*Impact of Chinese Slowdown on SAARC Region and Policy Options**

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It is indeed a pleasure to be here this morning. Let me welcome our guests of honour from the seven other South Asian Association for Regional Cooperation (SAARC) countries; especially Mr. Arjun Mahendran in his capacity as the present SAARCFINANCE Chair as also Mr. Fazle Kabir, the Bangladesh Bank Governor and Mr. Dasho Penjore, Governor Royal Monetary Authority of Bhutan who will be attending the SAARCFINANCE event for the first time. I welcome our distinguished guests, including our invitees from the IMF and the BIS.

SAARC[1], as a regional bloc was set up in 1985 with the aim of promoting the welfare of the people of South Asia, to accelerate regional economic growth, strengthen collective self-reliance and contribute to mutual trust, understanding and appreciation of one another's problems in the region. Since then, our nations have come a long way. They share a common goal of sustainable economic development, and face several similar developmental challenges. In terms of GDP based on Purchasing Power Parity (PPP), SAARC's share in the globe has increased rapidly from 4.0 per cent in 1980 to 9.0 per cent currently. However, SAARC nations also make up 24 per cent of total world population. We do need more growth, and do need to do more to support each other in this quest. Intra-regional trade accounts for a measly 5 per cent[2] compared to 66 per cent within EU.

However, today, I will not be talking of SAARC alone but the challenges SAARC faces in the context of globalisation. The world has become increasingly interdependent, with the strengthening of economic and financial linkages within geographic regions and across regions. Globalisation has brought several economic gains and improved consumer welfare, but at the same time exposed economies to spillovers from disturbances in one part of the geography to another.

Amid such growing vulnerabilities and imbalances, SAARC region shows continued resilience in the face of turbulent international markets, maintaining its spot as the fastest-growing region in the world. Average growth in the region has outstripped the average growth of Emerging Market and Developing Economies (EMDEs) throughout the post-crisis period. The outlook for the region has also improved as a result of significant disinflation in the region during 2014-16. However, within the region, growth trends have diverged temporally and spatially.

Moreover, the region is now facing newer challenges arising from uncertainties in other parts of the world. Possible moves by the US Fed, a potential rebound of oil prices, possible Brexit, geopolitical risks in the Middle East and volatility in financial markets due to risk-on or risk-off sentiment are some of the possibilities we have to anticipate. However, when we decided the theme of this conference, a common uncertainty that confronted us was the possible sharp slowdown of the Chinese economy. To my mind, this still remains a significant risk for the global economy and our region, though Chinese policymakers have a record of over three decades of astute policy making, which suggests they may significantly mitigate the potential downsides. Therefore, in the rest of this discussion, I will focus on the impact of the Chinese slowdown on SAARC region. I will also address potential policy responses, drawing specifically on India's policy actions.

Over the past two decades, China has emerged as a powerhouse of global production. China eclipsed the United States in 2013 to become the world's largest trading nation. As per WTO data, China was the world's

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[1] Afghanistan, Bangladesh, Bhutan, India, Maldives, Nepal, Pakistan and Sri Lanka.

[2] UN Commodity Trade Statistics Database, 2014.

largest exporter and second largest importer in 2014 accounting for 12.4 per cent and 10.3 per cent share, respectively. The United States accounted for 8.6 per cent of the world's exports and 12.7 per cent of the world's imports. So it is clear that a slowdown in China will affect the global economy, including the SAARC region. The sharp contraction in China's imports over the past year, has already led to spillovers through the trade, confidence, tourism and remittance channels. SAARC nations have not been able to avert its impact. More negative externalities could follow as Chinese economy adjusts to a more sustainable path.

Not only has China had to rein in production as a result of weak post-crisis industrial country demand, it has also suffered from weak aggregate demand of its own, as it shifts from an investment- and export-led growth model to a consumption-led model. Combined with the previous bouts of leveraged expansion, China now has a number of sectors that suffer from the twin ailments of overcapacity and high leverage. Bad loans in the banking system are likely to grow over current levels – stressed loans are estimated to be around 5.5 per cent of the banks loan book today. In addition, there may be serious weaknesses in the shadow banking system, which could feed back to banks. Clearly, cleaning up the financial system will be a challenging but necessary task.

Work at the IMF suggests that a 1-per cent permanent negative shock to China GDP caused by one-off 1-percentage decline in its real GDP growth will knock off 0.23 percentage points from global growth in the short-run[3]. A key question is whether we in SAARC region are at significantly more risk than others. The answer probably is no because none of us is primarily commodity exporter to China, but it cannot be an unqualified one. Trade could be impacted due to second round effects – we export to those who traditionally export to China and have thus slowed down -- and due to similarity in trade patterns with China – we compete with those who now have excess production capacity.

On the financial side, exposure to China is large for the Asia-Pacific banks, especially for banks from Hong Kong, Singapore and Australia and much less for banks from our region. However, some of our countries, though not India, have significant borrowing from Chinese banks, and these borrowings could become costlier if Chinese banks turn inwards. Moreover, financial market losses in China can heighten the risk premia that industrial country investors will charge for investing in our region, and the result could be capital outflows of the kind that were seen last August and early this year.

