View metadata, citation and similar papers at core.ac.uk

brought to you by CORE

provided by Research Papers in Economics

Global imbalances: the perspective of the Reserve Bank of India

DR DUVVURI SUBBARAO
Governor
Reserve Bank of India

The pre as well as post crisis discourse on global imbalances has largely focused on the zero-sum current account equation involving United States on the one side and the rest of the world (ROW) on the other. Most of the analysis has been from the perspective of the countries which are perceived to be integral part of the above equation. However, the implications of the imbalances went much beyond these few countries and had profound influence on the financial stability and monetary management in many countries. The huge cross border capital flows during the pre crisis period, arising from the liquidity glut in advanced economies and abetted by the expansion of the financial sector balance sheets, posed significant challenges for domestic policy makers. It is this peripheral perspective that this paper attempts to bring forth.

India is indeed a peripheral country as far as global imbalances are concerned as it did not contribute to either the origination or propagation of the imbalances. Its growth process is not dependent in any significant measure either on external demand or capital flows. It does not pursue a policy of achieving a particular level of current account deficit or surplus to support its growth strategy. Its exchange rate is essentially market determined and it does not pursue an explicit policy of reserve accumulation.

However, India did face the impact of global imbalances as a receptacle of global funds flow which were essentially volatile in nature. The paper articulates the policy imperatives that arose in this context and the design of policy framework that helped in addressing the challenges. The response was, and continues to be driven by a non-doctrinaire, pragmatic approach with the sole objective of maintaining broader macroeconomic and financial stability.

The paper concludes with a discussion on the potential risks to global financial stability on account of persisting global imbalances and the feasibility of post crisis efforts being pursued globally at various multinational fora to address these.

Persistent and growing global imbalances were generally seen as a threat to global economic and financial stability even before the subprime related pressures surfaced in 2007 and the debate on options to avoid a hard landing had already acquired centre stage in most international discussions. After the crisis, following sharp contraction in global trade and the loss of output and employment in advanced economies, the magnitude of the imbalances has moderated. The underlying factors that contributed to and sustained the imbalances, however, persist and going forward, the policy challenges from persistent imbalances are expected to accentuate. The post-crisis asymmetry in the pace of growth and stance of monetary policy between the advanced economies and the emerging market economies (EMEs), which may extend beyond 2011, will significantly influence global trade and capital flows. These have triggered concerns relating to protectionism, currency interventions and use of capital controls as potential risks to the global economy.

The pre as well as post-crisis discourse on global imbalances has largely focused on the zero-sum current account equation involving United States on the one side and the rest of the world (ROW) on the other. Most of the analysis has been from the perspective of the "core" group of countries which are perceived to be an integral part of the above equation. However, the implications of the imbalances were felt beyond these few countries, often having profound influence on the financial stability and monetary management of many countries, including India. Since most of the arguments and counterarguments on different dimensions of the problem of global imbalances are public knowledge, this paper will focus on two broad aspects. The first is the risks to financial stability in every country from persistent global imbalances. Since no single country can resolve global imbalances by solo action, globally coordinated systems would have to bear the responsibility for both containing the imbalances in a non-disruptive manner and also for providing safety nets to individual countries facing the adverse impact of the imbalances on their financial systems. The second aspect is the challenges that India would have to face while dealing with the ramifications of persistent imbalances even though India is peripheral to both the problem and its solution.

India's experience shows that a country can achieve and sustain high growth without adopting policies that contribute to global imbalances. A part of the global imbalances, driven by comparative cost advantages is, of course, a natural outcome of globalisation. But a large part of the imbalances is actually the result of national policies, which may be optimal for the country concerned, but sub-optimal for the global economy. I will conclude, therefore, by emphasising that a multilateral coordinated approach is the only option to deal with this global problem, and if the imbalances are allowed to continue as in the past, a main source of financial instability will remain unaddressed.

