Global Imbalances- An Indian Perspective[1]

Honourable Under Secretary General, Mr. Ocampo, Ambassador Nirupam Sen and Distinguished Guests,

It is a privilege and an honor to be invited at the United Nations to deliver a talk on 'Global Imbalances: an Indian Perspective". I would like to thank Professor Jose Antonio Ocampo, Under Secretary General, for inviting me to deliver this talk. In my presentation today, I hope to capture the debate among the policy makers as well as academics; though I must be humble in the presence of Mr. Ocampo who has been a Minister, and a Professor and currently international civil servant of eminence. To benefit from the discussions that are expected to follow, I will restrict my presentation to about 30 to 40 minutes.

First, I would like to reflect upon the international perspective on global imbalances by raising three issues: (a) the essential features of the global imbalances as they stand today, (b) possible causes of these imbalances, and (c) the emerging consensus on policy responses.

Second, I will attempt to highlight India's perspective on the global imbalances. While doing so, I would try to cover the following aspects: (a) India's role in global imbalances, (b) approach to global consensus on causes and policy responses, (c) possible impact of global imbalances on India, and (d) the emergence of oil as a new factor in the policy debate on global imbalances.

Third, I shall explore a possible agenda for analysis to enable better understanding of global imbalances.

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[1] Key Note Address by Dr.Y.V.Reddy, Governor, Reserve Bank of India at The Financing for Development (FFD) Office, Department of Economic and Social Office (DESA), United Nations, New York on May 11, 2006.

large trade and current account surplus for the Asian EMEs and large trade and current deficits elsewhere in the world, most noticeably in the US.

It is also clear that the sharp deterioration in the saving-investment balance in the US in the recent years along with sustained rise in consumption demand, could only be met by rising imports; hence rising large current account deficits in the US. The adverse shift in saving-investment balance in the US is reflected both in the high budget deficit since 2002 and the deterioration in net personal saving since 1998.

(c) The Emerging Consensus on Policy Responses.

The global imbalance as it stands today may get corrected on its own and perhaps there could be chances of a less favorable outcome of disorderly correction. It is held that one scenario could be that an orderly private sector led adjustment in imbalances could materialize even without policy action. It is argued that, however slim the chances of a disorderly adjustment, in view of huge cost of disorderly adjustments, public policy cannot afford but strive for relatively orderly adjustment. In any case, it is felt that there is a need for better understanding of policy issues with a view to take appropriate policy actionsof pol cstion in3boh policies — as well as implementation of comprehensive micro agenda of structural reforms.

A significant part of the debate seems to be on relative weights to be accorded by each country to the various elements of the package and the aspects of coordination among the countries that are appropriate. As regards the current global initiatives to correct global imbalances, the Communiqué issued by the International Monetary and Financial Committee (IMFC) released on April 22, 2006 highlights that action for orderly medium-term resolution of global imbalances is a shared responsibility, and will bring greater benefit to members and the international community than actions taken individually by countries. Key elements of the strategy towards orderly resolution of the global imbalance suggested in the Communiqué are as follows:

- Raising national saving in the United States—with measures to reduce the budget deficit and spur private saving;
- implementing structural reforms to sustain growth potential and boost domestic demand in the euro area and several other countries;
- further structural reforms, including fiscal consolidation, in Japan;
- allowing greater exchange rate flexibility in a number of surplus countries in emerging Asia; and
- promoting efficient absorption of higher oil revenues in oil-exporting countries with strong macroeconomic policies.

In the light of the above, the adjustments that are generally advocated in the individual economies and regions may be summarized as follows:

(i) A major challenge for US authorities could be to seek policies that balance between measures to boost personal saving coupled with measures to cut consumption. However, US policies would need to delicately balance a gradual withdrawal of fiscal stimulus without hurting the recovery. It should be noted that demand compression could result in another recession, which would not be in the interest of the global economy. A gradual realignment of the real exchange rate of the US dollar coupled with measures targeted towards fiscal consolidation is generally advocated. Having said that, proper calibration would hold the key to the success of such a policy mix and this is an important public policy issue.

(ii) The Euro area, which continues to depend largely on external demand, could pursue some structural reforms, especially product and labor market policies, to boost domestic demand and broad-base the recovery. While there are signs of recovery in investment, it is recognized by many that further progress would be helpful to foster better integration of labor, health care, product, pension and financial market reforms. It is recognized that structural reforms by their nature are complex and their impact at best could be only over the medium term.

