Duvvuri Subbarao: Frontier issues on the global agenda – need for global cooperation

Inaugural address by Dr Duvvuri Subbarao, Governor of the Reserve Bank of India, at the Indian Council for Research on International Economic Relations/InWent/German Development Institute (ICRIER/InWent/DIE) Conference on "Policies for growth and financial stability beyond the crisis – the scope for global cooperation", Mumbai, 27 October 2010.

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1. First of all, my thanks to the organizers of this conference – ICRIER, the German Development Institute (DIE) and InWent – for inviting me to inaugurate this conference on: "Policies for Growth and Financial Stability Beyond the Crisis – the Scope for Global Cooperation". Having just returned from a meeting of G-20 Finance Ministers and Central Bank Governors in Korea over this weekend, I am deeply sensitive to the value of generating a wider debate on issues that the world has to grapple with as we emerge out of the crisis.

2. The focus of this conference on global cooperation is particularly relevant. Everyone now has her/his list of lessons of the crisis, and one item common on almost every list is the lesson that today's macroeconomic problems cannot be resolved without global cooperation. The crisis has taught us that no country can be an island and that economic and financial disruptions anywhere cause ripples, if not waves, everywhere. The crisis also taught us that given the deepening integration of countries into the global economic and financial system, uncoordinated responses will lead to worse outcomes for everyone.

3. 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 the world showed extraordinary determination and unity of purpose 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.

4. The priority task today is to calibrate the exit from the crisis driven accommodative policies and put the world on a sustainable growth path. Global cooperation is as vital for managing this recovery as it was for managing the crisis. There is a growing apprehension though that the vaunted unity that the G-20 had shown during the crisis is dissipating and that its resolve to foster globally optimal solutions is weakening. When all the details are distilled out, two main worries emerge: first, that countries are not able to resolve their conflicts of interest, and second that at the world level we are bogged down by the tyranny of the present and are not able to resolve the balance between medium term sustainability and short term compulsions.

5. These concerns are valid, but the judgement on G-20 is perhaps harsh. The global problems we are facing today are complex and not amenable to easy solutions. Many of them require significant and often painful adjustments at the national level, and in a world divided by nation-states, there is no natural constituency for the global economy. At the same time, the global crisis has shown that the global economy as an entity is more important than ever. We cannot afford a situation where decisions essential for global prosperity become hostage to domestic concerns.

6. Against this background, and keeping in view the vast sweep of this conference theme, what I propose to do in this inaugural address is to highlight the frontier issues on the present day global agenda and emphasize how we cannot resolve them without global cooperation.

Multi-speed recovery

7. By all accounts, the world has recovered from the financial meltdown and the follow on recession much sooner than we had feared at the depth of the crisis. In its latest World Economic Outlook (WEO – October 2010), the IMF projected global growth for 2010 of 4.8 per cent; this marks a surprising upward revision from its earlier projection of 4.6 per cent. This remarkable turnaround in outlook masks some significant geographical variations in the recovery process. Emerging market economies (EMEs), contributing nearly half of this growth, have clearly been the engine of this recovery. World trade which shrank by 11 per cent in 2009, is projected to expand by 11.4 per cent in 2010, again powered by import demand of EMEs which is rising twice as fast as that of advanced economies.

8. On the other hand, in advanced economies, there are growing concerns about the slowing momentum of recovery, stubbornly high rates of unemployment and persistent output gaps. Although specifics vary, the G-3 – America, Europe and Japan – are caught in fierce policy debates on stimulus and exit strategies. At the heart of this debate are two issues that pit the short-term against the medium term: first, whether additional fiscal stimulus at this stage will jeopardize medium term fiscal sustainability; and second, whether continued expansionary monetary stance – QE2 in popular jargon – will be an adequate substitute for the waning fiscal stimulus, and what implications the ultra loose monetary policy may have for medium term inflation trends.

