

Suman Bery: Managing the cycle

Suman Bery / New Delhi July 08, 2008, 0:24 IST

How should India handle the global business cycle.

The current market turmoil in the world's main financial centres is without precedent in the postwar period. With a significant risk of recession in the United States, compounded by sharply rising inflation in many countries, fears are building that the global economy might be at some kind of tipping point."

It is with these chilling words that the latest (2008) Annual Report of the Bank for International Settlements (BIS), based in Basel, Switzerland, begins its concluding chapter, which is tellingly titled "The Difficult Challenge of Damage Control".

[Ads by Google](#)

Financial Market

Free Trial to Emerging Markets
Analysis & Forecasts Online
www.businessmonitor.com/Financial

The BIS was initially a club for central bankers from the rich countries, particularly the smaller European countries now largely absorbed by the European Central Bank. It has played an important role in shaping the international conventions that govern the activities of commercial banks that engage in international activity. In more recent times it has succeeded in enlisting the participation of the major emerging markets, including India, in its deliberations. This participation occurs via direct central bank participation (in our case the Reserve Bank of India, the RBI), rather than through the Ministries of Finance, which manage the relationship with the Bretton Woods institutions.

BIS Annual Reports are prized by connoisseurs for the quality of their analysis. The most recent BIS Annual Report accordingly provides a useful point of reference to assess how India has handled the extraordinary developments in global financial markets over the last four years (as it happens, roughly coincident with the life of the UPA government) and, more importantly, what is the right way for us to navigate the treacherous waters represented by the global economy at this time.

Such an effort is greatly facilitated by the inclusion of a separate chapter in the report (Chapter III), which deals explicitly with the emerging market economies (EMEs). This chapter helps us to isolate those aspects of the Indian experience and response which are similar to the other EMEs, and others where our response has been perhaps more atypical.

Our starting point must be the realisation, amply and forcefully documented in the report, that the EMEs were not marginal to the genesis of this crisis; they were central. This was so in three interrelated ways.

First, as a group, they were major beneficiaries of the "fat years" when cheap global credit, coupled with reserve capacity in both labour and commodity markets allowed the global economy to expand at record rates without provoking inflation.

While one might quibble with a definition of "emerging market economies" which includes a country as rich as Singapore, Table II.1 in the report shows that in the three years 2005-07 the emerging markets contributed fully 65 per cent to the growth of global demand measured at purchasing power parity (PPP) exchange rates. Even more remarkably, as residential investment began to slip in the rich countries (particularly the United States), in 2007 the emerging markets collectively represented 86 per cent of the growth in fixed capital formation (fixed investment) in the global economy.

While the report does not give a country-level breakdown, the sharp rise in the Indian investment rate in the last three years was surely a substantial contributor to the overall EME performance. A reassuring feature of the BIS report is that it does not yet see clear signs of this boom coming to an end.

Second, foreign exchange intervention by emerging market central banks, notably the Chinese, but also the Indian (and others) played an important role in the generalised credit expansion that preceded the current crisis.

This expansion was facilitated by unusually low "policy rates" in the advanced markets. These low interest rates, coupled with fast growth in the emerging markets ought to have been reflected in a generalised appreciation of the currencies of the emerging markets (against those of the advanced countries, particularly the US dollar).

Instead, to quote the report, "in many emerging economies, upward pressure on the currency was met over an extended period by an equivalent easing of monetary policy and massive foreign exchange intervention. The former is likely to have contributed to higher asset prices and increased spending in the emerging markets. The latter, via the investment of official foreign exchange reserves, is likely to have further eased financial conditions in the advanced industrial countries. In this way, the monetary stimulus to credit growth became increasingly global" .

Yet, despite these efforts some of this real appreciation did in fact occur, with inflation tending to be higher in emerging markets with rapid credit growth, and where appreciation in the nominal effective exchange rate was prevented. This is a reasonable description of the Indian policy response.

Third, and clearly linked to the first two, has been the sheer scale of capital movements across the borders of the emerging markets. The report looks both at net and gross cross border flows from private sources in recent years. These have so far shown little sign of diminishing, at least as of the end of 2007. While the figure for net capital inflows into emerging Asia is a manageable 3.5 per cent of GDP, gross private inflows were as large as 15 per cent of GDP; gross private outflows were almost as large. These numbers are no doubt heavily influenced by the presence of China and Singapore, and by the classification of state-influenced Chinese entities (commercial banks and sovereign wealth funds) as private sector.

What then of the future? Rightly or wrongly, India is clearly seen as one of the more vulnerable emerging markets, given the structure of its balance of payments (large trade deficit; heavy reliance on portfolio capital); its high public debt and weak fiscal position (in aggregate and in the quality of public expenditure) and in the stage of the political cycle in which it finds itself. Since portfolio flows seem likely to be muted for at least some time, and as the balance of payments is weakening on both current and capital accounts, there should be less hesitation in raising policy interest rates than in the past. Had there been more forceful fiscal adjustment in the good times, then there might have been a case for some easing at this time. But given the recent record, to recommend this would be irresponsible. The only way out is a burst of deregulation which maintains private investment buoyancy despite a deteriorating international environment.

The author is Director-General, NCAER, New Delhi. The views expressed here are personal.

<http://www.bis.org/publ/arpdf/ar2008e.htm>

Chapter I, "Introduction: The Unsustainable has run its course" p.8