The present global economy and the role of G20

Special Address of Secretary, Department of Economic Affairs on the occasion of the Conference on Global Cooperation for Sustainable Growth and Development
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Ladies and gentlemen, it gives me great pleasure to join you on the second day of this conference organised by ICRIER and its partners and devoted to the overarching subject of global cooperation for sustainable growth and development. I would like to thank the organisers and the Chair for giving me this opportunity.

I understand that several insightful papers were presented yesterday which were followed by stimulating discussions on subjects ranging from financial regulatory reform, reducing global imbalances and the international monetary system. Today's sessions have a heavy agenda covering issues like capital flow volatility, commodity markets, financial safety nets and the 'development agenda' which is in some ways central to all other economic endeavours.

The themes chosen for the conference are the subject matter of ongoing discussions in the G20 process. In each of these areas, the world faces several challenges and some of these are also a sequel to the global financial crisis, and indeed arising out of the policy response to the crisis itself. The challenge of economic development and poverty alleviation remains a continuing one. Therefore, a deeper understanding of how deeper global cooperation can be achieved in order to make tangible progress in each of these areas and ensure sustainable growth is not only welcome, but necessary. This is more so, at this juncture, since the global economy is showing renewed signs of weakness.
Global growth: Developments in the global economy over the last few months are a cause for concern. There are visible signs that the process of economic recovery is not proceeding satisfactorily. The problems in advanced economies on account of sovereign debt in the euro zone and in the US, coupled with the challenge of medium term fiscal consolidation against a backdrop of tepid growth are weighing heavily on financial markets. Financial market stresses in the European periphery are further magnifying the downside risks to global recovery.

At the same time, unemployment continues to be elevated at rates of 8-9 per cent in the advanced economies. This is close to the peak during the crisis. Given their enormous size, but weak economic growth, the task of restoring fiscal balance in advanced economies seems daunting, especially since monetary policy has already borne what burden it could for reviving animal spirits and growth.

There is no doubt that the advanced economies need to address the question of fiscal sustainability and consolidation. But there is a need to strike a balance between fiscal adjustment, that is neither too fast as to cause a further contraction, nor too slow, that it further worsens the fiscal burden and sends a wrong signal to the financial markets. The question that is uppermost in everyone’s mind is how can such a happy and credible Goldilocks solution be arrived at? Perhaps, the option of carefully targeting fiscal expenditure, as underscored by Kemal Dervis yesterday, so that there are spin offs in terms of both consumption and future growth needs to be explored.

Fiscal stimulus targeted at those with a higher propensity to spend, i.e. the most marginal groups, would help improve fiscal multipliers and
moderate the Ricardian equivalence effect. In this regard I would like to draw attention to our own fiscal stimulus, which included a substantial mark up in the outlay on the rural employment guarantee scheme. Fiscal stimulus targeted at investment, on the other hand, such as that announced by President Obama recently, would lay the ground for the future growth that markets are nervous about, and also pay for itself over the long-run. The two processes will need to be designed in a manner that they remain mutually reinforcing. Indeed there does not seem to be any magic solutions but concerted efforts backed by will is needed in that direction to restart growth which ultimately is an endogenous process.

The contrasting situation facing emerging market economies on the other hand poses another major challenge, as they are at a very different stage of the business cycle Emerging markets that recovered quickly from the global financial crisis are now confronted with elevated commodity prices, volatile capital flows, moderating growth and inflationary pressures. As a result, central banks have been raising policy rates with consequent implications on short-term growth

In India, the policy stance has had to change from being accommodative to one of aggressively combating inflation. The benchmark short-term policy rate was raised in quick succession from March 2010. While this tightening has been able to anchor inflationary expectation up to a point, it has had limited success in lowering inflation rates to acceptable levels.

There is no doubt that there are supply side constraints within the Indian economy. The issues of development, particularly in the area of infrastructure and in poverty alleviation, health education remain critical
challenges. We have been addressing them by investing in infrastructure, agriculture and in the social sector and continuing the structural reforms in the economy. While these supply constraints are no doubt contributing to inflation, the latter has also become more global in scope on account of external spillovers of domestic policy actions.

