

## **Global Economic Prospects and the Implications for India**

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Good afternoon! I am honored to speak today before the Federation of Indian Chambers of Commerce and Industry. As the oldest and largest business organization in India, the Federation has played an important role in your country's emergence onto the world stage—first as an independent nation and most recently as a leading economy. I congratulate you on your distinguished history, and am very pleased to be able to meet with you.

The topic of my remarks is "Global Economic Prospects and the Implications for India." This encompasses some of the crucial issues facing the world economy—and India—in a time of difficult transition. In the nearly five years since the financial crisis descended upon us, the international community has faced many challenges. As this audience certainly knows, the global economy continues to feel the aftershocks of the crisis, particularly in Europe. But the policy challenges are just as important here in New Delhi as they are in Brussels, or Beijing, or Washington.

I propose today to discuss the economic outlook for the coming year, beginning with the broad trends and then focusing on Asia and India. I will offer the IMF view of India's prospects, and perspectives on the challenges this country faces.

The IMF's forecasts show the world economy strengthening. But we still are not seeing the growth needed to drive a sustainable global rebound. While financial markets have recovered, the real economy continues to lag. That means there is not enough growth to generate jobs for the millions who have fallen into unemployment over the past five years.

### **Growth Forecast**

World growth was below 3 percent in the middle of 2012, but we are forecasting gradual strengthening over the course of the year to 3.25 percent. We are more optimistic about 2014, projecting 4 percent global growth. But this improvement masks significant disparities. We are experiencing a three-speed recovery. There are countries that are doing well, particularly emerging and developing economies. There are countries that are on the mend. Finally, there are countries that still have some distance to travel—including the Euro Area and Japan.

Let us examine each of these groups in turn, beginning with the countries on the mend. The most important of these countries is the U.S., where we are projecting growth of close to 2 percent in 2013, and 3 percent in 2014. The Federal Reserve's policy of quantitative easing is helping to boost private demand. But U.S. growth is still not strong enough to have a significant impact on unemployment. Moreover, this growth will be achieved despite strong fiscal consolidation equivalent to about 1.8 percent of GDP.

Indeed, while the IMF encourages longer-term fiscal consolidation in the U.S., from a global perspective one can question whether there has been too much, too soon. There is a real need for the U.S. to help drive world demand. As long as Washington avoids another deep

and sudden fiscal adjustment, a plan focused on medium-term adjustment can provide room for the needed recovery of private demand.

The U.S. role becomes all the more important when we consider the group of countries struggling to return to growth. Here the focus is Europe. The crisis affecting the euro area continues to depress European growth. We are forecasting a contraction of about one-quarter of a percent this year in the euro area, and this weakness will go right to Europe's core. Germany will grow less than one percent, France is likely to slip into negative territory, and Spain and Italy will experience substantial contractions.

### **Europe's Adjustment**

This is part of a very difficult adjustment in Europe's crisis countries that is being called "internal devaluation." This refers to the efforts to regain competitiveness when governments cannot adjust interest rates controlled by the European Central Bank, and when they lack a currency to devalue. While these countries are adjusting, including through structural reforms, those measures so far do not compensate for weak internal demand, struggling banks, the absence of credit to drive investment, and deep unemployment.

The problems of the European financial system require collective solutions. This should include bank recapitalization through the European Stability Mechanism, a comprehensive banking union that adds a single resolution authority to the recently established supervisory authority, and a deposit insurance fund. There is also a need for greater fiscal integration. All of this is essential if Europe is to climb out of a cycle of crisis and decline.

Japan, by contrast, is taking action after a generation of economic stagnation. As many of you know, Japan's new government and central bank governor have announced a radically different approach to economic revitalization, based on a fiscal stimulus and aggressive quantitative easing. This is reflected in our forecast of 1.6 percent growth this year. A stronger Japan is essential for a world economy that needs both growth and stability. So it is important to see the new government setting a credible path to sustainably higher growth and lower public debt.

