Structural Reforms on the Way to Recovery and Beyond

- **Since I am the last speaker at the conference I will indulge in some philosophic thoughts rather than go back to details**

- **The genesis of all problems is that sustainability limits are exceeded at various levels**
- **Sustainable action should be defined at four levels**

  - an individual

  - a corporate firm or financial institution

  - an economy at a macro level

  - at the international level

- **Imbalances in international trade are not the primary source of the crisis**
- **Current account surplus returning to deficit countries and creating excess liquidity is a problem**
- **Institutional reforms should address both the sustainable limits of economic activity and global trade imbalances**

- **The first two groups mentioned above can regulate themselves if a broad guideline is offered and monitored; the other two need more extensive structural mechanisms**
- **What is sustainable?**

  individuals – should be able to repay loans

corporate level – should not sell products at negative profit

economy level – public debt should not lead to “fiscal drag”

international – countries should restrict current account surplus to a point where it can be converted to domestic investment

- **I will now consider only international finance since that is the main theme**
- **How will international trade lead to a financial crisis?**

  - country X attempts to sell abroad, faces resistance, unsustainable sales reduce liquidity

  - country Y tries to sell more in X, products in X are cannibalized,

triggers a collapse in X

- country Y has a large surplus on current account, lends to X through uncontrolled financial institutions, excess liquidity and low interest rates, finance unsustainable activity, crisis

- country X has a deficit on current account, finances siphoned off,

liquidity reduced, reduction in activity

-country X has low interest rates, few new investment opportunities, capital shifts to Y either as FDI or FII, X faces reduced liquidity, Y may face greater volatility and/or inflation

- country X in financial crisis, reduced demand for goods from Y, crisis spreads to Y

- **Suppose country X has large current account surplus, cannot use for domestic investment**
- **International financial institutions can make X lend to an IFI, channel to Y in deficit systematically**
- **Do we know enough about how X is using the excess? If used for domestic**

investment need not intervene

- Why does Y maintain current account surplus?

  - may be to ensure growth prospects

  - OPEC countries have a political compulsion to maintain supply (suggests demand from X is not sustainable, do not penalize Y)

-the context of China more complex, outselling due to cost advantage?

- **Why does Y, with a deficit on current account, maintain excess reserves?**

  - to pay for imports, afraid of crisis like in India in 1991

  - to pay for sustainable supply augmentation

- concerns that SDRs from IMF have not been adequate

Even in this context if IFI comes forward to cater to sustainable demands may ask Y to lend the excess to IFI

- Should IFIs force a revaluation of Y’s currency?

  - only after making sure that country Y

is solely responsible in creating it, surplus is unsustainable, and IFIs have not been able to make it lend to others

If country Y has a deficit on current account but maintains excessive forex reserves the fault may lie elsewhere, correction in X should come up first

- **Every country should**

  - monitor sustainability of demand, not force surplus on current account on others

  -IFIs should cater to sustainable growth of emerging economies

  - IFIs should mediate capital flows in an efficient way

- if everybody knows this and complies the role of IFIs will reduce considerably

In essence, an international bank with a wider role than available today will be necessary

- For all practical purposes I am suggesting that the current NBFC like operation of the international financial

flows should be replaced by one single bank operating on commercial lines

- **It will set rates for different kinds of deposits from various countries, interest rates for different loans, essentially this replaces determination of exchange rates, arbitrage possibilities eliminated, and sustainability can be verified and enforced**

- **Countries will also be free to decide how much of excess on current account they want to keep with them, rather than deposit in the bank, for their domestic supply augmentation and growth depending on its sustainability**

- **India has not shown any tendencies of one-up-manship despite its characterization as a super power**
- **I am clear in my mind about India’s aims: sustainable growth, increases in supply potential to match sustainable limits of demand, inclusive growth to reduce inequalities which create the high expectations that we observe**

- **Our financial sector developments have been mostly inward looking even when some instruments are borrowed from international experiences**
- **Our banking sector is well controlled; even non-performing assets kept within check; so is exposure to subprime assets; note that our banks showed positive profits even at the height of the crisis**

- **The best long term scenario for every country is to define and adhere to sustainable limits on its own. Growth in some countries may be retarded. But we have to accept this**
- **Doing stupid things to be numero uno should be discouraged. That would be the essence of mature statesmanship**

Does G20 really have such an inclination or leadership?