

# Regional Keynesianism: An Urgent Need of the Hour and Its Relevance for India Today

By Ramgopal Agarwala  
Distinguished Fellow, RIS

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Research and Information System  
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# Introduction

**The Global Economic Crisis is going from bad to worse.**

**Risk of Great Depression II is serious.**

**Out-of-the –box thinking is needed**

**We need brutal frankness about the root causes and bold proposals for remedial action**

# Disorderly Unwinding of "Global Imbalances"

## Root causes of the crisis

- Greed of the financial players?
- Weakness of individual regulators?
- Failure of deregulation philosophy
- Stimulus package post 2001
- Misuse of dollar printing press and weak international surveillance
- Solvency problem and not just liquidity problem

## Disorderly Unwinding of "Global Imbalances" (continued)

The US policy is still on wrong track

- Massive use of printing press for financial bail-outs and economic stimulus with high fiscal deficits and risk of dollar crisis.
- Growing protectionism in the wake of appreciation of dollar and need for domestic stimulus.
- Risk of repetition of Great Depression of the 1930s.

## For orderly unwinding of global imbalances

- Restructuring global demand away from US consumption (about \$1 trillion) to consumption and investment in ROW.
  - Massive devaluation of US dollar in real effective terms
    - Tighter external budget constraint on the US
- Massive restructuring of global financial system needed with an SDR based system and a global Marshall Plan funded by SDRs. US may not be ready yet.
- In the meantime, Asia can play a vital role in helping an orderly correction of global imbalances and improve its own development performance.

## Role of Physical and Social Infrastructure in Asia for Near-Term Stimulus and Long term Development

Massive investment needs in Asia to help reduce dependence on US markets

- Earlier estimates of the huge infrastructure deficits of at least \$200 billion per year
- In addition, expenditures for mitigation of and adaptation to greenhouse gases
- Social infrastructure expenditures meet the Millennium Development Goals (MDGs).

Thus the demand stimulus measures to compensate for decline in net exports to the US do not have to be in the nature of what Keynes called digging holes and filling them up. These investments are needed for long-term sustainable growth. Activating them now will be a bonus in the present global economic crisis.

## Case of India as an illustration

In the remaining three years of the Plan (2009-12), infrastructure investments were expected to be about 8.3% of GDP. However on business as usual scenario, this ratio cannot be expected to be more than 6%. Thus there is a gap of at least 2% of GDP or about \$70 billion to be filled in the next three years just for meeting the infrastructure investment targets of EFYP.

For management of climate change the Indian policy paper, National Action Plan on Climate Change (NAPCC) .. has put forth a program of eight "missions" relating to solar energy, energy efficiency, sustainable habitat, water, sustaining Himalayan ecosystem, "green India", sustainable agriculture and strategic knowledge for climate change. There is no estimate in NAPCC of the level of expenditures needed for funding these missions. However, if we use the global figures on resources needed for managing climate change, (about 1% of GDP), these missions in India can be expected to absorb at least \$10 billion per year.

## Case of India as an illustration (continued)

In the social sector, possible shortfall of at least 1% of GDP.

Taking the need for physical and social infrastructure and green expenditures, a stimulus package of about 4% of GDP or about \$50 billion per year for the next three years may be entirely appropriate in the current conditions.

Need for external funding



## *Low returns on foreign exchange reserves*

In Policy Brief No.31 , we noted that foreign exchange reserves in Asia were about \$3.3 trillion in December 2006 and nearly \$2 trillion of these could be considered “excessive”. Since then reserves in Asia have been increasing and are now estimated to be about \$4.3, a large part of which is probably excessive as before.

The situation in India about “excess reserves” remains unchanged. Even after decline in recent months, reserves in India as of December 26, 2008 were \$254.6 billion, about \$100 billion more than in December 2006. Allowing for reserves for transaction needs (as 3 months of imports expected to be less than \$300 billion in 2009), precautionary needs as full provision for short term debt ( \$ 50 billion as of end-September) and FII investments ( \$53. 2 billion as of January 2, 2009), the reserve requirements at present are no more than \$178 billion, which leads to an estimate of “excess” reserves as above \$75 billion.

