Global Imbalances, Spillover Effects and External Monitoring: Some Indian Perspectives

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Introduction

Jointly with Canada, India co-chairs the G-20 Framework Working Group. This working group was set up at the G-20 Pittsburgh Summit with the mandate to elaborate the leaders' agenda of returning the global economy to strong, sustained and balanced growth. At Seoul in November 2010, the leaders tasked this group to develop indicative guidelines with the technical support of the IMF for consideration by the G-20 Ministerial to take place in Washington in April 2011.

As co-chair of a critical and influential working group, India has been thrust into the heart of a complex and contentious global debate on how to measure, assess and correct the current imbalances and prevent future ones. In this article, I will not comment on India's position as co-chair of the working group, except to note that within India there has been remarkably little discussion on how the country's officials should exploit this prestigious platform. Rather, I examine these issues more broadly from the perspective of India's own growth strategy, its medium-term interest in deepening its own global integration while avoiding unreasonable risk, and its domestic political structures and constraints. It seems reasonable to assume that India's views of these medium-term interests will in turn affect the positions assumed by Indian officials and leaders in the global discussions. Given that the objective of this collection of articles is to encourage fresh thinking on these issues, this paper also tries to assimilate some of the more recent analysis emerging from the global recession to provide a personal assessment.

Analytical Considerations

From the perspective of the major emerging markets in the G-20, is anything really distinctive about the recent recession? Other than China, none of them are as yet systemically important for the global economy, although many of them now enjoy significant regional influence as growth poles and as potential sources of contagion. For at least the last 20 years, officials of these economies have voiced growing concerns on a range of issues in global finance. These concerns include the unpredictability and fickleness of capital flows, the volatility of cross-rates across major currencies, the reality and unfairness of contagion, and the steady reduction in the relative scale of official finance available as a safety net. There has also been considerable bitterness about the influence over major governments that international banks leveraged in order to ensure repayment of debt that had been incurred under questionable circumstances.

The "spillover effects" on emerging markets from policy decisions taken by advanced economies have been a source of concern for many years now. These concerns did not generate much policy traction because the influence was largely unidirectional from the advanced countries to the emerging markets without much impact in the opposite direction.

Seen in this light, it is not the policies of the advanced countries which are distinctive this time round. Rather, three other factors seem to be at play. First, collateral damage from such spillovers has been sustained by other advanced countries and not just by the poorer countries. Second, one important emerging market, namely China, is now important enough to affect global economic activity. Third, as pointed out by Blanchard and Miles-Ferreti,[1] the fiscal and monetary policy space is now sharply curtailed in many advanced countries.

These circumstances have compelled the advanced countries finally to pay attention to some of the concerns previously voiced by the emerging markets. This provides an opening for the latter group to press some of their earlier concerns. Yet there is also justified unease among these countries at putting in place a set of disciplines that might be unnecessarily intrusive, selectively applied and administered by the executive board and staff of the IMF—an institution whose own legitimacy and impartiality are currently under examination.

I next turn to the links between global imbalances, official financial flows and the recent crisis. As mentioned earlier, there has been sufficient intellectual and analytic consensus to prompt concerted action on failures of regulation and supervision, to identify perverse incentives in financial markets, and to address difficult issues of measuring and curbing systemic risk.

By contrast, there is little such consensus on global imbalances. An early formulation focused on the global savings glut, which resulted from the failure of investment to recover after the Asian crisis, with the U.S. current account adjusting passively to these autonomous flows. Seasoned observers are skeptical of this explanation, arguing that the crisis was not caused by "net flows across the Pacific but gross flows across the Atlantic"—a view that has received some endorsement in more recent work emerging from the Federal Reserve.[2]

Within the G-20, the focus of the discussion has shifted from the trade deficit to the current account and to reserves accumulation. Governments in countries besides the U.S. are irked that the central bank at the heart of the international monetary system, the U.S. Federal Reserve, sets policy completely disregarding international consequences, while the Federal Reserve argues that its best contribution to the world economy is by ensuring sustained noninflationary growth of the U.S. economy.

