Duvvuri Subbarao: Frontier issues on the global agenda – emerging economy perspective

Commemorative oration by Dr Duvvuri Subbarao, Governor of the Reserve Bank of India, at the 60th anniversary celebrations of the Central Bank of Sri Lanka, Colombo, 29 March, 2011.

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First of all, my thanks to the Central Bank of Sri Lanka (CBSL) and to Governor Cabraal for inviting me to deliver this commemorative oration as part of CBSL's Diamond Jubilee celebrations. I gather that a number of distinguished people have given orations as part of this anniversary series. I am indeed honoured to add my name to that very select list. My compliments to the management and staff of CBSL on this happy and historic occasion.

As institutions, central banks go back several centuries. The first central bank, the Riksbank in Sweden, was established in 1668, nearly 350 years ago. The Bank of England came shortly thereafter in 1694. By the turn of the century in 1900, there were only 18 central banks. Today, there are around 180 central banks, a tenfold increase in the last one hundred years.

In relative terms, both the Reserve Bank of India (RBI) and the Central Bank of Sri Lanka (CBSL) are young institutions. RBI was established in 1935, and we celebrated our Platinum Jubilee last year. Apart from relative youth, there are several other similarities between our two institutions. Both of us have a wider mandate than is typical of central banks. In addition to maintaining price stability and macroeconomic stability, we both have responsibilities for currency management, debt management and external sector management. More importantly, we also have an obligation to calibrate our policies to promote the socio-economic development of our peoples. And in the wake of the crisis, we face the common challenge of managing our policies, particularly preserving financial stability, in the face of globalization.

India and Sri Lanka are not just geographic neighbours; we have deep social, cultural and economic links that go back several centuries. And as we navigate an increasingly complex world, we face a number of similar opportunities and challenges. We are both fast growing emerging economies; we aspire to raise our growth rates to double digits, and want to efficiently translate that rapid growth into poverty reduction. We also have to manage our "inclusive growth" strategies in the face of globalization.

Experience shows that globalization offers incredible opportunities but also poses immense challenges. If the years before the global financial crisis – the period of the so called "Great Moderation" – demonstrated the benefits of globalization, the devastating toll of the crisis showed its costs. As emerging market economies (EMEs), we cannot withdraw from globalization. That is neither feasible nor advisable. We have to confront globalization head on, but manage it in such a way that we exploit the opportunities and mitigate its costs. Surely, we have our concerns about the forces of globalization and how they might impact us. Many of these issues are on the global agenda that the G-20 is deliberating upon.

G-20

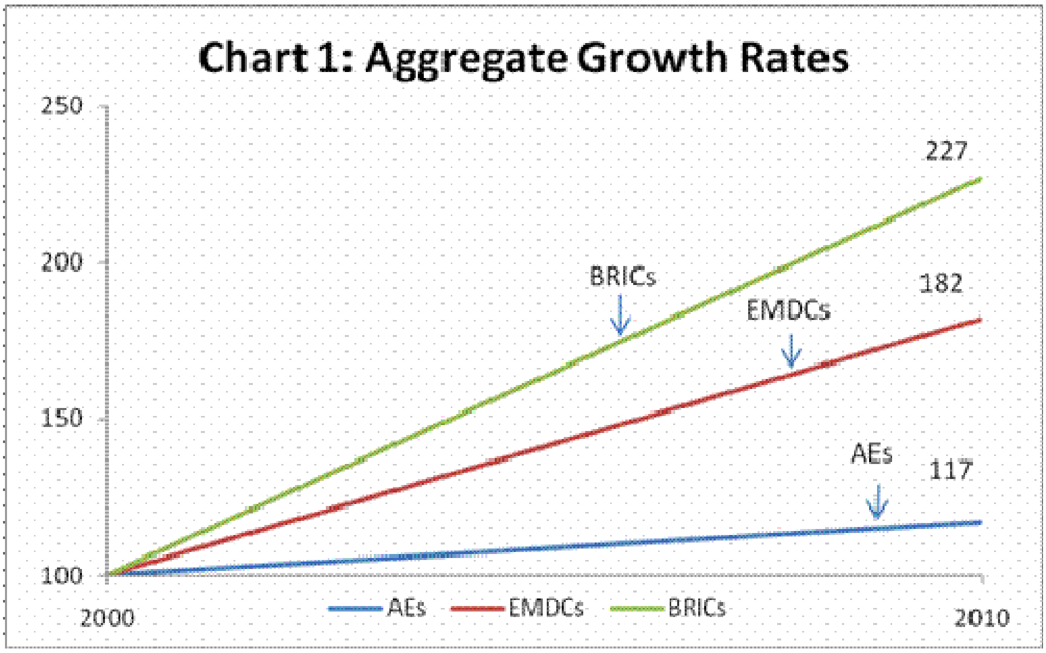
I attended a meeting of the G-20 Finance Ministers and Central Bank Governors in Paris in mid-February 2011. Apart from the specific issues on the agenda, what impresses me about the G-20 forum is its group dynamics driven by two underlying convictions. First, that global problems cannot be solved without global cooperation and that uncoordinated responses will lead to worse outcomes for everyone; and second, that solutions to global problems are sustainable only if they reflect also the EME perspective. I thought the way I can best add value to this series of orations is to focus my remarks on the EME perspective on issues on the global agenda.

