

Spillovers from Unconventional Monetary Policy—Lessons for Emerging Markets

Christine Lagarde
IMF Managing Director
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Photographs

Introduction

Good afternoon, Ladies and Gentlemen.

Governor Rajan, thank you for your generous introduction, and for inviting me to speak before this distinguished audience today.

It is indeed a privilege to share the stage with Dr. Rajan, one of the world's most highly regarded financial economists, one whom the Fund is fortunate enough to have had as its Economic Counselor. Raghu certainly has been very busy since he took over Governor of the RBI in September 2013. He has deftly steered the Indian economy to safer waters after it was hit by the market turmoil following the “taper tantrum” episode of mid-2013—a point I will come back to shortly.

More recently, India has introduced flexible inflation targeting as the new regime for conducting monetary policy—a very welcome step.

As India's monetary policy rests in good hands, let me talk about a topic that I know has been as important a concern for this central bank—as it has been for your colleagues in other emerging market countries. I am referring, of course, to the unconventional monetary easing in the large advanced economies following the global financial crisis.

We are perhaps approaching the point where, for the first time since 2006, the United States will raise short term interest rates later this year, as the first country to start the process of normalizing its monetary policy. Even if this process is well managed, the likely volatility in financial markets could give rise to potential stability risks.

Let us think today about the risks of such monetary policy “spillovers” – as we have called them – and what can be done to minimize their potentially adverse consequences.

1. State of the Global Economy and Challenges

It is best to begin this discussion by placing it into the context of current global developments, and the risks that the world economy is still facing.

Global growth is still fragile and uneven. Despite a boost to global growth from a decline in oil prices, we now expect the world economy to grow by about 3.5 percent this year, picking up modestly next year to 3.7 percent.

The outlook differs significantly across countries and regions. In **advanced economies**, growth has rebounded in the United States and the United Kingdom and is expected to remain above trend in the near term, but activity is strengthening only gradually.

By contrast, in the *euro area* and *Japan*, domestic demand, especially credit to private sector and investment, has yet to recover fully.

In **emerging markets and developing countries**, growth is projected to pick up from less than 4.5 percent this year to a little more next year, but it will vary widely across countries as well.

Among the emerging markets, **India** is shining brightly. No doubt India has seen a windfall gain from a sharp drop in oil prices – as have other oil importing countries. More importantly, however, India is reaping the benefits of good policies and policy announcements.

My meetings with Prime Minister Modi and Finance Minister Jaitley yesterday have left me strongly convinced that the new government is skillfully shifting the focus to good macroeconomic management, clean and efficient government, and inclusive development. This has raised business confidence and hopes for all levels of Indian society, and is borne out by the latest GDP statistics which suggest a strong pace of economic activity this year and next.

Challenges

Yet many challenges lie ahead for the global economy, of which two are particularly relevant for India.

The **first challenge** is the recent strengthening of the U.S. dollar that has resulted from the relatively strong U.S. recovery combined with the divergence of monetary policy paths in advanced economies. This has put pressure on countries whose exchange rate regimes are linked to the dollar but yet conduct a substantial share of their external trade in other currencies, as well as on sovereigns who have borrowed in foreign currency heavily.

The appreciation of the U.S. dollar is also putting pressure on balance sheets of banks, firms, and households that borrow in dollars but have assets or earnings in other currencies. India's corporate sector, which has borrowed heavily in foreign currency, is not immune to this vulnerability. Corporate sector debt has risen very rapidly, nearly doubling in the last 5 years to about US\$120 billion.

The **second challenge**, and here we come to the main theme of my remarks, is the prospective normalization of monetary policy in the United States and its spillovers to emerging markets. The risk of financial market and capital flow volatility, along with sudden increases in interest rate spreads, remains a real possibility as U.S. interest rates begin to rise.

Let us look at this topic in some detail.

2. Spillovers from Unconventional Monetary Policies—Lessons for Emerging Markets

Unconventional monetary policies—including large purchases of government debt—has been used to provide policy accommodation in advanced economies since the 2007 global financial crisis. These policies have had both positive and negative spillovers.

Unconventional monetary policies helped avoid a financial market meltdown in the initial stages of the crisis, and later supported a recovery in advanced economies and elsewhere. I am convinced that these policies were necessary to avert a 1930's style global depression. To that extent, the unconventional monetary policies have had **strong positive spillovers** for the global economy, and by implication for India and other emerging markets.

However, it is also true that these policies led to a **build-up of risks** in this part of the world. Between 2009 and the end of 2012, emerging markets received about US\$ 4½ trillion of gross capital inflows, representing roughly one half of global capital flows. Such inflows were concentrated in a group of large countries, including India, which received about US\$ 470 billion.

As a consequence, bond and equity prices rallied, and currencies strengthened. Recent work by Fund staff suggests that spillovers to asset prices and capital flows in emerging market economies from expansionary *unconventional* monetary policies were even greater than from earlier *conventional* policies.

The danger is that vulnerabilities that build up during a period of very accommodative monetary policy can unwind suddenly when such policy is reversed, creating substantial market volatility.

We already got a taste of it during the “taper tantrum” episode in May and June of 2013, when most emerging market economies suffered indiscriminate capital outflows. India was also affected.

