

Duvvuri Subbarao: Emerging market economies leading global growth

Remarks by Dr Duvvuri Subbarao, Governor of the Reserve Bank of India, at a panel discussion on the “Role of Emerging Economies Going Forward and Key Policy Challenges”, Washington DC, 9 October 2010.

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The three issues laid out in today’s agenda are particularly relevant at this juncture and how we answer them in the months ahead will determine how the world regains and then sustains economic growth and financial stability.

Let me begin with the first issue: How can emerging market economies (EMEs) best contribute towards securing global economic prosperity?

The most important way in which EMEs can contribute to global economic prosperity is by doing more of what they have been doing – that is by maintaining their growth momentum.

The last few months have witnessed a remarkable phenomenon. EMEs have, to use a word that has now become clichéd, decoupled from advanced economies in a powerful way and started charting their own exit paths out of the crisis driven accommodative policies. Even a few months ago, not many would have thought that this meant much or mattered much to the global economy. But now we know EMEs have made a “difference”. By recovering from the crisis sooner, EMEs have provided much needed stimulus to the global economy.

To take a historical perspective, according to Angus Maddison’s long term GDP time series, China and India accounted for about half of the world GDP before the industrial revolution. Since then their contribution declined to less than 10 per cent. Rapid economic growth should help China and India to raise their per capita GDPs, gradually bridging the gap with advanced economies, as Japan, Korea and Singapore already have. That way they will provide diversified growth poles to the global economy and contribute to global economic prosperity.

That EMEs can provide support to the global economy has been clearly demonstrated by our experience of the crisis. The Great Recession, for example, has been less deep than it would have been because of the growth contribution of EMEs, particularly China and India. And at the current juncture, when advanced economies are still experiencing a demand recession, it is the import demand from EMEs which is helping them make the necessary adjustment.

In order to maintain their growth momentum, EMEs will need to address huge challenges and put in place both collective and individual country strategies. What these should be is by now quite well known.

What the October crisis has made us aware of is that putting all one’s eggs in one engine of growth (pardon my mixed metaphor) is risky. Rebalancing the economy towards domestic demand is clearly key. Expanding and deepening intra-EME trade not just in goods but also in services is the other area where EMEs need to focus. Intra-EMEs financial flows are pathetically low. These are virtual greenfields that can and should be exploited.

A lot of things need to be done at the country level too. In the case of India, for example, we need to bridge the infrastructure deficit, focus on social sector outcomes, improve governance and implement strategies for private investment and job creation.

The second area where EMEs can contribute to global prosperity is through ensuring that the G-20 forum remains meaningful and effective.

When the history of this crisis is written, the London G-20 Summit in April 2009 will be seen as a clear turning point when the leaders of world showed extraordinary determination and unity in combating the deepest economic crisis of our generation. Sure there were

differences, but they were debated and discussed, and compromises were made without eroding the end goal – that is to end the crisis.

Now, as we exit from the crisis, there are concerns and apprehensions that the vaunted unity that the G-20 had shown during the crisis is dissipating. There are many stereotype, and I believe, mistaken views about the G-20. Here are some examples: that the G-20 process has become hostage to differing perceptions on financial sector regulation; that reforms being initiated at the national and regional levels are not consistent with a global optimal; that the trans-Atlantic differences on, for example, the size of fiscal stimulus, that surfaced during the height of the crisis have mutated into “north-south” differences as we are getting out of the crisis; that in spite of EMEs being given seats at the table, the G-20 agenda is still largely driven by advanced country concerns.

EMEs can contribute to global economic prosperity by fighting these perceptions and breaking these stereotype views. The G-20 may not be a perfect forum, but it is still the best that we have.

A well functioning global economy is a huge asset for advanced and developing economies alike. For most of the last century, the US and Europe had played a dominant role in setting the architecture for governing the global economy. From establishing the Bretton Woods Institution and forging agreements for liberalizing international trade, to establishing global financial standards to coordinating responses to economic crisis. EMEs now need to step in and do their part. We must remember that in a world divided by nation states, there is no natural constituency for the global economy. But as the October crisis has shown, the global economy as an entity is more important than ever. We should not allow a situation to develop where decisions essential for global prosperity fall through the cracks.

The short point therefore is for EMEs to step in and work actively with advanced economies under the G-20 umbrella to design and implement globally optimal strategies.