Emerging market economies in the global context

Fifty years from now, when historians look for the defining features of the first decade of the 21st century, they will probably mark the rise of world-wide terrorism, the deepening of the internet culture and the devastating global financial crisis. Whether the emergence of EMEs as a group will rank *pari passu* with those others will depend on what EMEs achieved in the last decade, but importantly also on how they consolidate those gains in this decade and beyond.

Before I go on to specific issues, let me make a brief comment on EMEs in the global context. The shift in the global balance of power in favour of EMEs is by now a familiar story. Some broad trends will show what a remarkable shift this has been. Setting GDP at 100 in the base year of 2000, the following chart shows the aggregate growth in the decade 2000-10 (***Chart 1***)[1]. Against the aggregate growth of 17 per cent of advanced economies, emerging market and developing countries (EMDCs) grew by 82 per cent and BRICs (Brazil, Russia, India, China) by a whopping 127 per cent.

When we look at shares in global GDP, the growing dynamism of EMEs becomes even more persuasive. The share of advanced economies in the global GDP dropped from 80 per cent in 2000 to 67 per cent in 2010 with a mirror increase in the share of EMDCs (***Chart 2***). Quite expectedly the share of BRICs increased more impressively from 8 per cent to 17 per cent[2].

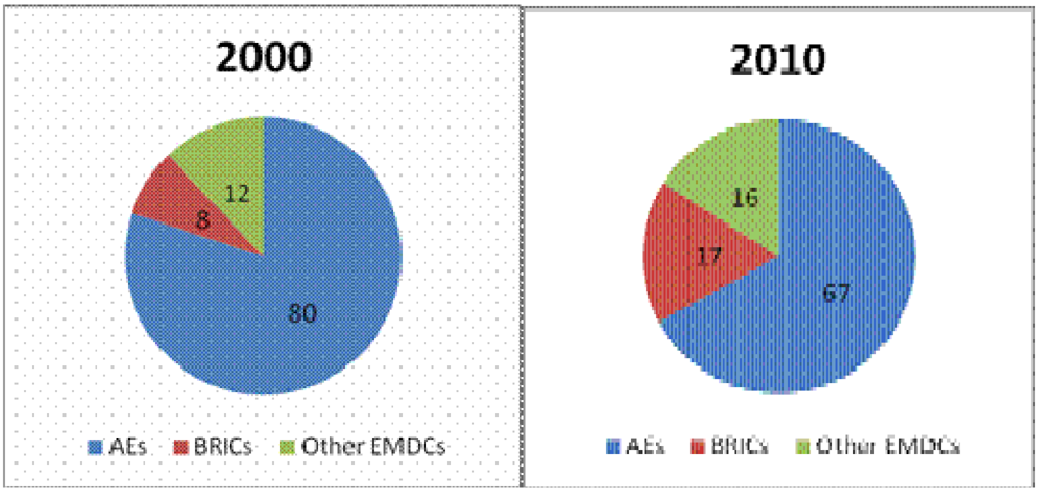


1 Disaggregated numbers are in Annex Table - 1.

2 Disaggregated numbers are at Annex Table - 2.

Chart 2: Share of Global GDP (at current US$ prices)

(Percentage)



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. The recovery is all the more remarkable because global income, trade and industrial production fell more sharply in the first twelve months of this crisis than they did in the first twelve months of the Great Depression. In its latest World Economic Outlook (WEO – January 2011), the IMF estimated global growth for 2010 of 5.0 per cent; this marks a surprising upward revision from its earlier projection of 4.8 per cent made in October 2010. EMEs, contributing nearly half of this growth, have clearly been the engine of this recovery. EMEs have also been the motive force behind the estimated expansion of world trade at 12 per cent in 2010, an impressive reversal from shrinkage of 11 per cent in 2009.