9. A question often asked is whether EMEs will be able to sustain global growth even if advanced economies continue to languish. People who put this question, I believe, are doing so as a rhetoric – to encourage analytical thinking rather than to solicit an affirmative answer. Sure, multiple growth poles are a safety-net for the whole world, but to expect EMEs, by themselves, to lift global growth will be unrealistic. Note that emerging and developing countries account for less than half of world GDP even when measured at PPP valuations, and only about a third of the world trade in goods and services. Notably, the much hyped "decoupling" does not stand to strict scrutiny. On the contrary, there is evidence of powerful coupling. Recent research within IMF shows that the detrended aggregate output growth of EMEs has strong association with the aggregate output growth of advanced economies and this "association" has in fact increased over time, evidencing not only that the coupling is strong but that it is getting stronger. Sure, in recent years EMEs have been less affected by recessions in advanced economies owing to improved policy framework and more effective macroeconomic management. But over an entire cycle, the economic prospects of EMEs remain firmly coupled with those of advanced economies.

Global adjustments – short term and medium term

10. All members of the G-20 are deeply conscious that purely national solutions do not solve global problems and that they each need to make an adjustment to the post-crisis global realities. It is in calibrating the exit in the short-term and sequencing the structural reforms in the medium term that the differences arise, and that is where global cooperation is most vital.

11. The post-crisis global scenario has thrown up three interrelated issues. The first is the need for rebalancing across and within economies. In as much as global imbalances – no matter whether they were caused by "a consumption binge" in advanced economies or a "savings glut" in EMEs – were one of the root causes of the crisis, reducing imbalances is a necessary condition for global financial stability. A second issue is the role of exchange rates in redressing external imbalances. A third set of questions relates to capital flows into EMEs raising the familiar challenge of managing the impossible trinity. Let me turn to these one by one.

12. The first issue, rebalancing, is the focus of the latest (October 2010) World Economic Outlook of the IMF. I can do no better than to quote from the foreword to the Report.

> "Achieving a "strong, balanced and sustained world recovery" – to quote from the goal set in Pittsburgh by the G20 – was never going to be easy. .... It requires two fundamental and difficult economic rebalancing acts.
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> First, internal rebalancing: When private demand collapsed, fiscal stimulus helped alleviate the fall in output. But fiscal stimulus has to eventually give way to fiscal consolidation, and private demand must be strong enough to take the lead and sustain growth.
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> Second, external rebalancing: Many advanced economies, most notably the United States, which relied excessively on domestic demand, must now rely more on net exports. Many emerging market economies, most notably China, which relied excessively on net exports, must now rely more on domestic demand.
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> These two rebalancing acts are taking place too slowly."

13. A prime lever for redressal of external imbalances is exchange rate flexibility, the second issue that I listed. Rebalancing will require deficit economies to save more and consume less. They need to depend for growth more on external demand which calls for a real depreciation of their currencies. The surplus economies will need to mirror these efforts – save less and spend more, and shift from external to domestic demand. They need to let their currencies appreciate. Managing currency tensions will require a shared understanding on keeping exchange rates aligned to economic fundamentals, and an agreement that currency interventions should be resorted to not as an instrument of trade policy but only to manage disruptions to macroeconomic stability.

14. That brings me to the third issue that I listed, return of lumpy and volatile capital flows. Since capital flows have become such an emotive topic around the world in recent months, it is important perhaps to recall a few realities. First, that emerging and developing economies do need capital flows to augment their investible resources, but such flows should meet two criteria: they should be stable and be roughly equal to the economy's absorptive capacity. The second reality that we must remember is that capital flows are triggered by both pull and push factors. The pull factors are the promising growth prospects of EMEs, their declining trend rates of inflation, capital account liberalization and improved governance. The push factors are the easy monetary policies of advanced economies which create the capital that flows into the EMEs. What this says is that international capital flows comprise a structural component and a cyclical component. It is the cyclical component that typically causes all the adjustment problems for EMEs.

15. That said, the multi-speed recovery around the world and the consequent differential exit from accommodative monetary policy has triggered speculative capital flows into EMEs. The biggest problem thrown up by capital flows is currency appreciation which erodes export competitiveness. Intervention in the forex market to prevent appreciation entails costs. If the resultant liquidity is left unsterilized, it fuels inflationary pressures. If the resultant liquidity is sterilized, it puts upward pressure on interest rates which, apart from hurting competitiveness, also encourages further flows.

16. Currency appreciation is not the only problem arising from the ultra loose monetary policy of advanced economies. Speculative flows on the lookout for quick returns can potentially lead to asset price build up. The assurance of advanced economies to keep interest rates "exceptionally low" for "an extended period" has also possibly triggered financialization of commodities leading to a paradoxical situation of hardening of commodity prices even as advanced economies continue to face demand recession. Hardening of commodity prices has affected those EMEs which are net importers of commodities.