(iii) We are already witnessing that the Japanese economy is on the way to recovery; the current account surplus has begun to narrow against the background of strengthening domestic demand, which is critical. Thus, the Japanese economy is expected to continue to take some concrete measures to strengthen its financial system, restructure the corporate sector, and reduce large fiscal imbalances.

(iv) As for the emerging economies, especially in Asia, some experts suggest that the growth strategy could be reoriented towards domestic demand to offset possible declines in exports to the US. There are already some signs of strengthening in domestic demand in this region. It is felt that improvement in the investment climate to support higher private investment in the emerging economies is important. It is argued by some that the exchange rate policy may require some attention of the policy makers in the region. However, some others consider that exchange rate adjustments may not serve the interests of output and employment in these countries, while effectiveness of such exchange rate adjustments by themselves in unwinding the imbalances is not conclusive.

(v) The oil exporting countries have recorded large trade surpluses, the investment of which in the domestic market and abroad would help rebalancing global demand. It is suggested that these countries could boost expenditures to some extent in areas where social returns are high like education, health, infrastructure and social security. It is felt that structural policies to strengthen legal and economic infrastructure in these countries may help promoting investment. However, it is also argued that in many oil exporting countries scope for domestic absorption is limited in the short run.

II. India's Perspective on Global Imbalances

(a) India's Role in Global Imbalances

Since Independence, India has moved from a moderate growth path of the first three decades (1950 to 1980) to a higher growth trajectory since the 1980s. Over the last two and a half decades, India has emerged as one of the fastest growing economies of the world, averaging about 6 per cent growth rate per annum and the ranking of the country in terms of size of the economy, especially modest current account deficit in the last two years. In fact, going by the current indication and the projections of the tenth Five Year Plan, India is likely to maintain a modest and sustainable current account deficit in the near future.

(ii) It is observed that generally current account surplus accounted for a considerable proportion of reserve accumulation in most of the Asian EMEs and Japan during 2000-05. For India, current account surplus has been a minor source of reserve accretion. In our case, capital flows, as opposed to current account surpluses, played an increasingly important role in the accumulation of reserves.

(iii) Our approach aimed at market determined exchange rate with no predetermined target along with market interventions essentially to manage volatility has served us well. At the empirical level, the flexibility of Indian exchange rate policy is captured by marked two-way movement of Indian rupee against the major currencies including US dollar. Recent international research on viable exchange rate strategies in emerging markets has lent considerable support to the exchange rate policy followed by India.

(iv) The main driver of growth in India has been domestic demand. Impressive growth in exports and imports does strengthen the economy but the ratio of exports to GDP in India is lower than most EMEs.

(v) The overall improvement in GDP growth during the reform period has also been facilitated by improvement in the rate of aggregate domestic saving. For instance, in the high growth phase of last three years, the saving rate rose by 5.5 percentage points from 23.5 per cent in 2001-02 to 29.1 per cent in 2004-05. Gross domestic investment rate, for the first time, remained above 30 per cent in 2004-05, mainly on account of private investment growing at 19.7 per cent. With the Fiscal Responsibility and Budget Management Act in place, the fiscal situation in India has shown improvement in the recent years. The fiscal consolidation process envisages phased reduction in the key deficit indicators. Monetary policy, while being supportive of investment demand places emphasis on price and financial stability and has succeeded in containing inflation expectations. These factors give confidence to the possibility of sustaining the present growth momentum – GDP growth of close to 8 per cent per annum.

India has, thus, been following policies which not only served it well but also contributed to global stability. As mentioned by our Finance Minister, Mr. P. Chidambaram, we do not expect any change in the basic framework of our policies both in terms of growth based on efficient use of capital and stability assured by sound macroeconomic policies.

(b) Approach to Global Consensus on Causes and Policy Responses

We view that global developments, particularly those in the world financial markets, have the most direct and serious impact on the financing conditions in the emerging markets. Any abrupt and disorderly adjustment to global imbalances may have serious adverse implications. Recognising these developments, Prime Minister of India, Dr. Manmohan Singh in his welcome address to the Board of Governors of the Asian Development Bank (ADB) at the 39th Annual General Meeting in Hyderabad, a couple of weeks ago, highlighted the importance of correcting these imbalances. I quote from his address:

> "While to some extent mismatches in current account positions are to be expected - and even desirable - in the global economy, large disparities raise concerns about unsustainability and hard landings. The process of correcting imbalances can be disruptive if it is sudden and unexpected. The present level of global imbalance cannot be sustained forever. It calls for action both from countries having current account surpluses and those having current account deficits. A coordinated effort is necessary to

with other countries in the process of unwinding of global imbalance. I quote from his address:

> "I must reiterate that to sustain the recovery process and to correct the global imbalances in an orderly manner, there is an imperative need for a cooperative approach."