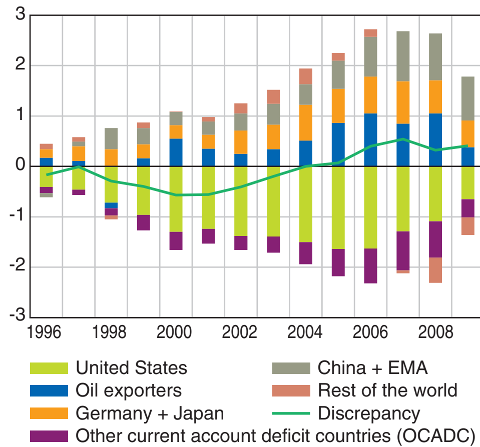
1| Why global imbalances must be seen as a major contributor to the global financial crisis?

Even though several alternative causative factors have been highlighted in the academic and policy debates while trying to unravel the genesis of the global crisis, I would specifically highlight the role of global imbalances, since crisis prevention mechanisms are generally being strengthened based on lessons from the crisis, but very little progress has been made in terms of effective policy coordination at the international level to contain the imbalances in future.

What is Global Imbalance? It is the large dispersion in the pattern of current account positions of countries, with some having large persistent deficits and others running persistent surpluses (Chart 1). This aggregate overview masks the true nature of the imbalance. In the years preceding the crisis, deficit and surplus countries had built up mutual and growing interdependence. In the deficit countries, particularly the United States, as domestic savings declined, they depended increasingly on capital flows for financing investment and consumption. The mono-reserve currency status of the dollar and its safe-haven appeal provided the United States with unhindered access to capital from the ROW. On the other hand, countries with current account surpluses also had domestic savings, and had to look for external avenues for investment of the surplus. They became dependent

Chart 1
Global imbalances

(current account positions as % of world GDP)



OCADC: Bulgaria, Croatia, Czech Republic, Estonia, Greece, Hungary, Ireland, Latvia, Lithuania, Poland, Portugal, Romania, Slovak Republic, Slovenia, Spain, Turkey and United Kingdom.

EMA: Hong Kong SAR, Indonesia, Korea, Malaysia, Philippines, Singapore, Taiwan Province of China and Thailand.

Source: IMF.

on deficit countries such as the United States both for generating the surpluses in the first place and for their investment. This mutual dependence bind served the interest of the national economies, at any rate in the short-term, but engendered imbalances at the global level which started threatening global monetary and financial stability.

2| How were the imbalances responsible for the global financial crisis?

Four specific factors explain this point. The first factor is the emergence of a global "saving glut", which exerted sustained downward pressures on global interest rates. Even when the United States raised its short-term rates, long-term rates did not change, giving rise to the famous "Greenspan Conundrum". With real interest rates remaining permanently depressed, there was a general "search for yield" in alternative financial instruments, which provided the impetus to the growth of innovative financial products in the United States, which later proved destructive. Second, several EMEs and oil exporting countries accumulated large foreign exchange reserves, which was largely a consequence of the growing imbalances, but also emanated partly from the preference of countries for stronger self-insurance following the experience of the Asian crisis of the mid-90s. Given the conservative investment norms for official reserves, reserves increasingly crowded-out private demand for high quality low-risk financial assets, besides also abetting the under-pricing of risk in the United States because of the market presumption that its large current account deficit (CAD) will be financed on a sustainable basis by rising foreign reserves of the rest of the world. As a result, risk appetite for financial products, whose risks were hard to understand, increased.

Third, persistent global imbalances, aided by the saving glut and the mono-reserve currency status of the dollar, fuelled the asset price bubble. The bubble, as it was building up, distorted incentives as reflected in the declining household saving and rising consumption in the United States, encouraged by the "wealth effect" of the asset prices and declining cost of debt. It would have been hardly feasible to sustain the levels of consumption and neglect savings without the global imbalances.

The fourth and final factor on the causation chain from global imbalances to the crisis is the absence of an effective alternative to the US dollar as the reserve currency; the United States running a current account deficit on a sustained basis became a necessary condition for the world to meet its demand for international liquidity. The confidence in the dollar led to deferment of the necessary macroeconomic adjustments in the United States and possibly also led to dilution of regulation and supervision standards that allowed its financial system to grow freely by masking vulnerabilities.