Two FAQs

This post-crisis scenario, marked by the faster recovery of EMEs, throws up two frequently asked questions relating to EMEs in the global context. The first is whether EMEs will be able to sustain global growth at near pre-crisis levels 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 to former levels will be unrealistic. Note that EMDCs 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.

The second question about EMEs in the global context relates to decoupling. The decoupling hypothesis held that even if advanced economies went into a downturn, EMEs would not be affected because of their improved macroeconomic management, robust external reserves and resilient financial sectors. The crisis failed to validate the decoupling hypothesis as all EMEs were affected, admittedly to different extents. What the crisis, in fact, reinforced is that the economic prospects of advanced economies and EMEs are interlinked through trade, finance and confidence channels.

Even as the decoupling hypothesis gained intellectual credence in the pre-crisis years, it was never very persuasive in the face of globalization. In fact, 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 that 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, more effective macroeconomic management and growing intra-EME trade. But over an entire cycle, the economic prospects of EMEs remain firmly coupled with those of advanced economies.

In an increasingly globalizing world, advanced economies and EMEs are dependent on each other, and going forward, both have big challenges in terms of sustaining growth, containing inflation and reducing unemployment. By far the biggest challenge for EMEs will be to convert high growth into poverty reduction. Against that backdrop, let me proceed to look at some of the issues on the global agenda from the EME perspective.

Global rebalancing

The first issue I want to address from the EME perspective is global imbalances. No crisis as complex as the one we have gone through has a simple or a single cause. We now have a fairly good idea of the multiple causes of the crisis and almost everyone is agreed that one of the root causes of the crisis is the build up of global imbalances. 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 the root cause of the crisis, reducing imbalances is a necessary condition for restoring global financial stability.

The post-crisis debate on global imbalances has three interrelated facets. The first is the role of exchange rates in global rebalancing. The second relates to capital flows into EMEs raising the familiar challenge of managing the impossible trinity. And the third facet is the framework for the adjustment process. Let me turn to these one by one.

Role of exchange rates

First, on the role of exchange rates – a prime lever for redressal of external imbalances. Global 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. The question boils down to what can surplus countries do domestically to increase consumption and what can deficit countries do domestically to increase savings. The problem we have is that while the adjustment by deficit and surplus economies has to be symmetric, the incentives they face are asymmetric. 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.

Capital flows

That takes me to the second facet of global imbalances – 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 EMEs 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 disrupts the macroeconomic stability of EMEs.

That said, the multi-speed recovery around the world and the consequent differential exit from accommodative monetary policy have triggered speculative capital flows into EMEs. The most high profile problem thrown up by capital flows, in excess of a country's absorptive capacity, 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.

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. EMEs have been hit by hardened commodity prices through inflationary pressures, and in the case of net commodity importers, also through wider current account deficits.

EMEs have dealt with the problem of excess flows in diverse ways depending on their macroeconomic situation. This has broadly taken one of several forms: controlling capital at entry, taxing it on entry or intervention in the forex market. Such measures would have attracted criticism in the past as they went against the broad economic orthodoxy that market forces should not be resisted. The crisis has changed the terms of that debate. It is now broadly accepted that there could be circumstances in which capital controls can be a legitimate component of the policy response to surges in capital flows.

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. Our current theory of external sector management draws from an outdated regime of fixed exchange rates and limited capital flows when the task was largely limited to managing the current account of the balance of payments. What we now need is a theory that reflects the changed situation of flexible exchange rates and large and volatile capital flows. The intellectual challenge is to build such a theory that encompasses both current and capital accounts and one that gives a better understanding of what type of capital controls work and in what situations. 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 spillover 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.

G-20 framework for global growth

The third facet under global imbalances is happily not actually a problem but an approach to a solution. At the Pittsburgh Summit in 2009, the G-20 committed itself to a new "framework of strong, sustainable and balanced growth" as also on a "Mutual Assessment Process" (MAP) to determine the degree to which G-20 macro policy actions are "collectively consistent" when examined together. The framework and its assessment should ensure that individual actions of countries add up to a coherent path forward.

The framework essentially consists of identifying a few indicators and the guidelines against which these indicators for each of the countries will be assessed. At the Paris meeting of the G-20 in mid-February, there was an agreement on the broad indicators that will aid us to focus, through an integrated two-step process, on those persistently large imbalances which require policy action. It was also agreed to decide on the guidelines for assessing the indicators by the next meeting of the G-20 scheduled for April 2011.