Third, it is desirable to convince the policy makers in each country that actions considered appropriate are in the long term interest of the country itself. In this regard, the contextual challenges for each economy should be given due weight. For example, in countries like India, employment and poverty reduction need to be given highest priority.

Fourth, it is essential to recognize that co-ordination is necessary given the complex situation where neither the causes nor the solutions are clear-cut. As a first step, there could, however, be a broad agreement on the directions and the first principles that are most appropriate. Emphasis on harmony in policies and search for co-operative solutions appears appropriate.

(c) Possible Impact of Global Imbalances on India

As highlighted by our Finance Minister during the recent ADB annual meetings that apart from the impact on the real and external sectors, it is felt that the developments in the currency and capital market are intrinsically intertwined with the global imbalance and, therefore, in the eventuality of a disorderly correction, disruption in these markets in the form of large cross-currency volatility and sharp rise in interest rates are likely in the global economy. What could be the possible impact of less than orderly adjustment of global imbalances on the Indian economy?

India does not depend on the international capital market for financing the fiscal deficit and consequently to some extent adverse consequences of the global developments would be muted. However, there could be a spill-over effect of global developments on domestic interest rates and thus on fisc also. The fiscal position of the Government could also be indirectly impacted through the nature of management of foreign exchange reserves held by the Reserve Bank.

Similarly, any abrupt adjustment in global imbalances may affect corporates, banks and households in India though the impact may be less than some other emerging economies.

With respect to the impact on corporates, if there is widening of spreads due to a shift in investor confidence in the international markets, those corporates which have borrowed at variable rates may possibly suffer more than those, which have taken loans on a fixed rate basis. Corporates which have hedged against currency and interest rate risks may escape the adverse effects. It may be noted that the Reserve Bank has been urging banks to encourage corporates to hedge their foreign currency exposures. Further, exposure of the corporate sector as a whole to the external debt is limited by indicative ceilings on external commercial borrowings imposed by the Government and the Reserve Bank of India. The level of total external debt of India is currently less than the portfolios. However, the banking sector has acquired some added strength to absorb such probable shocks, largely aided by regulatory actions.

As regards impact on the households, there is a risk that rises in interest rates in general could impact the housing market and expose the balance sheet of the households to interest rate risk, increasing the risk of loan losses for banks. The overall banking sector's exposure to housing loans being relatively small, adverse developments may not have any systemic implications on the banking sector.

(d) The Emergence of Oil as a New Factor

The emergence of large current account surpluses among the oil exporting countries is an important recent development. The current account surplus of the oil exporting countries increased from 6.2 per cent of their GDP in 2001 to 19.1 per cent in 2005. Less than third of the combined current account surplus of the oil exporting countries has been reflected in their foreign exchange reserves which rose by US $ 90 billion in 2005. The IMF (World Economic Outlook, April 2006) has highlighted that to the extent that higher net savings by oil exporters have driven down global interest rates, and that these lower rates have boosted demand in economies with market based financial systems, such as the United States, the oil price shock may also have had an additional negative effect on the US external position.

The fact remains that the rising oil prices would result in further widening of global current account imbalances as according to consensus forecast the current account balance of the US is projected to deteriorate further in 2006. Other industrialized economies are projected to run a combined surplus led mainly by Japan and Germany. The aggregate current account surplus of the major oil exporting countries is expected to increase further in the near term.

In this regard, it may be noted that India's oil import bill amounted to 2.9 per cent of GDP in 2001-02, but the bill climbed to 5.5 per cent of GDP in 2005-06, though in volume terms the increase has been marginal.

III. Agenda for Analysis

In view of complex nature of global imbalances and the way forward to minimize the risks of disorderly adjustments, it may be useful to explore possible agenda for further analysis.