India's Situation

For India, distinguishing between various concepts of "imbalance" is relevant to ensuring that global rebalancing over the coming decade helps to support and sustain its own growth over the medium term and does not act to retard it. In turn, India's growth can make an important, though not decisive, contribution to sustaining recovery of the global economy. In his remarks, at the various G-20 meetings, Indian Prime Minister Manmohan Singh has been clear on the primacy that India gives to restoring growth in the advanced countries. This is because of the boost that this will give to India's own growth and because improved prospects for growth in the advanced countries is essential to sustain the commitment of those countries to an open world economy.

India's growth pattern has been qualitatively different from that of its peers in East Asia. India's rapid growth in the first decade of the 21st century has recently caused it to be considered an "honorary" member of this Asian fraternity. While there are some characteristics such as the role of the demographic transition which are similar, there are others which are distinctive and have an important bearing on India's stake in global rebalancing. This is true whether one considers: the earlier wave of successful industrializers, which include Japan and the "newly industrialized economies" of Korea, Taiwan, Hong Kong and Singapore; the more sophisticated ASEAN countries which followed, notably Malaysia and Thailand; or most recently China. All these countries have been characterized by fast growth in output and employment in manufacturing on the supply side and an important role for net exports as a source of demand.

By contrast, a striking aspect of the Indian experience is the relatively poor performance of manufacturing, particularly manufacturing in the so-called "formal" sector, and the corresponding specialization of the economy and trade in services. Equally on the demand side, net exports have been an insignificant source of final demand. Over the last two decades, India has also been plagued with a chronically weak fiscal position, leading to a relatively high debt stock—one that remains tolerable only because of relatively rapid growth.

These differences from other successful Asian emerging markets reflect themselves in the structure of India's balance of payments. In the decade since the Asian financial crisis, most East Asian countries have tended to run surpluses on their current accounts. In the case of the ASEAN countries, these surpluses reflect the fact that investment rates did not recover after the Asian crisis even as saving rates remained relatively strong. In the case of China, they famously reflect the fact that despite a towering and possibly inefficient investment rate, corporate and household savings are even higher, generating a large current account surplus.

With the exception of a couple of years in the middle of the last decade when it ran a small surplus, India has typically run a deficit on its current account of around 2 percent of GDP. This is financed by a net surplus on private capital flows, particularly portfolio flows and to a lesser extent net foreign direct investment. Yet this relatively tranquil overall picture masks a large and growing deficit on merchandise trade—now approaching 10 percent of GDP—offset by a surplus on invisibles account, including both services exports and large and relatively stable remittance flows. Given India's dependence on imported oil—about 70 percent of domestic consumption—the trade account is heavily affected by movements in the international oil price.

Similar to its Asian peers, India has accumulated significant stocks of international reserves despite this deficit on the current account primarily because of a fluctuating surplus on the net private capital account. It has done so for the same reasons that many other emerging markets accumulate large foreign exchange reserves. The reserves act as a financial safety-net in case of a "sudden stop" in capital flows and they help avoid disruptive nominal appreciation of the exchange rate, even while accommodating an increasingly wide degree of flexibility in the rupee-dollar exchange rate.

India is significantly poorer than most of its G-20 emerging market peers despite having sustained rapid growth for almost three decades. This is partly because India is much less urbanized. As its demographic transition is still incomplete, India faces sustained growth in its labor force over the next two decades.

If the focus is on the adjustment of current account balances, India has little "rebalancing" to do. It may nonetheless have considerable and legitimate concerns on the impact of global policies designed to reduce imbalances elsewhere. However, if the focus is more on imbalances in the trade account as seems to be the case, then India's interests are perhaps more closely aligned with those of the advanced countries, particularly the U.K. and the U.S., than with China. And if the focus of policy coordination is to reduce the accumulation of official reserves by emerging market countries, then India's interests lie with those concerned in strengthening so-called "safety-net" policies and any associated disciplines on capital movements and exchange rate regimes so to avoid becoming a victim of sudden stops in net foreign capital movements.

