

Duvvuri Subbarao: Gross financial flows, global imbalances, and crises

Welcome remarks by Dr Duvvuri Subbarao, Governor of the Reserve Bank of India, at the Twelfth L K Jha Memorial Lecture, Mumbai, 13 December 2011.

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1. Good evening. On behalf of the Reserve Bank of India, I have great pleasure in welcoming Prof. Maurice Obstfeld, who will shortly be delivering the L.K. Jha Memorial Lecture. Warm welcome also to Mrs. Jeniffer Obstfeld. I also have pleasure in acknowledging the presence here of members of the family of late Dr. L.K. Jha – Smt. Dipika Maharaj Singh, Smt. Sharika Glover and Master Kiran Glover. Your presence here means a lot to us. Thank you very much. Of course, a warm welcome to all our distinguished invitees who have made time to be here for this lecture.

Dr. L.K. Jha

2. Dr. L.K. Jha was by far one of India's most distinguished civil servants. With a remarkable career as an economic administrator and several impressive accomplishments to his credit, he has been a role model for generations of civil servants. After graduating from the Banaras Hindu University, "LK", as he was popularly known, went on to study at Trinity College, Cambridge where he was a student of legendary economists such as A.C. Pigou, J.M. Keynes and D.H. Robertson. He joined the Indian Civil Service in 1936. After an early career in Bihar, he was seconded to Government of India in 1942 where he served in several important positions, and ended up in the pivotal job of Secretary to Prime Minister.

3. Dr. Jha was Governor of the Reserve Bank from July 1967 to May 1970, at a time when the economy was going through one of India's most challenging phases. The country was shaken by food security concerns, and initiatives to redress this resulted in the much celebrated "Green Revolution". The Reserve Bank, under Governor Jha, was an influential force in shaping these initiatives. The distress suffered by the poor because of the overall scarcity situation resulted in poverty reduction becoming the overarching consideration of all policy. The Reserve Bank, under Dr. Jha's stewardship, contributed to designing and implementing many of these policies.

4. After his tenure in the Reserve Bank, Dr. Jha served as India's Ambassador to the United States and as Governor of Jammu and Kashmir. He was also a member of the widely acclaimed Brandt Commission which made a persuasive case for North-South cooperation. That some of the issues raised in the Brandt Commission are relevant even today is a testimonial to the foresight and wisdom of the Commission's members such as Dr. Jha.

5. This lecture series in his name honours Dr. Jha's outstanding service to the nation and his leadership of the Reserve Bank during a very critical period. So far, there have been 11 lectures. The last one was given by Prof. John Taylor in February 2010, two years ago, on "Lessons from the Financial Crisis for Monetary Policy in Emerging Markets". The lecture by Prof. Obstfeld this evening will be the 12th in the series.

The distinguished speaker – Prof. Maurice Obstfeld

6. It is perhaps presumptuous to introduce Prof. Maurice Obstfeld, who is a distinguished academic and internationally renowned economist. Regardless, I will indulge in the pleasure of doing so because the occasion demands it.

7. Prof. Obstfeld is currently the Class of 1958 Professor of Economics and Director of the Center for International and Development Economic Research (CIDER) at the University of California in Berkeley. He got his Doctorate from the Massachusetts Institute of

Technology (MIT) in 1979 under the supervision of the legendary Professor Rudiger Dornbusch of the textbook fame. Thereafter, Prof. Obstfeld taught at Columbia, University of Pennsylvania and Harvard before moving to UC, Berkeley in 1989.

8. Publishing papers is part of plying the trade of being an academic. A few of them also write text books. But far fewer of them write text books that become standard teaching material cutting across university and national barriers. Prof. Obstfeld belongs to that select category. Many among the audience here must have learnt economics from his seminal textbook on *International Economics*, co-authored with Prof. Paul Krugman.