Chinese growth will depend not just on its policies, but on growth elsewhere in the world. There appears to be a general consensus that global growth has been too slow for too long. The IMF downgraded its outlook for global growth in 2016 and 2017 by 0.2 and 0.1 percentage points, respectively. It is true that downside risks and uncertainties to the global outlook are large in the backdrop of event risks I have alluded to. However, a more careful look at the data suggests some care in jumping to the conclusion that growth has been slow. Global growth has averaged 3.5 per cent since 1980 and, in fact, if we take out the credit boom supported average growth of 4.5 per cent during the period 2000-2007 that led to global financial crisis, the global average falls to 3.2 per cent. The fact is that after the small contraction in 2009, global growth has averaged 3.8 per cent during 2010-15 and is still expected to be 3.2 per cent in 2016.

What this means is that growth in period before the financial crisis was perhaps goosed up by borrowing, and the post financial crisis period is not so bad in comparison, especially if we account for the deleveraging that has taken place in industrial countries. Of course, the question of why underlying industrial country growth has slowed in recent years is still being debated, and the answer probably lies in the hard-to-understand

[3] Cashin, Paul, Kamiar Mohadess and Mehdi Raissi (2016), 'China›s Slowdown and Global Financial Market Volatility: Is World Growth Losing Out?' IMF Working Paper, No. WP/16/63, March.

effects of population ageing and productivity slowdown. While stronger global growth may be just around the corner, as the IMF has anticipated every year in the last few years, it may yet be some time in coming. It might therefore be optimistic to expect that China will be lifted by global tides, and it will probably have to undertake the needed policy adjustment without the tailwind of global growth.

What should SAARC countries be doing? While growth in India, Bangladesh and Bhutan is still quite good, overall we are confronted with a difficult combination of relatively slow domestic demand growth since 2013 and a difficult global environment. Portfolio flows have turned more volatile in this period. Let me explain what India has been doing in the face of these global uncertainties.

First, there is no substitute for good policy. India has outlined and adhered to a path of fiscal consolidation to reduce the fiscal deficit that had widened dramatically following the post-financial crisis stimulus. It has contained inflation through a combination of better food management, a new inflation framework and calibrated monetary policies, and of course the good luck of lower energy prices. The resulting demand management has resulted in a lower current account deficit, down from 4.8 per cent in 2012-13 to about 1 percent in 2015-16. We have also embarked on a cleanup of bad debts in the banking system so as to free bank balance sheets to support growth.

In addition, the government has embarked on ambitious structural reforms to revive growth, including significant efforts in the agricultural sector to boost productivity through irrigation, insurance, and access to markets, a strong push to deregulate business, especially for start-ups, important efforts to improve the governance of public sector banks and to resolve distress in power distribution companies, and an immense effort to expand financial services to the excluded through the provision of bank accounts and of direct benefit transfers. While the eyes of the world have been on the much anticipated Goods and Services Tax reform, a number of other significant reforms have taken place, including the recent passage of the new Bankruptcy bill, which is likely to speed the resolution of distress tremendously. With the benefit of hindsight, I am sure we will see the cleaning up of the process of allocating public resources like spectrum and mines, as well as the process of appointing critical personnel such as public sector bank chiefs, as one of the most effective reforms undertaken by the government. This is significantly increasing transparency in our system.

A second element of our defense is being careful about foreign borrowing, especially at the very short term. So we have expanded limits for foreign portfolio investment into government debt in a very measured way, even though considerable pressure has been put on us by foreign investors to create more room. We have required any new debt investment to be in debt over 3 years in residual maturity. We have also reformulated our rules on foreign bank borrowing to ensure that domestic entities without foreign earnings either borrow in rupees or really long term. We are trying to create an offshore rupee corporate 'masala' bond market. Finally, a strong liberalisation of FDI regulations, coupled with the government's active efforts to attract foreign investors, have resulted in record FDI inflows last financial year.

We also are careful in moderating periods of extreme volatility in the currency through exchange intervention. This is more of an art than a science, and we are extremely careful not to try and target any particular rate. Instead, we let the market adjust as needed, intervening only when we are convinced the movement is excessive. As a result, despite running a current account deficit, the currency has been relatively stable even in extreme risk-off periods. Based on our macroeconomic situation, we also intend to expand or contract what can be taken out annually by households --- this will be a macro-prudential instrument.

The fourth element of our defense is foreign exchange reserves. We have about US$ 360 billion, plus forward positions to offset possible forward liabilities.

We also see merit in pooling reserves, and have a Contingent Reserve Agreement with BRICS countries, and a currency swap arrangement with SAARC countries. I am glad to say that this SAARC facility has been of use to some of you.

We are very conscious of the role the Indian economy plays in influencing growth in other SAARC economies. To avoid any negative externalities, we have kept the objective of securing and preserving macro-stability at the top of our agenda. The ongoing disinflation, aided by our new monetary policy framework, and the resultant outcome of relative exchange rate stability compared with other emerging market peers, have hopefully served as a public good in this region. We have contributed to strengthening the safety nets in the region. We look forward to a strengthening Indian economy as recent structural reforms take hold, and hope that some of this growth will spillover to your economies. In turn, we hope to be benefited as your economies pick up. Together, we can hopefully be an island of relative stability and co-operation in this turbulent world.

Thank you. I look forward to fruitful deliberations at the rest of the symposium.