While the market concern at present is the unsustainable combination of escalating public debt against a backdrop of low growth in advanced countries, we are also cognisant of the need to maintain prudence in fiscal policy and have focussed our efforts towards fiscal consolidation, bolstering revenues and containing public expenditure. The need to do so stems not so much from rising debt-GDP ratios, which are indeed falling, but from the imperative of maintaining a healthy investment climate on which the economy’s potential growth depends. Regardless of these immediate challenges, the process of economic reforms, including reforms of the financial sector continues to occupy our focus, both in terms of policy and practice and our engagement to the multilateral process remains strong.

A key challenge for the G20 at this current juncture, as the premier forum for international cooperation, is to ensure that international policy cooperation is sustained and enhanced. In an increasingly interconnected world, the biggest risk to the global economy arises from policy dissonance. It is here the efforts of the G 20 on the various themes outlined for the conference become relevant. Multilateral policy coordination does not mean that policies in all countries should move in the same direction, but that they should be coherent and consistent with their business cycles.
G 20 Framework agenda: Short-term concerns regarding the global economy currently seems to be overshadowing the signature effort of the G 20 to lay the foundation for Strong, Sustainable and Balanced Growth of the global economy launched in the Pittsburgh summit in September 2009 in the form of the ‘Framework’. It holds the key to the credibility of the G20 to deliver in a post crisis scenario. Leaders launched the Framework with a commitment to work together to assess the collective implications of national policies on global growth and development, identify potential risks to the global economy, and take actions to achieve shared objectives.

At the Seoul Summit, G 20 leaders tasked the Framework Working Group, which India co-chairs along with Canada, to develop indicative guidelines for identifying persistently large imbalances, which has since been done.

The selection criteria for countries moving into the second stage also stipulated more stringent norms for systemically important economies, i.e those G20 countries accounting for more than 5% of G20 GDP (on either MER or PPP exchange rates) since they have the potential for greater spillover effects on the wider global economy.

The focus of the Framework on systemically important economies derived from the fact that global crises in the past, including the recent one, emanated from large economies. However, as we work to redefine elements of the MAP process in the G 20 countries we are faced with a new crisis arising from imbalances in relatively small economies in the periphery of the Euro Zone, which has spread to countries which were not on the periphery. This is because given the highly interconnected nature of financial markets, large imbalances even in a small economy in a large currency union can destabilize global markets.

Comment [as1]: Imbalances of course are not limited to the periphery, because the counterpart ‘surplus’ imbalances are in northern Europe, especially Germany. As pointed out by Keynes there is however no market pressures on surplus countries to adjust.
As far as India is concerned, while public debt is high, so are its private savings. As a result, most of the public debt is held domestically and does not spillover into international markets. While fiscal consolidation remains high on the policy agenda, it is important not to lose sight of the fact that India has a high growth rate and therefore a high investment rate which can be expected to remain robust. The fact remains that a high investment rate at this stage of growth begets high savings rate and India cannot take measure that reduces or discourages savings. However our focus will remain on developing our financial markets so that more of the saving gets channeled and intermediated into productive investment.

I would also like to add that India is a net source of demand in the global context and as such not a source of global imbalances. The Gross Domestic Product (GDP) in India expanded 7.7 percent in the second quarter of 2011 over the previous quarter. Our policies remain tuned to ensuring that the growth prospects of India remain intact and we are confident of growth gaining further momentum.

This brings me to the rebalancing process. The fact remains that many of the imbalances that world has been witnessing large current account deficits in some advanced countries, and large current account surpluses, mounting reserves and an undervalued currency, in some emerging markets, remain to be addressed.

Progress on this front has been slow. Admittedly, the transition of a pegged exchange rate to a market determined one may take time. Similarly, it is understandable that domestic saving is determined by micro behavior of households and the progress made on other attendant measures like improving the social security nets. But if exchange rates are kept artificially low indefinitely, it can only lead to further pressures and build up of imbalances both internationally as well as in the domestic economy. The burden of adjustment in such a case would fall
even more disproportionately on an increase in wages and real exchange rate apart from other disruptive effects that it may have on the economies of other trading partners. In other words, economies with large imbalances that have strong external effects need to recognize the stake they themselves have in a multilateral system and take measures to address the same.