9. Economists have been categorized in several ways – classical and neo-classical, macro and micro, Keynesian and monetarist, free market and leftist. It is fashionable these days to categorize economists as salt water or fresh water to classify their academic persuasion which, curiously, seems to be correlated with whether their university is located inland or on the coast. Prof. Obstfeld has largely been in coastal schools, and it will be interesting to find out if his academic persuasion fits in with this salt water – fresh water dichotomy.

10. Prof. Obstfeld's earliest research was focused on portfolio models of exchange rate and capital flows, and the effects of sterilization policies, including foreign exchange intervention. Later, he turned to models of monetary and real international adjustment based on dynamic optimization, an approach that has since become standard in international economics. In the mid-1980s, Prof. Obstfeld began to pursue the insight that speculative attacks on exchange-rate regimes could be self-fulfilling. Subsequent developments, notably the Asian crisis of the late 90s, validated this theory.

11. Prof. Obstfeld will be speaking today on "Gross Financial Flows, Global Imbalances and Crises", unexceptionably a topic of great relevance in the current context.

Global imbalances need to be redressed for the sake of global stability

12. No crisis as complex as the one we are going through has a simple or a single cause. In popular perception, the collapse of Lehman Brothers in mid-September 2008 will remain marked as the trigger of the crisis. At one level that may well be true. Indeed, I can visualize future text books in finance dividing the world into "before Lehman" and "after Lehman". But if we probe deeper, we will learn that at the heart of the crisis were two root causes – the build up of global imbalances and developments in the financial markets over the last two decades. And received wisdom today is that these two root causes are interconnected, and that financial market developments were in a sense driven by the global imbalances.

13. Global macro imbalances got built up because of the large savings and current account surpluses in China and much of Asia in the wake of the Asian Crisis in the 1990s. These were mirrored by large increases in leveraged consumption and current account deficits in the US. In short, Asia produced and America consumed.

14. And why did these imbalances get built up? The answer lies in globalization – globalization of trade, of labour and of finance. The world witnessed a phenomenal expansion in global trade over the last three decades; global trade as a proportion of global GDP increased from 37 per cent in 1980 to 53 per cent in 2008, just before the crisis hit us.¹ Globalization of finance was even more prolific, especially over the last decade. For the world taken together, the ratio of foreign assets and foreign liabilities to GDP rose from 133 per cent in 1994 to over 300 per cent in 2008.²

¹ Calculations based on IMF Direction of Trade Statistics, June 2010.

² Calculations based on IMF Balance of Payments Year Book, 2010.

15. The impact of globalization of labour was by far more striking. Emerging Asia added nearly three billion to the world's pool of labour as it integrated with the rest of the world over the last two decades thus hugely improving its comparative advantage. Together, the three dimensions of globalization – trade, finance and labour – helped emerging Asia multiply by a factor its exports to the advanced economies. The result was large and persistent current account surpluses in the Asian economies and corresponding current account deficits in the importing advanced economies. These global imbalances combined with developments in the financial sector to brew the crisis to its explosive dimensions.

16. So, where do we go from here? The G-20 is now actively engaged in the challenging task of redressing structural imbalances in the global economy. At their Pittsburgh Summit in September 2009, the G-20 leaders agreed on a “Framework for Strong, Sustainable and Balanced Growth” and committed to a “Mutual Assessment Process” (MAP) which is a peer review of each country's progress towards meeting the shared objectives underlying the framework. Recognizing that global imbalances, which had narrowed during the crisis, started widening again in the exit phase, the G-20 resolved that promoting external sustainability should be the focus of the next stage of the MAP and entrusted this task to a Framework Working Group (FWG).

17. India is privileged in co-chairing, together with Canada, the Framework Working Group for managing the task of developing the indicative guidelines for assessing and addressing persistent global imbalances. The success of this initiative is critical for redressing the problem of global imbalances.

18. In moving forward on finding a sustainable solution to global imbalances, we will be guided, individually at the country level and collectively at the G-20 level, by insights from academic research. It is in this context that work of insightful economists like Prof. Obstfeld will be important. Ladies and gentlemen, please join me in welcoming Prof. Maurice Obstfeld to deliver the 12th L.K. Jha Memorial Lecture.