17. Managing capital flows should not be treated as an exclusive problem of EMEs. In as much as lumpy and volatile flows are a spillover from policy choices of advanced economies, the burden of adjustment has to be shared. How this burden has to be measured and shared raises both intellectual and practical policy challenges. The intellectual challenge is that we do not have a good theory that explains the role of capital flows in the determination of exchange rates. We, of course, have an established theory of current account management and the role of exchange rate as a variable in that. What we now need is a theory that encompasses both current and capital accounts and one that gives a better understanding of what capital controls work and in what situations. That is the intellectual challenge. What is the practical challenge? The practical challenge is that once we have such a theory, we need to reach a shared understanding on two specific aspects: first, to what extent are advanced economies responsible for the cross border spill over impact of their domestic policies, and second, what is the framework of rules that should govern currency interventions in the face of volatile capital flows.

Protectionism

18. In the post-crisis world, there may not actually be "deglobalization" but the earlier orthodoxy that globalization is an unmixed blessing is being increasingly challenged. The rationale behind globalization was, and hopefully is, that even as advanced countries may see some 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 efforts of several countries around the world to resist currency appreciation are a manifestation of protectionist pressures.

19. There is concern in some quarters that while open protectionism has been resisted relatively well during the current crisis, opaque protectionism has been on the rise. Opaque protectionism takes the form of resorting to measures such as anti-dumping actions, safeguards, preferential treatment of domestic firms in bailout packages and discriminatory procurement practices. Experience shows that countries resort to restrictive trade practices in areas not covered by multilateral rules or by exploiting the lack of specificity in certain rules. To strengthen multilateral trade discipline, the need for a quick conclusion of the Doha Round can hardly be overemphasized. In a world with growing worries about the debt creating stimulus packages, a Doha Round agreement should be welcomed as a non-debt creating stimulus to the global economy.

International monetary system

20. The global crisis has revived the familiar concerns about the robustness of the international monetary system. The system we now have is that the US dollar is the world's reserve currency by virtue of the dominant size of the US economy, its share in global trade, the preponderant use of dollar in foreign trade and foreign exchange transactions and a host of other intangible factors. The US has met the obligation of an issuer of reserve currency by running fiscal and external deficits while enjoying the comfort of not having to make the necessary adjustment to bridge the deficits. Such persistent deficits of a dominant economy can potentially create imbalances at the global level as indeed happened in the build up to the crisis. While the US took care of the supply side of the reserves, the demand side impetus comes from several factors including the accumulation of reserve assets by EMEs as a measure of self-insurance against external shocks.

21. The problem with the world having only a single reserve currency came to the fore during the crisis as many countries faced dollar liquidity problems as a consequence of swift

deleveraging by foreign creditors and foreign investors. Paradoxically, even as the US economy was in a downturn, the dollar strengthened as a result of flight to safety.

22. Based on the experience of the crisis, several reform proposals have been put forward to address the problems arising from a single reserve currency. One is to have a menu of alternative reserve currencies. But this cannot happen by fiat. An alternative currency or currencies will take root as reserve currency/currencies only if those currencies are fully convertible and acquire a dominant share in world trade. A second option is to develop the SDR as a reserve currency. This does not seem to be a feasible option. For the SDR to be a genuine reserve currency, it has to fulfil several conditions: the SDR has to be accepted as a liability of the IMF, has to be automatically acceptable as a medium of payment in cross-border transactions, be freely tradeable and its price has to be determined by forces of demand and supply. A third suggested solution aims at reducing the need for self-insurance and thereby the dependence on a reserve currency by supporting a multilateral option of a prearranged line of credit that can be easily and quickly accessed. Such a multilateral option is necessary as a complement to self-insurance but it cannot be a substitute; some measure of self-insurance will continue to be the first line of defence.

23. None of the above solutions as you can see fully addresses the problems arising from a single global reserve currency. What this underscores is that at the global level we need to explore these and other options for protecting ourselves from the vulnerabilities that we confront as a consequence of a single reserve currency.

