

India in the G-20: What Should Matter Most?

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To what degree does the work programme and the initial decisions mandated by the G-20 address the issues that are of concern to the major emerging markets, and what cues should the latter group derive from the deliberations thus far? The heated discussion at the G-20 on a coordinated fiscal stimulus has crowded out a much more difficult and important debate on the issue of global imbalances and mechanisms to intermediate these. Much of the current work emerging out of the G-20 remains oriented to the political and economic predicament of the advanced economies.

For those of us who are financial sector groupies, these are indeed stirring times. Quite apart from each day's headlines, volumes of exegesis are being produced by the good and the great in the financial sector, nationally and internationally.

Over the past month we have enjoyed, inter alia, the Turner Review from the Financial Services Authority of the UK; the multi-volume report of our own, indigent Committee on Financial Sector Assessment; and the communiqué emanating from the recent Summit of the G-20 Leaders in London on 2 April, with associated more specialised annexes dealing with financial regulation and reform of the architecture for governance of the international economy.

While I make no claim to have studied each of these documents in deep detail, collectively they provide a useful framework for reflecting on international finance, domestic finance, the links between the two, and India's interests in any new order that emerges from the rubble of the old.

A useful starting point is the succinct diagnosis of the sources of the present crisis provided in the report of one of the Working Groups set up by the Leaders in Washington last November, to prepare for the more recent Leaders' meeting. This was the Working Group 1 on "Enhancing Sound Regulation and Strengthening Transparency", co-chaired by Canada and India.

The report (available on the G-20 web site) notes,

The turmoil which began to unfold during the Summer of 2007 was, in part, a consequence of an extended period of low real interest rates around the world, supported by an expansionary monetary policy, large current account imbalances, robust global growth and limited volatility in economic conditions. This benign environment caused

investors to extend their search for yield further out on the credit quality curve, leading to overly optimistic assessments and lack of due diligence in assessing credit risk.

There are several aspects of this formulation that are noteworthy. Sensibly, it merely notes the presence of unusually low interest rates, and of global imbalances, without taking a view on the underlying causes of these imbalances. As such it avoids being drawn into the controversy between the two polar views on the sources of these unusually low global interest rates which were an important part of the story that was to follow, and that we are now seeing played out in all its gory finality.

Fed versus European Views

These competing explanations include what I might call the "Federal Reserve" view, first articulated by Ben Bernanke when he was a governor of the US Federal Reserve under Alan Greenspan, that low real interest rates in international financial markets reflected a "savings glut" in the global economy, largely associated with the collapse of investment demand (and undiminished, indeed rising, saving supply) following the East Asian crisis of 1997.

By contrast, the "European" view (also, I believe, substantially shared by our own monetary officials as well as those of China, and also occasionally articulated in the reports of the Bank for International Settlements in Basle) is that excessively loose US monetary policy, and an ideological predisposition against acting pre-emptively to address asset-price bubbles, coupled with ineffective and fragmented regulation were primary factors in driving both low real interest rates, and in generating the global imbalances, both of which were proximate causes of the current debacle.

Two further implications of the above statement are worth highlighting. First, in contrast to much of the hand-wringing that has been the norm since the storm broke, it is honest in acknowledging that the middle years of the present decade were excellent for growth, at least in the developing world. In the

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main this was fairly high quality growth, at least on the supply side: rising productivity, rising investment rates, relatively low inflation. While the episode may have come to a somewhat sticky end, the aim of global policy should be to try and restore the fundamental elements that allowed such broad-based growth to bless the present generation of rising developing countries, in the way that the growth of the 1960s launched the countries of southern Europe and east Asia. In other words, there is an urgent need in addressing the considerable weaknesses that have undoubtedly been revealed, not to throw the baby out with the bath water.

Turning more specifically to India, a second implication is that the transmission of low global interest rates into the domestic economy was relatively limited, for several reasons. There are many different ways of assessing and measuring real interest rates, both anticipated and ex post, and it is certainly the case that the abundance of global liquidity permitted an easing in Indian *nominal* policy interest rates early in the cycle. It is also true that creditworthy domestic borrowers with access to international finance also benefited from low international nominal rates and abundant liquidity, reflecting the narrowing of credit spreads. Here, one should take a full cycle, hedged cost approach to measure the true cost of these international resources.

These positives are, however, offset by the degree of structural segmentation of the domestic market, as between prime corporate, smaller bank borrowers and the large unbanked sector. Of these, at best it was the first group who benefited from benign global conditions. These structural factors were reinforced by the efforts of the Reserve Bank of India to conduct an independent monetary policy via sterilised intervention of capital inflows. So the narrative of low interest rates presented above is more relevant to countries with open capital accounts and floating exchange rates, mainly in the advanced world, and less relevant to the larger emerging markets of India, China and Brazil, where the influences were largely via the equity markets rather than the debt markets.

Concerns of Emerging Economies

Looking ahead, to what degree does the work programme and the initial decisions mandated by the G-20 address the issues that are of concern to the major emerging markets, and what cues should the latter group derive from the deliberations thus far? My own view on this is that the discussion on coordinated stimulus has crowded out a much more difficult and important debate that, so far, has been inconclusive on the issue of global imbalances and mechanisms to intermediate these. A globally integrated world ought to be able to do a better job in channelling savings from one set of surplus countries to another set of deficit countries. Yet, as the continuing acrimony surrounding sovereign wealth funds indicates, this apparently innocent objective raises the most powerful of sentiments even in previously robust free-marketeers such as Australia and the us. It will be interesting to see if previously liberal voices such as the United Kingdom keep their faith in the present charged environment.

Second, the attention being given to strengthening the IMF, particularly by the most recent Leaders summit, seems to me overstated, at least from an Indian perspective. Since few Asian borrowers are likely to access IMF resources, cynics have had a field day insinuating that the expansion of IMF resources is a thinly disguised bailout of European banks on their eastern Europe portfolio, much as American banks were the main beneficiaries of past IMF largesse in Latin America. I am not quite so pessimistic, since I believe all developing countries would gain were the Fund's style and resources become such as to encourage "no-fault" borrowing, more or less as a matter of right, and thereby reduce the need for expensive self-insurance through reserve accumulation.

By the same token, I am surprised that not more attention is being paid to sorting out the constraints on lending by the multilateral development banks. Led by the model of the World Bank, these banks were a marvellously creative device for channelling funds from the capital markets to the cause of development finance, particularly in infrastructure. (More

creative than anything so far to have come out of the G-20, one may add.)

Yet, over time, the accretion of constraints of all kinds on the approval and utilisation of these funds (the so-called safeguard policies) and the rising influence of the NGO lobbies, not to mention staff constraints in the World Bank have conspired to keep the volume of lending much below need. As India is one of the most interested countries, and stands to make a big contribution to global growth were its infrastructure programme to be unaffected, or even accelerated, by the current crisis, it should offer to take the lead in identifying those policies and practices which currently impede growth in lending to the productive sectors, and develop proposals that could lead to a doubling or quadrupling of funds actually spent (not just approved) on, say, infrastructure.

In sum, I would assert that much of the current work emerging out of the G-20 remains oriented to the political and economic predicament of their economies. There is no reason why this must remain so. There is also much hypocrisy in establishing elaborate early warning systems when the build-up of imbalances was widely noted and critiqued at the time, and when the decision to alter time-honoured distinctions between financial firms received full review in the us Congress. As against these fads, there is real work to be done on issues of concern to India and the other major emerging markets. India should now start pressing gently for some of these issues also to be examined.

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