First, national balance sheets, as mentioned by Governor Mervyn King, could be given special attention to get a fuller picture of financial claims that countries have against other countries. Looking at the national balance sheets would also be useful to acquire a sense about the potential for adjustment, and they will give a sense of the possible impact of relative price changes on the value of assets and liabilities. The composition and size of the liabilities and assets of the national balance sheets are crucial as by viewing them together we could get a global picture. However, we should look deeper into the balance sheets in terms of disaggregating them into public and private sector components and the incomes generated in the process. A relevant observation here is the perceived higher returns to external assets held by US relative to US assets held by the rest of the world. A disaggregation enables analysis of the role of private and public sector in perpetuation as well as the resolution of imbalances. There could be dominance of bilateral claims of the private sector of one country to the public or the private sector of other country. Could such dominant bilateral claims become a noticeable force allowing, at times, non-economic factors to play a role in the whole process of engagement?

Second, following the experience of the East Asian crisis of 1997-98, where private sector vulnerabilities rather than public sector imbalances played a key role in precipitating the crisis, the third generation models have explicitly brought to the fore the role of balance sheet mismatches in causing financial crises. A country's balance sheet as evident from traditional macroeconomic aggregate could be quite sound, yet, analysis of composition and size of the liabilities and assets of the balance sheets of domestic entities may be useful in assessing vulnerability to the manner of unwinding of imbalances. It would therefore be useful to analyze the impact of global imbalances on various balance sheets within the country such as the government sector, financial sector including banks and financial institutions, non-financial private sector including corporates and households.

Third, as mentioned earlier, surplus of oil exporting countries has emerged as a new factor in the debate on the global imbalance. There are some indications that the oil surpluses are being deployed in more diversified avenues than official reserves. Oil exporters appear to have taken advantage of emerging investment opportunity in stock markets and real estate. Such inflows could have helped to keep long-term interest rates as also emerging market bond spreads low, even as policy rates are rising. An interesting issue would be the nature of their responses to unwinding of global imbalances.

Fourth, in a way global imbalance is a reflection of incomplete globalization. If there were complete globalization, the surplus in saving of one country could be utilized by a country which has deficit in saving as it happens among different States in India or the US. It could be argued that as the global economy integrates further, the resolution of the global imbalances might be smoother.

Fifth, what is the evolving role of viewing exchange rate regimes in influencing domestic economy? It is argued by some that the emerging evidence indicates that domestic price movements remain somewhat immune to considerable exchange rate movements. If so, the possibility of bringing about global rebalancing through exchange rate adjustment by itself may not be very encouraging. No doubt exchange rate would have an important role to play in global rebalancing, but the issue is its relationship with other components of the whole package like saving–investment, fiscal deficit, raising investment, structural reforms and domestic output as well as employment. The linkages among the various components described here could be very country specific.

Sixth, there is wide diversity among the Asian economies in terms of saving and investment rates, fiscal deficit, drivers of growth (domestic versus external demand) and the degree of flexibility in their exchange rates. Thus, it may be difficult to treat all of them as contributing to global financial imbalances, in the same manner, nor would all the Asian economies be identically affected by the adjustment of global financial imbalances. Correspondingly, the policy response of each country to the issue would be tailored to the circumstances. More importantly, with growing integration among Asian economies, how would the process of rebalancing affect them depending on the manner in which dominant economies in Asia manage the process?

Seventh, our Prime Minister, Professor Manmohan Singh has suggested that given the potential for investment demand in the region, we must find ways of making better use of savings and finding investment avenues within the region. In this regard, an important issue would be generation of demand within the region so that the aggregate current account surpluses are absorbed in the region itself. This process of demand generation would help in orderly correction of the global imbalances

Eighth, one wonders whether there is a dissonance between the response of the financial markets is often out of alignment with the signals. Interestingly, anecdotal evidence shows that analysts in financial intermediaries are sensitive to the downside risk of imbalances, but the conduct of the participants does not reflect the awareness. No doubt, this sense of dissonance is not new, as for example, stock markets went up after Mr. Alan Greenspan's statement regarding irrational exuberan story both in terms of growth and stability. The Indian economy has responded well to the rising global competition with gradually increasing integration with the world economy. The current high growth phase of the Indian economy is also coinciding with rising domestic saving rates. While India by itself hardly contributes to the current global financial imbalances, any large and rapid adjustments in major currencies and related interest rates or current accounts of trading partners could indirectly, but significantly, impact the Indian economy. We therefore have a large stake in the process of unwinding of global imbalances, and we are willing to play our part in ensuring successful outcomes from current initiatives.

Thank you