One of the effects of the persistent imbalances in the pre-crisis period was a significant expansion in the financial sector balance sheets in developed economies. The increasing financialisation of economies resulted in a self-fulfilling boom in financial products and instruments, some of which were clearly far riskier than they were perceived to be. From the financial stability perspective, it was this dominance of the financial sector which was critical in shaping the regulatory philosophy in the pre-crisis period and in the rapid transmission of the crisis across the global financial system.

3| Should imbalances be seen as a risk to financial stability in the future?

In the absence of effective multilateral efforts to redress the imbalances, the risks to global monetary and financial stability will persist. Current assessment suggests that the recent moderation in the magnitude of the imbalance is at best temporary, since the underlying drivers of imbalances will regain steam over time. Two new dimensions would impact the imbalances in the near-term. First, the OECD projects that output gaps in advanced economies will remain negative up to 2015. Given the robust recovery and strong growth outlook of EMEs, the monetary policy asymmetry between advanced economies and EMEs will likely not only continue but may even widen. While the growth imbalance will alter the current account positions of countries, the differentials in interest rates and earnings prospects may trigger surges in capital flows to EMEs, exerting upward pressure on their exchange rates and asset prices. Second, as projected by the IMF in its October 2010 WEO, due to lack of corresponding increase in absorptive capacity in EMEs, most of these inflows may end up adding to their foreign exchange reserves and then flow back to the safe haven dollar. We will then return to the pre-crisis pattern of capital flowing uphill. Save for the unlikely event of a sudden loss of faith in the US dollar, a hard landing or disruptive unwinding of the imbalances may not happen. But exchange rate and asset price uncertainties will persist.

The dynamics of public debt in major economies may, however, interfere with the process of redressing the imbalances. Pre-crisis, huge capital flows into developed economies and a general tendency for under-pricing of risks all around resulted in a benign perception of high public debt levels. Post crisis, however, fiscal health of sovereigns has become one of the key risks in global portfolio allocations. How the unwinding of large fiscal support is going to play out will be a critical determinant of the unwinding of imbalances. This risk is bound to impact the exchange rate readjustments as well.

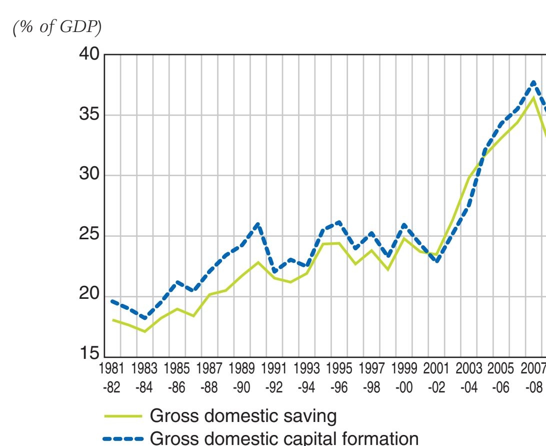
4| Global imbalances and India

India is a peripheral country as far as global imbalances are concerned as it did not contribute to either the generation of the imbalances or their propagation. Its growth process is not dependent in any significant measure either on external demand or capital flows; it does not pursue a policy of achieving a particular level of current account deficit or surplus to support its growth strategy; its exchange rate is essentially market determined and it does not pursue an explicit policy of reserve accumulation. This paper explains these points in greater detail to emphasize the point that India did not contribute to global imbalances, but it cannot escape its ramifications, and hence has a stake in the resolution of global imbalances on a sustainable basis.