### **The Emerging Economies: Driving Global Growth**

Now let me turn to the emerging market and developing economies, which have been generating a considerable portion of global growth. This group includes most of Asia, including India and China, but also Brazil, Russia, and many other economies. We are projecting that the emerging market and developing countries will see their growth accelerate from 5 percent growth in the first half of 2012 to nearly 6 percent next year. One exception is the Middle East and North Africa, where there are several challenges, most notably the difficult political transitions after the Arab Spring.

But overall, the emerging market and developing countries are benefiting from low interest rates, high commodity prices, and solid domestic demand.

Let us now examine Asia in greater detail, because this region has been the engine room of global growth since 2008. Asia saw a relatively subdued economic performance in 2012, but growth is picking up again. We project that regional growth will reach 5 ¾ percent this

year, but developing Asia will grow 7.1 percent, and a bit more in 2014. Driving this growth will be robust domestic demand and a modest strengthening of external demand.

Consumption and private investment will be supported by accommodative monetary policies and increasing capital flows; rapid credit growth; and favorable labor market conditions. Growing intraregional trade will also be a positive factor. We expect inflation to remain broadly unchanged. However, I do note that headline inflation was somewhat higher here in India because of supply bottlenecks. I will return to this topic shortly.

Let us briefly take a closer look at the issue of capital flows. Quantitative easing in the U.S. and Japan certainly will continue pushing capital into this region. The prospects of higher Asian growth are likely to serve as a potent pull factor. We also expect portfolio investments to boost private consumption and investment by raising asset prices and boosting credit growth.

For emerging Asia, an increase of 1 percent of GDP in portfolio flows translates into a rise of about ½ percentage point in private consumption growth after three or four quarters. It also means a 1½ percentage point increase in investment growth. The challenge that policymakers face in the longer term is to ensure that capital flows do not create the basis for a future crisis.

### **The Outlook for India**

Let us now turn to India. Before I discuss the outlook, it is important to take a moment to remind ourselves of this country's extraordinary achievements. Some are well known in the world at large—the emergence of a world class IT industry, the rapid growth of exports, and the development of a sophisticated financial sector. India has a strong voice in the global discussion of many key issues, including trade and climate change.

Then there are the very important achievements in the war against poverty. The share of the population living below the poverty line has fallen from 45 percent in 1994 to below 30 percent in 2010. The total number of poor has declined from 407 million in 2005 to 356 million in 2010. This is very impressive.

Two more examples: India's telecommunications network is the world's second largest based on the total number of telephone users. There are more than 900 million mobile phone subscribers. Also, the government's plan to gradually implement direct cash transfers using the Unique Identification Number system is an impressive development that my colleagues at the Fund are watching closely. Its cutting-edge technology will improve the targeting of social programs as it approaches full enrollment in the next few years.

These successes highlight the gradual process of reform India has undergone during these years of rapid growth. Regulatory changes have been significant. For example, the government recently took the politically challenging step of raising diesel prices and imposing quantity limits on subsidized LPG. That will help shrink the budget deficit, narrow current account imbalances, and help the environment. Change is never easy in any country, and sometimes the democratic process can make the process even more difficult. So India deserves great credit.

All this should serve as a backdrop to the issues behind the current growth outlook. In a sense, India immediate prospects suggest that our construct of a “three speed recovery” may not adequately describe each country’s experience. From abroad, India fits comfortably into the category of countries that are doing well. Its growth is strong by advanced country standards, but, as you know, the discussion here centers on a slowdown. So let’s examine that trend.

### **Outlook for India**

As many of you know, corporate investment began to fall in 2011 and now has dropped three percentage points as a share of GDP from pre-crisis levels. This now is having an impact on consumption and exports. We forecast that India will see growth of 5.8 percent this fiscal year and 6.3 percent in 2014-15.

Meanwhile, many analysts are scaling back their forecasts of potential GDP growth. We estimate that India can grow between 6 ¼ and 6 ¾ percent a year, down from closer to 8 percent two years ago.

There are three explanations for this slowdown: the global economy, cyclical policies, and structural bottlenecks. Each probably contributes. As I have said, the global recovery is slow and uncertain, so there *is* less demand for Indian exports. But that alone does not explain the slowdown.