Reform of the International monetary System: The recent crisis has underscored the weaknesses in the international monetary system which does not have a robust mechanism for preventing the build up of unsustainable imbalances. Seen through this perspective, the Framework exercise is a mechanism to force such such adjustments. Be it as it may, the underlying frailities in the international monetary system need to be addressed, as there is a realisation that there can be further, and maybe more serious disruption to the global economy if the safety and stability of the international monetary system is not ensured.

A more ambitious agenda is the issue of the global reserve currency itself, including an expanded role for the SDR and expanding the composition of the SDR basket so as to provide alternative reserve assets for greater financial stability. While the SDR basket needs to be expanded from time to time, to take into account the changing role and prominence of international currencies, it needs to be done in a manner consistent with the IMF articles of agreement. Accordingly, to qualify for inclusion, the country and its currency should have free convertibility both on current and capital account and enjoy large and open financial markets apart from satisfying the free usability criteria.
The international financial crisis underlined the importance of developing deep, efficient and properly regulated public and private local currency bond markets in developing countries as they have large investment needs that can absorb the savings emanating in their own economies. The recent crisis has shown how the inability to absorb these savings domestically can destabilize the global economy through global imbalances. We welcome the initiative for development of financial markets so long as it remains anchored on deep and strong linkages to the real economy and the absorptive capacity of the economy. In the absence of this, larger absorption of capital flows could end up in asset bubbles.

Continuing on that last point, the issue of volatile capital flows has been a matter of concern for several emerging markets. A key challenge facing policy makers worldwide is reaping the benefits from financial globalisation, while preventing and managing risks that undermine financial stability and sustainable growth.

Our experience with macroeconomic management suggests that there are spill over effects arising from macroeconomic policy choices of major economies that have been feeding through the external account and fuelling inflationary pressures. There is little doubt that long term capital flows are beneficial for the EMEs including India, in view of the large investment requirements, but short term capital and the associated volatility not only pose a policy challenge, but can also have disruptive consequences on account of the possibility of sudden stops and reversals due to developments taking place elsewhere.

India's exchange rate is market determined and this approach towards macroeconomic management has been instrumental in not having been adversely affected on this count. India on its part has been opening in a
calibrated manner and will continue to do so with regard to the external economy, including capital flows. At the same time, volatile capital flows cannot be treated as an exclusive problem of emerging markets, since the sources of liquidity that lead to such flows also need to be considered. While macroeconomic and macro prudential tools are important, capital controls also remain a useful policy instrument.

it needs to be clearly borne in mind that reserves remain the first line of defence as a financial safety net especially in the case of EMEs. An important issue in the IMS agenda is that of strengthening global financial safety nets. India has been of the view that the issue of financial safety nets needs to be viewed on the basis of 3 pillars with domestic reserves being the first, regional financial safety nets being the second and multilateral resources being the third. A diversified financial safety net is more robust as it provides safety valves at each level. It needs to be borne in mind that reserves remain the first line of defence as a financial safety net, especially in the case of EMEs running current account deficits, and those countries with large reserves fared better during the crisis.

Financial regulation: In the Washington summit held in November 2008 in wake of the global economic crisis, the leaders made a pertinent observation about the roots of the global financial crisis in their declaration, and I quote:

"During a period of strong global growth, growing capital flows, and prolonged stability earlier this decade, market participants sought higher yields without an adequate appreciation of the risks and failed to exercise proper due diligence. At the same time, weak underwriting standards, unsound risk management practices, increasingly complex and opaque financial products, and consequent excessive leverage combined to create vulnerabilities in the system. Policy-makers, regulators and supervisors, in some advanced countries, did not
adequately appreciate and address the risks building up in financial markets, keep pace with financial innovation, or take into account the systemic ramifications of domestic regulatory actions."

In line with the Washington declaration, financial regulatory reform has therefore been a core issue in past G20 summits. The broad contours of the international initiatives spearheaded by the G20 on regulatory reforms rests on four broad pillars: regulation, supervision, resolution, especially in respect of global systemically important financial institutions (or SIFIs), and assessment of the implementation of new standards. So far, one pillar that has received substantial public attention is regulatory reform, where there have already been some notable achievements, including agreement on the new Basel III capital and liquidity standards.