- India's high domestic saving rate has coexisted with sustainable current account deficit, a key trend that differentiates India from other major countries that contributed to the global imbalances. In India, even though the saving rate has improved significantly in the last decade, the investment rate continued to exceed the saving rate, implying full absorption of domestic saving at home (Chart 2).[1] Excluding a short period of current account surpluses, India has generally witnessed current account deficits within a range of 3 per cent of GDP (Chart 3). Thus, domestic saving has been supplemented at the margin by

Chart 2
Saving and investment

(% of GDP)

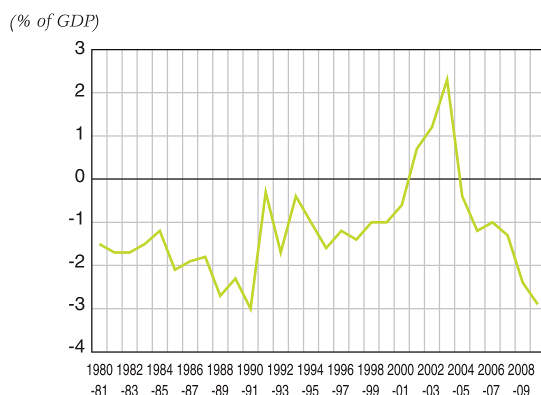


Source: Reserve Bank of India.

1 *As the financial year in India begins in April each yearly data (in Charts 2, 3 and 6) is overlapping two calendar years and Q1 (in Chart 7) represents April to June period*

Chart 3
Current account deficit

(% of GDP)



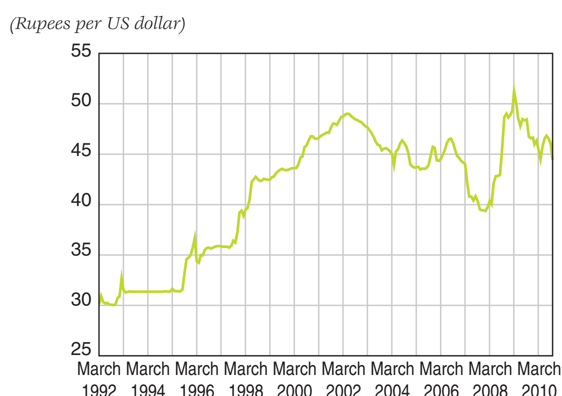
Source: Reserve Bank of India.

foreign capital to the extent of the financing needs of CAD. All in all, the investment and growth process of India has not been excessively dependent on either external demand or external capital.

- India has had a market driven flexible exchange rate regime since 1993. The exchange rate policy has not been guided by any specific goal relating to exports or the current account position in the balance of payments (Chart 4). The thrust of the exchange rate policy has been to contain undue volatility, particularly that arising from volatile capital flows, but such intervention is not conditioned by any targeted exchange rate. The two way movement of the exchange rate, and the absence of a policy on using exchange rate as an instrument to attain any goals relating to external balance position or domestic inflation vindicates India's position that its policies

Chart 4
Rupee/US dollar exchange rate

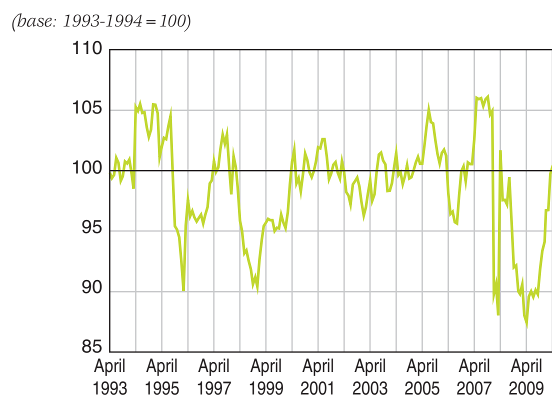
(Rupees per US dollar)



Source: Reserve Bank of India.

Chart 5
36 currency trade-based real effective exchange rate

(base: 1993-1994 = 100)



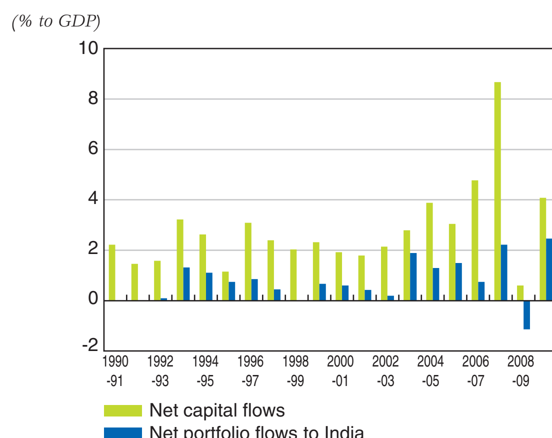
Source: Reserve Bank of India.

do not contribute to global imbalances. The absence of a sustained major undervaluation of the rupee is also evident from the behaviour of the real effective exchange rate (REER), which has exhibited a mean reverting pattern and generally remained around the base level in the medium-run (Chart 5).