I am afraid this may not be a one-off episode. This is so, because the *timing* of interest rate lift-off and the *pace* of subsequent rate increases can still surprise markets.

As economic conditions improve in at least some advanced economies, portfolio rebalancing out of emerging market economies can be expected, and some volatility cannot be ruled out. Emerging markets need to prepare in advance to deal with this uncertainty.

Lessons for the international community and emerging markets

There are many important lessons we have already learnt from the “taper tantrum” episode that I would like to share with you.

First and foremost, advanced economies can help. Clear and effective communication of policy intentions can reduce the risk of creating very large market volatility. While admittedly it is a difficult task, I would also agree that there is scope for greater international policy cooperation to minimize the negative spillovers.

Second, emerging markets need to prepare well in advance. Evidence from our research suggests that emerging markets that had already addressed their economic vulnerabilities before the taper tantrum fared better during episodes of market volatility.

In particular, higher GDP growth, stronger external current account positions, lower inflation, and more liquid financial markets helped dampen market volatility. In addition, more resilient financial sectors contained the effects of such volatility. The reforms initiated here in India are therefore going in the right direction, are very timely, but will also need to be pursued with the utmost speed.

Third, if market volatility materializes, central banks need to be ready to act. Temporary—though aggressive—domestic liquidity support to certain sectors or markets may be necessary, along with targeted foreign exchange interventions. Moreover, cross-country foreign currency swaps lines have proven helpful in enabling necessary access to foreign exchange liquidity at times of market stress.

There are a few examples where **good fundamentals**, as well as decisive and **swift policy responses**, helped countries reduce, and cope with, market volatility. Think of Korea, which improved the resilience of its financial sector with measures that reduced banks’ short term external debt by half—to 27 percent—between 2008 and 2013. Other countries such as Brazil, Uruguay, and Indonesia used some form of capital flow management measures to discourage short term inflows and thus decrease the build-up of risks. Peru intervened directly, though temporarily, in the foreign exchange market to limit excessive volatility.

Here in India too, the **RBI took decisive action** during and after the taper tantrum episode. It provided foreign currency liquidity support to key sectors, allowed the rupee to depreciate, and provided judicious foreign exchange interventions to minimize disruptive movements in the rupee. The RBI also arrested the surge in gold imports, narrowed its current account deficits sharply, and started to rebuild foreign exchange reserves.

So I am very pleased to say that, in a very short time span, India successfully contained its domestic and external vulnerabilities more than in many other emerging economies.

Does this mean the work is done? Well, you would be surprised if I answered “yes” to this question.

3. Rethinking Financial Development

Indeed, there is more work to be done. Apart from short term policy responses to deal with acute economic crises, it is equally important to continue building a **safe and inclusive financial system**—which will serve well in good times in supporting broad based growth and provide an effective buffer in bad times in ensuring financial stability.

But there are questions about the extent and speed with which financial development should be pursued. The experience of advanced economies has shown the dangers that can arise from oversized financial systems.

IMF economists have done some work on rethinking financial development and its implications for stability and growth in emerging markets. This work is still being finalized and will be published in the next month or so. Allow me to share with you a few encouraging findings.

First, there are many **benefits still to be reaped from further financial development in most emerging markets**, including India. By financial development, I mean greater depth and efficiency of institutions and markets, as well as higher access of all its citizens to banks and financial instruments.

The RBI has taken several encouraging steps. By allowing for a greater role for the private sector in India’s public sector banks, there will undoubtedly be a striking increase in efficiency in the banking sector. Moreover, Prime Minister Modi’s commitment to broadening access to formal finance to all segments of the population through the ambitious *Jan Dhan Yojana* is impressive, and so are the results which were achieved in just a few months.

The **second** and related finding of the IMF study is that when it comes to financial deepening, *there are speed limits!* When done too fast, deepening financial institutions

can lead to more instability, both economic and financial. It encourages greater risk-taking and high leverage, particularly when poorly regulated and supervised.

This puts a premium on developing good institutions and regulatory frameworks.

India's record in promoting good practices has been positive in recent times. It is making progress toward addressing bad loans in public sector banks, and in developing a sound regulatory and supervisory regime for banks, insurance, and securities market.

Best international practices are also being adopted. For example, India is well ahead of many countries in implementing Basel III standards. The government's recent announcement to introduce legislation on a new Indian Financial Code, which will simplify and revamp India's financial regulatory architecture, is a revolutionary step.

The **third** finding of the IMF study relates to **potential tradeoffs of financial regulations**. One view is that tighter and more regulations to help safeguard financial stability can hamper financial development.

The IMF study provides a new angle. It finds that, among a large number of regulatory principles, there is a small subset that is truly critical for financial development as well as for financial stability. Some examples include regulations related to capital buffers, non performing loans, financial disclosures, and compensation. And, it is essentially the same small subset that matters for both!

In other words, there is very little or *no conflict between promoting financial stability and financial development if you choose the right regulations to focus on*.

On this note, let me conclude.

4. Conclusion

I am fascinated by the vibrance I see wherever I go in India. I see hope in the eyes of the small sellers by the street side. I see dreams in the eyes of young people, and there are so many young people! But above all I see change, change for the better.

The world is looking to India to lead the path to higher, sustainable, and inclusive growth.

Thank you.