The IMF has examined how individual countries have been affected by slower growth among their trading partners, and we found that Indian growth has slowed more than can be explained by the impact from abroad. The economy certainly was affected by slower growth in export markets during 2008 and 2009. But an even more important factor was financial contagion: trade and long-term credit dried up, equity prices fell, and the Indian economy paid the price. That is not happening this time.

So if trade and financial channels do not fully explain the slowdown, how about cyclical policies? The RBI has tightened monetary policy, and the budget deficit has been coming down. But while nominal interest rates are high, real rates are significantly lower because of India’s high inflation. When IMF staff talks to Indian businessmen like you, we generally do not hear tight credit blamed for the slowdown.

On the fiscal side, the budget deficit has been falling—but slowly. While deficit reduction subtracts from demand, stimulus is being withdrawn more gradually than it was added during 2008-2009. The growth slowdown is too big to be explained by fiscal consolidation and monetary tightening.

### **Capacity Constraints**

That leaves us with capacity constraints. This is not a new issue for India. The need for infrastructure investment is obvious when you drive in this city, when you take a commuter train in Mumbai, or when electricity is needed for a new factory in Chennai. As investment in new roads, factories, ports, and energy has fallen, the speed limit of the Indian economy has come down too. Getting back to 8 percent growth will require addressing the investment problem, and that means getting companies investing again.

So what is new about the current issue with capacity constraints? In the past, infrastructure may have operated at capacity, but new capacity was coming online. Even if regulations complicated matters, developers knew how to get roads built, railroads repaired, and port facilities expanded. But that appears to have changed in the last few years. As you know, project approvals have become much more difficult. That's perhaps because of the scandals related to big projects, increasingly complex and overlapping regulations, and intensified scrutiny of all projects. The slowdown in bureaucratic approvals is affecting road building, power plant construction, and even new factory approvals. In other words, the difficulties of the reform process are starting to have a negative impact on the economy.

This also has external ramifications. Capacity constraints mean that exports cannot keep up with demand. Demand for goods that cannot be produced domestically is being met with imports. We see this very clearly with coal: India needs to increase power generation and distribution, and it needs to make better use of its large coal reserves. But domestic coal has not been coming to the power plants fast enough, so imports have been rising. The result is a weaker trade balance that hurts both the rupee and the balance of payments.

But there has been progress. Staying with the example of coal, the Finance Minister has opened the door to possible public-private partnerships with Coal India. The new Cabinet Committee on Investment can speed up project approvals. But these approvals need to be accelerated, and promises to harmonize domestic and imported coal prices delivered upon.

There are other important steps to be taken. A new land acquisition bill would help companies and government entities to obtain sufficient land for new investment projects. Simpler labor market regulation would allow workers to move between companies more freely and encourage small companies to grow. And the Goods and Services Tax would streamline India's complicated tax system. These structural reforms would all help bring growth back to pre-crisis levels.

### **The Role of the IMF**

The IMF's mandate calls for it to play a central role in addressing many of the policy challenges that I have outlined in this speech. We are charged with analyzing the risks to global stability and advising our 188 member countries on the policies needed to ensure that future crises do not emerge. For example, we are working to develop and monitor policies that help tackle the impact of volatile capital flows. We also are working to deepen the effectiveness of policies to regulate and supervise financial sectors.

We also have the responsibility of working with each of our member countries to advise on the most effective economic policies—balancing the need for growth with the imperative of reducing fiscal, financial, and private balance sheet risks. For countries in crisis, the Fund continues to provide financing that is combined with well-designed reform programs designed to restore stability and growth quickly. Fortunately, it has been 20 years since we have been asked to play this role in India. This is a tribute to your country's strong policies.

The Fund's advisory role remains central to our interaction with your government as India makes its way through the challenges of the global economy, and particularly the ongoing European crisis. I believe that our analysis and advice can help to ensure that India continues to prosper. It is essential that the world economy returns to growth and stability in the near future. And so it is essential that India continues to play its role by generating the growth that helps attain that goal.