The G-20 Mutual Assessment Process is a potentially promising mechanism to facilitate timely identification of disruptive imbalances and to ensure that preventive and corrective action is taken in time. Needless to say, global cooperation is vital for the success of MAP.

Global reserve currency

The global crisis has revived the familiar concerns about the robustness of the international monetary system, and in particular about the global reserve currency and the provision of liquidity in times of stress. 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 and the preponderant use of dollar in foreign trade and foreign exchange transactions. And as Barry Eichengreen tells us in his latest book on the story of the dollar[3] , the reserve currency status depends also on a host of intangible factors such as strategic and military relationships, laws, institutions and incumbency.

In line with the Triffin paradox, the US has met the obligation of an issuer of reserve currency by running fiscal and external deficits while enjoying the "exorbitant privilege" of not having to make the necessary adjustment to bridge the deficits. With no pressure to reduce the deficit, a dominant economy can potentially create imbalances at the global level as indeed happened in the build up to the crisis. An argument can be made that even in the context of a single reserve currency, global imbalances are not inevitable. The US could not have run persistent deficits had not the EMEs provided the demand side impetus by accumulating reserve assets either for trade advantage or as a measure of self-insurance against external shocks.

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.

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. To be a serious contender as an alternative, a currency has to fulfill some exacting criteria. It has to be fully convertible and its exchange rate should be determined by market fundamentals; it should acquire a significant share in world trade; the currency issuing country should have liquid, open and large financial markets and also the policy credibility to inspire the confidence of potential investors. In short, the exorbitant privilege of a reserve currency comes with an exorbitant responsibility.

A second solution to a single reserve currency is to develop the SDR as a reserve currency. This does not seem to be a feasible option. For the SDR to be an effective 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.

None of the above solutions 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

[3] Exorbitant Privilege: The Rise and Fall of the Dollar and the Future of the International Monetary System by Barry Eichengreen.

other options for protecting ourselves from the vulnerabilities that we confront as a consequence of a single reserve currency.

Protectionism

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.

Recent international developments mark an "ironic reversal" in the fears about globalization. Previously, it was the EMEs which feared that integration into the world economy would lead to welfare loss at home. Those fears have now given way to apprehensions in advanced economies that globalization means losing jobs to cheap labour abroad.

There is concern in some quarters that even as 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.

The most familiar form of protectionism is trade protectionism operationalized through tariffs and controls. There can be other forms of protectionism as well. Martin Wolf talks about what he calls "macroeconomic protectionism" which is an attempt by a country to shift inadequate aggregate demand on to its own output[4] The efforts of several countries around the world in recent times to resist currency appreciation is a manifestation of macroeconomic protectionism.

Another form of protectionism is "financial protectionism". What is financial protectionism? It is a situation where countries impose controls increasingly not on capital inflows but on capital outflows. In a recent op-ed piece in the Financial Times[5] , Richard Dobbs and Michael Spence argue that "the 30-year era of progressively cheaper capital is nearing an end. The global economy will soon have to cope with too little capital, not too much." Their thesis is that even as investment needs of EMEs, especially in infrastructure will grow, global savings will not rise in step because of several factors: ageing populations who will spend rather than save, increased expenditure on adapting to climate change and large economies like China rebalancing towards consumption rather than saving. This will make capital scarcer and raise long term interest rates for corporates and consumers. The question is, will the savings constraint be so large as to push countries into restricting capital outflows as a defence against rising interest rates at home? If yes, we will have to brace for financial protectionism in the years ahead.

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4 Financial Reform: An Emerging Market Perspective by Martin Wolf, at the Korea-FSB Conference on Financial Sector Reform, Republic of Korea, September 2–3, 2010.

5 "The Era of Cheap Capital Comes To a Close" by Richard Dobbs and Michael Spence, Financial Times, February 1, 2011.

The short point is that in the years ahead, the pressures for protectionism will mount and protectionism will also take new forms. Global welfare will be maximized when collectively we resist short-term pressures and put our long-term interest ahead of narrow short-term advantage.

Financial sector reforms

Received wisdom today is that financial deregulation shares the honours with global imbalances as being the twin villains of the recent crisis. It should not be surprising therefore that vigorous reforms in the financial sector are under way. The Basel III package finalized by the Basel Committee on Banking Supervision (BCBS) has since been endorsed by the G-20 at its Seoul Summit last November. Broadly, these reforms will require banks to hold more and better quality capital and to carry more liquid assets, limit their leverage and will mandate them to build up capital buffers in good times that can be drawn down in periods of stress.