- India has often experienced surges in capital flows (particularly during 2003-2008), a part of which financed the current account, and the balance led to build up of reserves. The pattern of capital flows to India, thus, is consistent with the expected downhill flow pattern from advanced economies to emerging and developing economies, unlike the uphill pattern that was evident for some of the other countries that contributed to the global imbalances. As could be seen from Chart 6, annual net capital flows to

Chart 6
Net capital flows and net porfolio flows

(% to GDP)



Source: Reserve Bank of India.

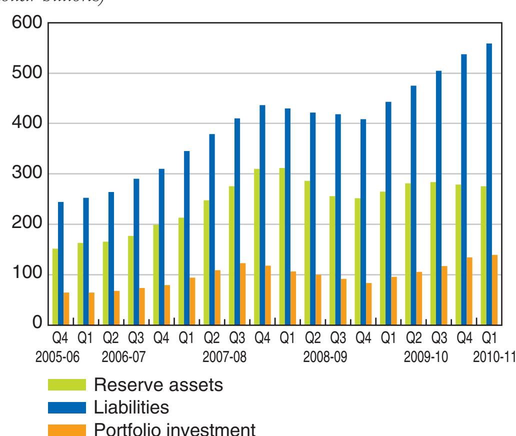
India have often exceeded the financing needs in the current account, and net inflows were as high as 10 per cent of GDP in 2007-2008, when the current account deficit was only 1.3 per cent of GDP. As a result, the remaining part of the inflows returned to the ROW through deployment of India's foreign exchange reserves in the international markets.

- India does not have a self-insurance policy, even though forex market interventions of the Reserve Bank and significant increase in forex reserves built up over the last one decade have often been highlighted by analysts as obvious examples of a strategy on self insurance. One needs to understand why these two indicators are not the only possible characterisation of a self-insurance policy.

The variations in India's foreign exchange reserves are an offshoot of its exchange rate policy, which is to intervene in the market only to smooth exchange rate volatility and prevent disruptions to macroeconomic stability. The "volatility centric approach" to exchange rate also stems from the source of volatility, which is capital flows. As could be seen from Chart 7, India's foreign exchange reserves had increased alongside increase in the stock of overall external liabilities as well as portfolio liabilities, and the latter have occasionally been highly volatile. To manage the episodic pattern of surges, reversals and sudden stops in such flows, given their sudden and damaging implications for the exchange rate and domestic liquidity conditions, intervention purchases/sales have been resorted to, which gets reflected in the country's foreign exchange reserves.

Chart 7
Reserve assets relative to total external liabilities and portfolio investment liabilities

(US dollar billions)



Source: Reserve Bank of India.

Past experience suggests that even while India's reserves got built up over the years owing to capital flows in excess of the financing needs in the current account, the same reserves at times had to be used to contain volatility in the event of capital reversals. Importantly, given India's persistent trade and current account deficits, its foreign exchange reserves comprise borrowed funds, which is qualitatively different from accumulating reserves through trade and current account surpluses. Foreign reserves have certainly helped India to face the adverse external sector shocks better, but they do not reflect the result of any specific policy adopted by India that could have contributed to global imbalances.

5| How has India managed the fallout of global imbalances?

For India, given its gradual opening to globalisation involving both trade and financial flows, managing the implications of global imbalances has been a constant policy challenge. The dimension of the challenge magnified significantly when these imbalances emerged as a major contributing factor to the global crisis. In the period leading to the crisis, India had to actively manage surges in capital flows triggered by excess global liquidity.

