian economy had achieved a robust growth of 8.2 percent in FY 2016-17.
- After this there has been an impact of new policy initiatives, increasing reforms and increasing uncertainty at global level including trade disputes.
- The crisis of housing finance companies that started at the end of last year, low domestic demand coupled with weak income and rising costs also impacted the economy.
- According to data released by the Central Statistics Office (CSO) released earlier, India's GDP growth fell to a five-year low in 2018-19 and stood at 5.8 percent in the January-March quarter.

According to World Bank statistics

- In the global ranking of GDP, the Indian economy has slipped to seventh rank.
- According to World Bank statistics for FY2018, India ranked seventh on GDP, while Britain and France reached the fifth and sixth places respectively.
- In 2017, India had surpassed France, but this time it has slipped.
- In the case of GDP, the US economy remains at the top. In the year FY2018, the US GDP was $ 20.5 trillion.
- China is the second next to US. During this period, China's GDP was $ 13.6 trillion. With a GDP of 5 trillion dollars, Japan is on the third spot.
- Britain and France are at the fifth and sixth position in this list with a GDP of 2.8 trillion dollars, while India's GDP was recorded at $ 2.7 trillion.
- In the fiscal year 2017, the GDP of the Indian economy was $ 2.65 trillion, which made Asia's third largest emerging economy the world's fifth largest economy. During this period, UK's GDP was $ 2.64 trillion and France's 2.5 trillion dollars.

World economic outlook

- It is a survey conducted and published by the International Monetary Fund.
- It shows the global economy in the near and medium terms, with projections for up to four years of the future.
- Its forecast includes important economic indicators such as GDP, inflation, current account and financial balance of more than 180 countries worldwide.

International Monetary Fund

- It is an international financial institution that monitors the global economic situation of its member countries.
- It also provides financial and technical support to its member countries as well as help in stabilizing international exchange rates and facilitating economic development.
- It is headquartered in Washington D.C, United States.
- Its special currency is called SDR (Special Drawing Rights).
- It aims to ensure economic stability, promote economic progress, reduce poverty, create new employment opportunities as well as facilitate international trade.

Expected Questions (Prelims Exams)

1. Recently the World Economic Outlook report has been released; consider the following statements-

1. In this report, India's growth rate for the year 2019-20 is estimated to be 7 percent.
2. India's growth rate for 2020-21 has been reduced from 7.5 percent to 7.2 percent.
3. World Economic Outlook Report is released by the World Bank.

Which of the above statements is/are correct?

(a) 1 and 2 (b) 2 and 3

(c) 1 and 3 (d) None of the above

Expected Questions (Mains Exams)

Q. Recently the World Economic Outlook report of IMF was released which shows a decline in global growth rate and is predicted to continue. Evaluate the role of major Asian countries in preventing or reducing this crisis in Asia **(250 Words)**

Note: Answer of Prelims Expected Question given on 2 Aug. is 1(a).

Committed To Excelle