Governance of Bretton Woods institutions

24. The global crisis has underscored the importance of reforming the governance structures of Bretton Woods institutions – the IMF and the World Bank, so as to give representation to EMEs commensurate with their growing share in the global economy. These reforms are central to the legitimacy and effectiveness of these global institutions. There has been significant progress in respect of World Bank capital and voice reforms. Quota reform in the IMF is also expected to be completed soon. Countries which have not been traditional creditors, including India, have entered into sizeable credit arrangements with the Fund. This strengthens the case for quota shifts in their favour as a group, and in particular to dynamic EMDCs, to better reflect current global economic realities. These shifts need to be followed up by continuing the dynamic process aimed at enhancing the voice and representation of the poorest through a comprehensive review of the quota formula by July 2013. Here the need for cooperation among countries will be crucial.

Financial sector reforms

25. In September 2010, the Basel Committee on Banking Supervision (BCBS) put out a comprehensive paper indicating the broad agreement reached on the Basel III proposals. Broadly, these reforms will require banks to hold more and better quality capital and to carry more liquid assets, will limit their leverage and mandate them to build up capital buffers in good times that can be drawn down in periods of stress. The Basel III process is not yet complete. Some aspects of Basel III, such as common equity and tier I capital have been firmed up; others such as the new global liquidity standards and the leverage ratio have yet to be precisely specified. This will be done after a further assessment of the reasonableness of these measures and their impact on banks' balance sheets as well as the national economies. Though this would allow time for further calibration and refinement, it could on the other hand contribute to regulatory uncertainty. Moreover, there are several issues such as capital conservation buffer and countercyclical buffer which are fraught with severe definitional and implementation complexities and challenges.

26. Another crisis driven initiative has been to expand the erstwhile Financial Stability Forum into a Financial Stability Board (FSB) by giving representation to EMEs. The FSB has

been working on a number of initiatives including managing the moral hazard associated with systemically important financial institutions (SIFIs) through more stringent regulatory and supervisory norms, principles to guide compensation of bank managements, a single set of accounting standards and regulation of OTC derivatives, credit rating agencies and hedge funds. There are also several areas where substantial work needs to be done including in improving resolution regimes for cross-border banks and systemically important nonbank financial companies, addressing the procyclicality of the financial system, and macro-prudential surveillance. More work also needs to be done to extend the prudential norms on the lines of Basel III to the shadow financial system which lay at the heart of the recent financial crisis.

27. Within a common set of agreed-upon global standards, each jurisdiction may have to tailor some of its rules and supervisory practices to national conditions and preferences. The big challenge going forward will be to implement global standards with national differentiation but without giving any scope for the market to interpret national deviations from the standards as regulatory looseness.

Conclusion

28. Let me now summarize. In my remarks today, I covered what I believe are the frontier issues on the present day global agenda. In particular, I gave a picture of the multi-speed recovery and its implications for global adjustments in the short term and in the medium term. These adjustments need to cover three inter-related issues: redressing imbalances, exchange rate flexibility and management of capital flows. I emphasized how global cooperation is vital to reach a shared understanding on all the three issues. I then raised the possibility of a post crisis world which will be less welcoming of globalization and how this may trigger protectionist pressures. I moved on to emphasize how global cooperation is vital for reforming the international monetary system and the need for a comprehensive quota and representation reform in the Bretton Woods Institutions commensurate with the growing contribution of EMEs to global growth and global trade. Finally, I gave a brief status of the reforms in the financial sector, and how again restoring financial stability at the national and international levels requires global cooperation.

29. The common thread running through all the issues that I raised is the need for global cooperation in solving our most pressing problems of today. Given the strength and pace of globalization, purely national solutions are not only inadequate but may indeed be counterproductive.

30. I realise I have raised several issues without providing complete solutions. I believe that is the privilege of the inaugural speaker. The burden of identifying solutions and debating their pros and cons belongs to the conference proper.

31. The global crisis has taken a devastating toll on global growth and welfare. In their painstakingly researched book, "*This Time is Different: Eight Centuries of Financial Folly*", Kenneth Rogoff and Carmen Reinhart show how over eight hundred years, all financial crises can be traced to the same fundamental causes as if we learnt nothing from one crisis to the next. Each time, experts have chimed that "this time is different" claiming that the old rules do not apply and the new situation is dissimilar to the previous one. It will be too costly for the world not to heed this lesson. We should cooperate not only to firmly exit from the crisis, but also to ensure that in resolving this crisis, we do not sow the seeds of the next crisis.