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 non-bank financial companies, addressing the procyclicality of the financial system, and macro-prudential surveillance. We also need an approach for extending the prudential norms on the lines of Basel III to the shadow financial system which lay at the heart of the recent financial crisis.

The financial sector reform agenda is driven by the need to prevent the type of excesses in the financial sectors of the advanced economies that led to the crisis. Even so, EMEs too will have to fall in line and implement these reforms. Some of these reforms entailing higher capital and capital buffers will make the financial sector safer, but they come at a cost and pose implementation challenges. Let me expand on this a little.

Both the Bank for International Settlements (BIS) and the IIF have come out with some preliminary estimate of the macroeconomic impact of the Basel III package. The Basel Committee too is carrying out an extensive impact assessment study. EMEs will need to supplement that with their own self-assessments to more accurately determine the impact of the new norms on their financial and monetary systems. In all likelihood, EMEs will see the cost of credit going up at a time of growing credit demand arising from strong growth, structural transformation of the economy and financial deepening. The challenge for EMEs will be to balance the tension between implementing Basel III and keeping the cost of credit at an affordable level.

In terms of capital, banks in EMEs typically have higher capital ratios, and can be expected to comfortably meet the higher Basel III capital requirements. However, going forward, as credit expands and bank balance sheets grow, banks will find it necessary to raise further capital to conform to the Basel III requirement. Basel III also poses non-cost challenges. For example, operation of countercyclical buffers will need judgements to be made on the trajectory of the business cycle and on the identification of the inflexion point. Wrong judgements can entail huge costs in terms of foregone growth.

Many of these reforms on the anvil, including some elements of the Basel III package, allow for national differentiation. Should EMEs, keeping in view their national circumstances, decide to deviate from any global standard or norm, the challenge for them will be to communicate the rationale so that the market does not interpret the deviation as regulatory looseness.

Realizing that the reform measures designed for the financial systems of advanced economies will have different implications for EMEs, and that the challenges facing the EMEs may be entirely different from those facing the advanced economies, it was decided in the Seoul Summit of the G20 to work towards making the financial regulatory reforms better reflect the perspective of EMEs. The FSB, the IMF and the World Bank have been tasked with working on this agenda and report before the next Summit.

Conclusion

Let me now summarize. In my remarks today, I tried to give you an EME perspective on some of the issues on the global agenda. I started off by giving the big picture – the tectonic shift of global economic power towards emerging economies. EMEs, however, have not completely decoupled from the advanced economies; their economic prospects remain linked to the prospects of advanced economies. Even as multiple growth poles are a better safety-net for the world, we will be collectively better off if all segments of the world grow at a sustainable pace.

I then went on to the issue of global rebalancing which needs to address three inter-related issues: exchange rate flexibility, capital controls and an agreement on a framework for strong, sustainable and balanced growth. A prime source of vulnerabilities at the global level is the single reserve currency and I emphasized the need for global cooperation in finding a viable solution. An important issue on the global agenda is protectionism and I talked about why protectionist pressures may arise again and what new forms protectionism might take in the years ahead. Finally, I gave a brief status of the reforms in the financial sector and emphasized the need for further work to study the implication of these reforms for EMEs.

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. The crisis has taught us that no country can be an island and that economic and financial disruptions anywhere can 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. 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.

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.

Before I finish, I want to compliment CBSL for its significant contribution to the growth and development of Sri Lanka. Over the last 60 years, CBSL has acquired a great reputation for professionalism, integrity and sense of purpose. Moving forward, as central banks of emerging economies, both RBI and CBSL have their tasks cut out for them. We need to learn from the best in the world, but adapt our learning to the demands and culture of maturing emerging economies. We need to be constantly pushing the envelope, be at the frontiers of domain knowledge, oftentimes reinvent it, but all the time remain sensitive to the core concerns of an emerging economy. On behalf of the Reserve Bank of India, I want to wish Governor Cabraal and the management and staff of CBSL all the very best in their endeavour towards growth and development of Sri Lanka.

Annex Table - 1

Aggregate Growth Rate Over the 10 Year Period
(2000 - 2010)

	2000	2010
US	100	118
UK	100	115
Euro	100	112
Japan	100	107
Advanced Economies	100	117
Brazil	100	143
India	100	204
China	100	271
Russia	100	159
BRICs	100	227
EMDCs	100	182

Annex Table - 2

Share of Global GDP (at current US$ prices)

	2000	2010
Advanced economies	80	67
BRICs	8	17
EMDCs	20	33