The third way in which EMEs can contribute to global prosperity, which in fact follows my earlier point about the G-20 process, is to make the implementation of the Global Framework and the related Mutual Assessment Process (MAP) a success.

In their Toronto Summit in July 2010, the G-20 leaders agreed on a “Framework for Strong, Sustainable and Balanced Growth”. At the heart of this Framework are strategies to be put in place by advanced and emerging economies to restore external balances and repair their financial sectors where need be. For reasons that are quite obvious, these national strategies have to be coordinated in content and in implementation. Any framework like this can be successful only in an atmosphere of trust and reciprocity. Emerging economies can contribute to global prosperity by making an honest effort to making the Global Framework a success.

Le me now turn to the second issue. What are the key macroeconomic policy challenges that EMEs will likely face in the context of rebalancing global order?

Several challenges, admittedly inter-related, stare in the face of EMEs as they try to recover the growth momentum lost during the crisis.

The post crisis world will be defined by two important characteristics. First, growth in advanced countries will be tepid, and second, the global environment will be less friendly to globalization. Let us take these one by one.

Advanced economies will slow down because, as public discourse over the last four months has revealed, they will give priority to restoring financial stability even if that means sacrifice of growth. This may not just be a short term trade-off but may indeed run into the medium term. The IMF itself has spoken of a “new normal” – a downward shift in potential growth of advanced economies because of the impairment of their financial sectors and capital destruction. It will take at least a few years for advanced economy households and firms to repair their balance sheets at the individual level and for the economies to restore external

and internal balances at the aggregate level. In the process, advanced economies will have to contend with structural fiscal deficits, demographic transitions, worsening income distribution and unemployment.

A corollary of a low growth scenario, weighed down by domestic concerns, is a less welcoming attitude to globalization. There may not be actually be “deglobalization” but the earlier orthodoxy that globalization is an unmixed blessing is being increasingly challenged. The rationale was, and hopefully is, that even as advanced countries may see low end jobs being outsourced, they will still benefit from globalization because for every low end job gone, another high end job – that is more skill intensive, more productive – will be created. If this does not happen rapidly enough or visibly enough, protectionist pressures will arise, and rapidly become vociferous and politically compelling. The wave of currency depreciations that we are seeing around the world is a manifestation of protectionist pressures.

Going forward, the biggest challenge for EMEs will be to pursue their growth and development strategies in this evolving world of a “new normal” of growth and less welcoming of globalization. To address this challenge, EMEs will need to make adjustments, most notably by rebalancing from external to internal sources of demand. Even for a country like India where growth drivers have been predominantly internal, a lower global demand will hurt exports and the overall growth performance.

The second big challenge for EMEs is going to be to implement Basel III. The broad contours of Basel III – higher and better quality capital, counter-cyclical buffers, limits on leverage and maintenance of minimum liquidity – are all quite familiar and I need not repeat them here. There is also some flexibility for national differences in adoption and implementation by way of a “comply or explain” provision.

Basel III is undoubtedly well thought through and reflects the lessons of the crisis. However, its implementation comes at a time when EMEs see their credit demand picking up. India, for example, is the second fastest growing economy in Asia but our credit-GDP ratio is the second lowest in Asia. Non-bank sources of credit and internal savings have kept bank credit growth low. But all this means that there will be a sharp catch up as soon as these sources are exhausted. Our credit demand will see rapid expansion because of the investment needs of infrastructure, the “catch up” of the manufacturing sector, and most importantly, because of the credit demand that financial inclusion will bring.

Basel III requires capital buffers to be built. Buffers provide insurance against bad times but they also raise lending costs and may reduce overall lending. Moreover, counter-cyclical buffers require judgements to be made on the trajectory of the business cycle and on identification of the inflexion point. Wrong judgements can entail huge costs in terms of foregone growth. The challenge for EMEs will be to contend with the challenge of implementing Basel III, and at the same time ensuring that the hugely expanding credit demand is met at affordable cost.

Finally let me address the question of – How emerging economies can best cope with volatile capital flows? Can macroprudential policies be effective?

A clear outcome of the multi-speed recovery has been resumption of capital flows to emerging economies.

In order to restore financial stability, advanced economies have assured markets that they will maintain low interest rates over an extended period. And in order to manage expectations, they have repeatedly emphasized that intention.