As far as India’s banks are concerned, the capital adequacy position of the banks in India (CRAR) was over 14 per cent and core CRAR over 10 per cent as on September 30, 2010) under Basel II norms. This means that the Basel III requirements, once fully calibrated, are not likely to be very much higher than the current position though there could be some impact due to shifting of some deductions such as intangible assets and deferred tax assets from Tier I and Tier II capital to common equity.

The Basel III is still micro-regulatory and pro-cyclical on account of risk weighting and marking to market, and the issue of shadow banking that lay at the heart of the recent crisis has still to be addressed.

While deleveraging continues currently, there need for effective mechanisms for limiting the buildup of excessive leverage in credit cycle upswings. It is still too early to say whether most of these reforms would be carried through to their logical conclusion and, if so, whether they would not be diluted as animal spirits fired again, as has happened repeatedly in the past.
There is a view that cracks are already appearing in the international consensus on compensation practices, accounting standards, reining in rating agencies, financial transactions taxes and the implementation of the new capital standards. Norms for macro-prudential regulation, the regulation of shadow banking and resolution regimes for global SIFIs are still to be worked out. India is of the view that unless the reforms are implemented in all jurisdictions simultaneously, the fear of increasing costs of intermediation and the migration of financial activity overseas consequent on regulatory arbitrage could well derail even the reforms already agreed.

India is evaluating its financial regulatory framework with a view to harmonizing it with the package of measures agreed by FSB and BCBS under the aegis of the G20. National implementation plan of the Basel III has already been worked out to begin on 1 January 2013 and reaching the final level by the end of 2018. The road map for convergence of Indian Accounting Standards with IFRSs has also been drawn up.

**Commodity price volatility.** The recent commodity and food price rise and their volatility have induced considerable threat to economic growth and food security in energy dependent economies. While the factors behind recent price hikes are still to be specifically identified as even the G-20 is undecided on the role of speculation and global excessive liquidity, it does seem puzzling that commodity prices should be so buoyant even as the outlook for global growth is so weak. India has been of the view that price volatility is closely linked to the financialization of commodity markets, resulting from the impact of sustained excessive global liquidity. Furthermore, there is a need to ensure transparency in commodity markets and to implement IOSCO recommendations.
Ladies and gentlemen, the challenges before the global economy are many. And needless to say, there are no simple answers. Furthermore, the answers need to be conditioned by the policy and decision making process in respective countries. However, a useful beginning can be made by first recognising that the recovery of the global economy can be served better by recognising the commonality of interests in an increasingly integrating global economy with large spillovers.

For most practitioners engaged in economic policy formulation, the global economic situation today is indeed challenging, to say the least. This is, partly because there is little time to reflect, even less time to assimilate new ideas, and almost no time to react to events. It seems, as if, every policy action should have been taken yesterday. On the other hand, events and market reactions do not wait for policy makers to arrive at a final view on any issue, if there was one. They hand you down a judgment in a fraction of a second, that could even get reversed just a day or two later.

We need to recognise this reality. To some extent, the compression of ideas and actions in terms of time and space has been the result of technology. Even so, the disconnect between world of ideas and theory and world of practical policy making has always been there, with the latter mostly lagging behind. Having said that, the global financial crisis showed that if economic theories and models get divorced from empirical reality, or, if they are not well validated, then there is not only risk of their becoming irrelevant, but inference drawn on them may well place the economy at risk.

The foregoing problems assume an even more complex dimension when we consider the challenges being faced by global economy today in
where both ideas and actions need to be viewed in a multilateral context. There therefore a constant need to bridge the gap between economic theory and its practice.

A conference such as this which brings together scholars and experts and practitioners can greatly help in bridging this gap and improving our understanding about the way in which global cooperation could help achieve sustainable growth and development.

I am hopeful that the deliberations in this conference will provide the new insights help meet the global challenges at the current conjuncture innovatively. Ladies and gentlemen, I would like to thank you for your kind attention.

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