Summary of the discussion

In the discussion that followed Dr Reddy's speech, several issues concerning nature and direction of capital flows, persistence of global imbalances, exchange rate regimes and reserve currency choices and the political economy of macroeconomic policy framework and implementation surfaced. After some discussion, views converged on all important issues.

Exchange rate regimes and Reserve Currency

If the tendency of more and more countries adopting flexible exchange rates continues, exchange rates would get determined by economic fundamentals and countries will not have to accumulate reserves. Will this be a way of avoiding dependence on one reserve currency? This is premised upon the assumption that if there are multiple exchange rates, then there can be multiple reserve currencies and there would be no need for any single currency as a means of international payment and store of value. But, there will still be a need for a numeraire, and there are network externalities. Furthermore, there is increasing evidence that exchange rate by itself is not neutral to other macroeconomic policies, apart from the fact that some of the advanced economies themselves intervene in foreign exchange markets.

What we have ended up with is a non-system where it is perfectly legal to follow fixed exchange rates with closed capital markets or open capital markets or more flexible systems with open capital markets. But, more and more we see some hybrids of flexible rates, but influenced by periodic interventions with capital markets not being completely open. Above all, self correcting mechanism of market forces also does not work, as evident from the recent crisis. In this environment, the feature of a non-system is likely to continue for quite some more time. A universal flexible exchange rate regime by itself is not a solution.

Capital flows and Global Imbalances

One of the goals of the international monetary system is to deal with global imbalances. It is paradoxical that capital continues to flow uphill from developing economies to developed economies. Yet, there is no scope for this paradox changing in the near future. The public debt to GDP ratio of advanced economies has increased three fold to four fold while the share of GDP of the advanced economies as a share of the total global economy has declined. Public debt of the advanced countries is going to demand a large share of global capital on the demand side. Second, the age or demographic profile implies that fiscal stress will continue. On the supply side, the likelihood of savings to GDP increasing is not significant. Because of globalization, the labour force in advanced economies is worried about keeping their jobs and maintaining the same standards of living for themselves and for the next generation. So, there is no possibility of large public debt requirements of advanced countries being met without matching capital flows from the emerging markets.

Dr Sheng however viewed that the logic of the Triffin dilemma is that if the growth of the reserve currency country is slower than the rest of the world, the reserve currency country has to provide liquidity to the rest of the world and by definition the reserve currency country must run a current account deficit and the rest of the world has to finance the reserve currency country. And capital is not flowing downhill or uphill, it is nothing but the reverse side of current account deficit.

In so far as the Eurozone is concerned, it does not have economic imbalances *vis-à-vis* the rest of the world and the problem is internal to Eurozone. However, to the extent there is moderation in economic growth in the Eurozone, it definitely will affect the rest of the world due to spillover effects.

Ring fencing Trade Finance

Trade finance has followed the restructuring of the global economy. With rapid globalization of the manufacturing process, the growth of trade in inputs has grown more rapidly than growth in trade in final products and this has driven trade credit and the underlying forces have been much more non-financial than financial. When the crisis erupted in 2008, the first to be affected was trade finance and it was an area which hurt the real sector the most. If we can regulate trade credit so that it is ring fenced in a period of crisis, it would be of benefit to all. This could be through capital account management on which there is more consensus today. Most of the living wills seem to sacrifice trade credit in the first instance and it is desirable if through regulation, ring fencing of trade credit is ensured in the same way as we accept payments systems are important for current transactions and can justify their ring fencing.

Credit Risk Assessments

The primacy given to CRAs during the crisis was a mistake. Nevertheless, the process of securitization of finance places the largest burden of credit analysis on the end investor. Therefore, what is more mysterious is the comprehensive failure of the institutional investors who had the fiduciary responsibility to their clients while investing in instruments -which they probably did not understand- only on the basis of third party recommendations. While the large investors are supposed to have their own analysis, in the case of the institutions it was a business decision to outsource this activity. But, what is more important is for regulators to review their guidance on using external rating agencies for regulatory purposes and ensure that the CRAs follow the rules of the game.

Political economy of Policy framework and implementation

How does one deal with political and financial interests while bringing about an optimal regulation of the financial sector from the real economy perspective? Both political interests and financial markets have short term views, whereas the regulators have a long term view. The financial regulators may have become somewhat independent of the political leadership, but the acceptability of the regulations to the financial markets is still vital. When interests converge there is no problem; but, when they diverge there is a problem. In the final analysis, the regulatory instruments act as a constraint on the regulated institutions and markets. Occupy Wall Street is a sign of the people's spontaneous reaction to the way the financial markets function and their nexus with politics.

The political interference on specific regulatory decisions is varied. By and large, the desire is that there should be no political interference on regulatory decisions, in the short term. But, from a longer term perspective, regulation reflects the political thrust at any point of time.