Indian policymakers have clearly signaled their view that India expects to be a net importer of private capital for the foreseeable future, but it believes that self-insurance remains the only credible mechanism of risk mitigation available at the present time. As an absorber of foreign savings, India has not contributed to global imbalances. However, as a significant accumulator of reserves, India does have an interest in the liquidity and maintenance of value of such reserves and in the orderly management of global liquidity. India has benefited enormously from its integration into the global economy, yet its growth strategy cannot really be called export-led, unlike other countries in East Asia. Accordingly, its primary motivation for reserves acquisition has been and will continue to be precautionary. Even so, these are likely to grow with the size of India's trade, the scale of its payments obligations, and the size and maturity of its financial system.

India's fundamental policy challenge is less one of external adjustment than of internal adjustment. As reflected in the current account, both the absolute levels and the relationship between aggregate saving and aggregate investment are broadly appropriate and do not require change. Equally, aggregate growth is at healthy levels and is likely to be sustained. What is needed is an improvement in the quality of this growth.

India would move to a better development trajectory if it could depreciate its real exchange rate such as to improve the competitiveness of its tradables-producing sector. Yet the paradox and challenge for domestic economic management are that India needs to do so while improving the supply of key non-tradables, including infrastructure provisions in the public and private sectors, as well as a broad range of human capital enhancing interventions, such as better public education and public health.

Thus, the appropriate policy shift for India is one that promotes expenditure switching without requiring expenditure reduction. Political economy considerations aside, the most appropriate policy mix for achieving the desired outcome is through a combination of fiscal consolidation, public expenditure reform and additional trade liberalization. Fiscal consolidation in turn could legitimately include both revenue and expenditure elements, along the lines of major reforms of the systems of direct and indirect taxation currently under consideration. More important is a fundamental restructuring of government subsidies on food and fuel, which has been endlessly talked about but keeps foundering on the shoals of vested interests and political timidity. Reduction or removal of fuel subsidies in particular should help reduce the oil import bill, releasing resources for domestic expenditure. Finally, unilateral trade liberalization, which has been of decisive importance in reducing anti-export bias in the last decade, has now ground to a halt partly because of the desire to retain bargaining chips for the stalled multilateral negotiations and partly out of fears about unfair competition from China.

The hypothesis underlying this policy prescription is that the real exchange rate is more durably influenced by policies, such as taxation, that affect the real economy. The issue nonetheless arises: what is the role of nominal policies, such as the nominal exchange rate, in bringing about the desired shift? In the case of China, it has been argued that a nominal appreciation would be important in shifting demand impulses away from external to domestic. Shouldn't the same argument apply in reverse to India? While the argument is superficially attractive, my own inclination is to be cautious. The Reserve Bank of India has gained valuable experience and credibility in managing an increasingly flexible exchange rate, which gives it all-important freedom in conducting monetary policy for domestic Indian conditions. One important by-product of this flexibility is the shifting of exchange risk assessment to private agents and the development of hedging instruments to allow them to do so.

To conclude, India's primordial interest as a member of the G-20 is the restoration of buoyant global economic activity since that will give India more space for the necessary domestic adjustments. India should resist being clubbed together with China in the debate on global rebalancing as India's interests are more fundamentally aligned with the deficit countries. The country's goal should be further trade deepening of its economy through multilateral trade liberalization; therefore, avoiding protection in the advanced countries is critical. But the fundamental economic challenges for India are domestic and this is where the bulk of its attention must remain directed.

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References

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Endnotes

[1] Blanchard and Miles-Ferreti (2011)

[2] Bernanke et. al. (2011)