## Low returns on foreign exchange reserves (continued)

The rate of return on these reserves is now extremely low, even lower than before. The yield on one-year US Treasuries on December 30, 2008 was 0.4% per year as against 3.4 % a year ago. With the risk of depreciation in US dollar, the reserves held in US Treasuries are certainly set for negative real rates of return. There is a need, more than ever before, to see how at least the "excess" reserves of Asia can earn a better rate of return.

## Regional Co-operation Mechanism

With the total reserves of Asia at about \$ 4 trillion, some \$400 billion can be safely used for more aggressive management at a regional level. We suggest a two-track approach.

First, in view of the urgent need for a stimulus package in Asia, a deposit of say \$50 billion can be made in Asian Development bank (ADB) by Asian countries with current account surplus for on-lending in the three areas noted, namely, physical and social infrastructure and green expenditures. The rate of interest paid by ADB to the deposit-making countries could be 100 basis points higher than what US Treasuries are offering. ADB can re-lend these funds with a modest margin to Asian countries in need of stimulus package but with limited fiscal and balance of payments (BOP) space. Channeling funds through ADB, the premier regional development institution, would be better than just bilateral assistance because of the technical capacity it has and because of the apolitical atmosphere for assistance that it would provide.

## Regional Co-operation Mechanism (continued)

Secondly, a dialogue should be initiated immediately for a long-term restructuring of regional financial architecture to achieve the triple objective of restructuring global demand and allowing concerted appreciation of Asian currencies w.r.t.US\$ and putting a tighter external budget constraint on the US.

The proposal for issuing Asian Currency Unit (ACU) as a parallel currency made, among others, in RIS Discussion Paper No. 133 (March 2008), should be seriously considered.

- ACU could provide a mechanism for concerted appreciation of major Asian currencies with respect to the US \$, which may be essential for helping the US to reduce its net imports without protectionist measures.
- Moreover, issuance of ACU as the regional parallel currency will also generate the seigniorage (which is currently appropriated largely by the US) for funding regional public goods, including cross-border infrastructure investments.

## Outline of a Reserve Bank of Asia

As proposed in RIS Policy Brief No. 31, a Reserve Bank of Asia (RBA) may be established with subscribed capital of \$300 billion, 10% of which can be paid up. In addition, Asian countries will deposit \$300 billion in RBA on long-term basis at 100 basis points above the rates prevailing on 30-year US Treasuries. RBA will invest these funds in Asian equity indices and Asian bonds which can be expected to give rates of return higher than the cost to RBA on these deposits. These funds would be largely liquid and available to participating countries in cases of unexpected balance of payments needs. Investment in indices of equities and bonds in Asia will give a much needed boost to these markets in Asia. Moreover the profits made by RBA combined with the seigniorage obtained through the regional currency should provide substantial funds to fill up the financial viability gap to the extent it exists in the \$300 billion per year of investment expenditures mentioned above. Basically, the seigniorage that the US has been getting through the dollar reserve system will in part accrue to Asia in the proposed scheme.



## Possible Contributions of RBA

- Help adjustment of US \$.
- RBA could meet a substantial part of additional resources needed for stimulus packages in countries such as India which does not have adequate budgetary space.
- It could also help to make growth more inclusive both within countries and within the region.
- Armed with \$300 billion of capital and reserves, RBA can become a substantial regional financial institution to help in improving the capacity of the Asian countries for preparation and implementation of projects, as well as for improving the regulatory environment for infrastructure projects.
- More generally, RBA could become the key agency for developing policy paradigm suitable for the Asian conditions. A sample of such an Asian development paradigm is provided in RIS Discussion Paper No.133 (appendix I, pp.49-54).

**Thank You**