On the other hand, because of their earlier recovery, EMEs have begun to reverse their crisis triggered expansionary policies much sooner. In India, for example, because of our unique growth inflation dynamics, we raised policy interest rates five times since March 2010. One of the issues that dominate public discourse in India is, in fact, whether the Reserve Bank has reached neutral levels of policy rates, whatever they may be.

The interest rate differentials between advanced economies and EMEs have naturally triggered capital flows into EMEs putting upward pressure on their currencies and complicating their macroeconomic management. Quite understandably, EMEs are perturbed. Ideally, EMEs want stable capital flows, and just about enough flows to meet their current account deficits. That remains just that – an ideal. In fact, I have since formulated a law of capital flows which says that “capital flows never come in at the exact time or in the precise quantity you want”.

To manage capital flows, EMEs don't have easy options. It is possible, although not terribly efficient, to cherry pick the type of flows. Capital controls can be gamed or circumvented. Also stop-go policies send wrong signals to potential investors. Despite all this, different EMEs have tried, and will continue to try out, capital controls of both price and quantity varieties.

In India, we have had our share of concerns on managing the capital account. During 2007/08, the year before the crisis, we had flows largely in excess of our current account deficit (CAD). In the crisis year of 2008/09, flows were far short of the CAD. Last year, 2009/10 we were on a sweet spot, capital flows were just a tad higher than the CAD. Such sweet spots, of course, are uncommon.

During the current year, 2010/11, we saw some outflows during the spring when the unfolding Greek drama triggered a flight to safety. But over the last few months, we have seen rapid inflows no doubt triggered by the promise of higher short-term returns.

And so, we are back to facing the usual dilemma of managing the impossible trinity. Two considerations have guided our policy. First that, our policy should be as stable as possible without flip flop moves. Second, our use of controls should be prudent.

The aftermath of the crisis has triggered a debate on the costs of building up reserves as a self-insurance. We have to acknowledge that their foreign exchange reserves have insulated EMEs from the worst impact of the crisis. There is an argument that a multilateral option of a pre-arranged line of credit that can be easily and quickly accessed can be a substitute for costly self-insurance. Such a multilateral option is necessary but not sufficient. EMEs need a Plan B and reserves are that Plan B. And a good Plan B is often the difference between the success and failure of Plan A.

Furthermore, in evaluating the level of reserves and the quantum of self insurance of a country, it is important to distinguish between countries whose reserves are a consequence of current account surpluses and countries with current account deficits whose reserves are a result of capital inflows in excess of their economy's absorptive capacity.

India falls in the latter category. Our reserves comprise essentially borrowed resources, and we are therefore more vulnerable to sudden stops and reversals as compared with countries with current account surpluses.

In recent months, when inflows have swamped most EMEs, several central banks have intervened in the forex markets. We haven't despite receiving more portfolio inflows last month (September 2010) than in any other single month on record. The reason why we did not feel the need to intervene is because our absorption, driven by a widening current account deficit as imports have surged on the back of a positive outlook on growth and investment, has also increased. Economies that have current account surpluses or only small deficits have intervened. That does not mean we won't intervene. If the inflows are lumpy and volatile or if they disrupt the macroeconomic situation, we will do so. Our intervention will be to keep liquidity conditions consistent with activity in the real economy and to maintain financial stability. And not to stand against developments driven by changing economic fundamentals.

Will we use macro-prudential instruments? We already do and will continue to use them. But the operative word here is prudential. Just recently we tightened rules for bank lending against stocks. Our motivation was strictly the maintenance of financial stability.

Let me end, by making a pitch for monetary policy taking financial stability seriously. I know that there are many who continue to believe that monetary policy should be guided by a single objective, namely keeping goods inflation stable. I think the world paid a heavy price for doing so. It was this orthodoxy that prevented many central banks from seeing what else was happening in their financial markets which in turn brewed the global crisis.

In India, and in several EMEs, financial stability had been and has become increasingly important as an objective of monetary policy. And I am not talking just about asset price inflation, although it is a key consideration. In my view, it is this heterodoxy that helped EMEs avoid the kind of widespread disruption many developed financial markets suffered in the October crisis. I may be wrong, but the economics profession owes itself to examine the question seriously.