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Press Release

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Central Bank of Sri Lanka 65th Anniversary Oration

Dr. Raghuram G Rajan, the Governor of the Reserve Bank of India (RBI), delivered the 65th Anniversary Oration of the Central Bank of Sri Lanka today at the Cinnamon Lakeside Hotel, Colombo. Dr. Rajan is an eminent academic with an illustrious career in several areas of research such as banking, corporate finance, and economic development, especially the role of finance. Prior to his appointment as the 23rd Governor of the RBI in 2013, Dr. Rajan served as the Distinguished Service Professor of Finance at the Booth School of Business, University of Chicago, Chief Economist and Director of Research at the International Monetary Fund as well as the Chief Economic Adviser to Ministry of Finance, Government of India. He has widely published on various issues, including two interesting books providing new directions and perspectives of economic thinking such as '*Saving Capitalism from the Capitalists*' with Luigi Zingales and '*Fault Lines: How Hidden Fractures Still Threaten the World Economy*', for which he was awarded the Financial Times-Goldman Sachs prize for best business book in 2010. He has also published numerous academic articles in top tier finance and economics journals, including the *American Economic Review, Journal of Economic Perspectives, Journal of Political Economy, Journal of Financial Economics* and *Journal of Finance*. Dr. Rajan is a member of the Group of Thirty. He was the President of the American Finance Association in 2011 and is a member of the American Academy of Arts and Sciences. In 2003, the American Finance Association awarded Dr. Rajan the inaugural Fischer Black Prize for the best finance researcher under the age of forty.

In his Anniversary Oration on the theme ‘The Global Financial System and Rules of the Game’, Dr. Rajan highlighted that over time, the role of central banks have become immeasurably more, than it used to be in the past and perhaps, one may argue that it may have become excessive. In that context, Dr. Rajan’s speech was centred on the global economic environment and the role of central banks in the present circumstances.

It was highlighted that although there are few areas of robust growth around the world, the present period of slow growth is particularly dangerous because both industrial countries and emerging markets need high growth to manage domestic political tensions. In an environment of such tensions, there is a tremendous pressure for growth in different countries and such countries are more likely to focus on the policies attempting to divert growth from others rather than creating new growth.

Before the crisis, many emerging markets were exporting to China and China was exporting to the industrial world. Nevertheless, industrial countries’ demand was built on shaky foundations. For example, in the United States, it was based on private debt, whereas in Greece it was based on public debt and a number of countries were built on very low interest rates, excess spending and debt accumulation, which came to an end with the crisis. Although the Federal Reserve has intervened with relevant policies during the sub-prime mortgage crisis, the crisis then spread from the United States to a full-fledged crisis in the Euro zone and finally, to a crisis in the emerging market economies. However, traditional measures such as fiscal stimulus were deemed as inadequate to provide a solution for countries to get out from the crisis. In fact, such traditional measures have not had the force that is necessary to pull these economies out of the problems. In some economies such as Europe and Japan, there was not enough space for government spending as they were highly indebted. Even the private sector refrains from spending when they are confronted with large and devastating crises. In such circumstance, a tremendous amount of spending is needed by the governments to offset the impact. However, spending money by the governments would take time in terms of evaluating the viability and suitability of the projects, monitoring, etc. In the meantime, monetary stimulus is also associated with certain limitations.

It was however highlighted that the major cause of weak demand and the delay in revival of growth may not be related to fiscal or monetary stimulus, but it would be the real problems in the global economy that have to be fixed. For example, demand in industrial countries has significantly weakened due to ageing population who want to consume less and the increasing income share of the very rich mass, whose marginal propensity to consume is small. In the backdrop of the crisis and sluggish demand by industrial countries, emerging countries which were focusing on export led strategies need to reorient and refocus their policies towards new sources of demand, particularly the domestic demand. At the same time, as an alternative explanation, low growth could be associated with the changing world in terms of innovation, which is less effective to impact on productivity levels. In particular, it is observed that post-World War total factor productivity growth was lower than its high levels prevailed during 1920-50. More recently, while productivity growth has fallen further, growth has been affected by plateauing education levels and labour participation rates, as well as shrinking labour force.

In this context, in order to compensate low growth and to raise potential growth, structural reforms leading to rise in competition, foster innovation and drive institutional change as well as increase productivity are much needed. Such structural reforms could be politically sensitive and painful in the short term, but will deliver results in the long term. Hence, the gains to constituencies that are benefited are typically later and uncertain, which could also have political consequences. For example, Jean-Claude Juncker, then Luxembourg's Prime Minister, said at the height of the Euro crisis, "We all know what to do, we just don't know how to get re-elected after we've done it!". Although some countries have opted to undertake a large number of structural reforms and have yielded intended results, most of the countries have chosen to postpone such painful adjustments.

During the times of pre-global financial crisis, both emerging markets and industrial countries were locked in a dangerous relationship of capital flows and demand. Sustained exchange rate interventions by emerging market central banks, as well as an excessive tolerance for leverage in industrial countries contributed to an eventual global disaster. In fact, industrial countries have curtailed their investment without increasing their consumption leading to a reduction in demand for foreign goods and the reliance on foreign finance. This shift of advanced economies from current account deficits to surpluses has caused substantial decline in current account surpluses in emerging markets.

As fiscal stimulus, structural reforms and export led strategy may not work in generating growth, monetary policy may be used as the last resort. In fact, in industrial countries, interest rates were brought down to zero levels and that has led to a financial expansion due to rise in the prices of financial assets, which will also have some positive effect on consumer spending. Secondly, with the reduction of interest rates and exceptional monetary easing, exchange rates start depreciating, thereby incentivising the export markets. However, this may not be perceived as a fair strategy as emerging market economies could be adversely affected.

In conclusion, it is neither an industrial country problem, nor an emerging market problem, but a problem that requires a collective action. Accordingly, even as countries create conditions for sustainable growth, new rules of the game enforced impartially by multilateral organisations are required to ensure that countries would adhere to international responsibilities. In particular, well-capitalised stronger multilateral institutions with widespread legitimacy, which can provide long term capital and others that can monitor new rules of the game, are required. Meanwhile, countries need to work hard to develop a consensus for free trade, open markets, and responsible global citizenry. If countries can achieve all this even as recent economic events have made countries more parochial and inward-looking, it will set the stage for strong and sustainable growth.

The full text of the oration is available at Central Bank website (www.cbsl.gov.lk).