It is now well recognised that large capital flows in short bursts, beyond the absorptive capacity of an economy, impose significant costs. From the macroeconomic perspective, exchange rate overshooting becomes a real possibility, causing lasting damage to the real sector competitiveness and hence the current account balance. Such inflows can also militate against the monetary policy objectives during a domestic tightening phase and can impact the autonomy of monetary authorities to set domestic interest rates. There are also implications for financial stability in the form of induced risks of asset price bubbles, excessive foreign currency exposures and crowding out of domestic financial institutions on the lending side thereby increasing their risk appetite in search of returns, resulting in misallocation of capital. All these impose significant adjustment costs and complicate monetary and exchange rate management.

The policy approach in India to the issue of capital flows has evolved from addressing the singular variable of exchange rate to the broader objective of maintaining financial and macroeconomic stability. The salient elements of this framework are as under:

- an explicitly stated active capital account management framework, based on the policy stance of encouraging non-debt creating and long-term capital inflows and discouraging debt flows;

- avoiding the 'original sin' of excessive foreign currency borrowings by domestic entities, particularly the sovereign;

- prudential regulations to prevent excessive dollarisation of balance sheets of financial sector intermediaries, particularly banks; and

- significant liberalisation of permissible avenues for outward investments for domestic entities.

The above framework has till now obviated the need for sudden capital control measures, which could be perceived to have a longer term adverse impact. In any case, the objective of any capital control measures cannot be to protect a particular level of exchange rate or to control the aggregate flows but only to reduce the volatility impact of excessive short term flows.

6| Multilateral policy response to global imbalances

The IMF's multilateral consultation process on global imbalances, which was endorsed by the International Monetary and Financial Committee (IMFC) in 2006, suggests that global imbalances were clearly seen as a source of vulnerability even before the global crisis. Also what individual countries should do to contain the risks was more or less known. The actions that are being contemplated now by the G20 are not very different. Rebalancing will require deficit economies to save more and consume less while maintaining open markets and enhancing export competitiveness. They need to depend more on external demand for growth and their currencies have to undergo a real depreciation. The surplus economies will need to adopt the opposite stance, i.e., save less and spend more, and shift from external to domestic demand. They may also need to let their currencies appreciate. Thus, movement in currency is generally believed to be part of the solution.

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. In their Toronto Summit in July 2010, the G20 leaders agreed on a "Framework for strong, sustainable and balanced growth". At the heart of this Framework are strategies to be put in place by advanced and emerging economies to restore external balances and repair their financial sectors where need be. For reasons that are quite obvious, these national strategies have to be coordinated in content and in implementation. Any framework like this can be successful only in an atmosphere of trust and reciprocity. From the perspective of EMEs, the critical issue would be to have recourse to viable policy options to address the potentially disruptive impact of spurts in capital inflows as well as outflows. This would be particularly relevant for countries having a relatively more open capital account. In this regard, *ex ante* measures of managing capital flows would be as important as the *ex post* measures of dealing with the implications.

Increasingly, *ex ante* management of capital flows using price-based measures has come to be recognised as a legitimate tool of macroeconomic management with even agencies such as the IMF taking a more flexible view in this regard. The objective of such measures is to alter the structure of price incentives that market participants confront thereby inducing them to modify their behaviour. However, evidence from different countries on the effectiveness of the above measures is inconclusive. The limited studies that are available suggest that capital controls have a stronger effect on the composition of inflows than on their aggregate volume and do not materially impact the level of the real exchange rate. The main criticism against the above measures has been that, in practice, it may be difficult to implement them effectively. However, the bottom line is that there is a cost involved in any form of evasion which is precisely the limited objective of the measures –to throw sand in the wheels of capital flows.

Exchange rate appreciation is generally touted as the preferred *ex post* policy option in dealing with

inflows. The only caveat accepted post-crisis is that intervention may be justified only if there is major veering away of the currency from its fundamental value. The aftermath of the crisis has triggered a debate on the costs of building up reserves as a self-insurance, and the risks of continuing with a mono-reserve currency –the US dollar. While multilateral/regional/bilateral arrangements to enhance alternatives to foreign exchange reserves will be supported by most countries, the self insurance motive and national policies on forex reserves may need to continue. In evaluating the level of reserves and the quantum of self insurance of a country, however, it is important to distinguish between countries whose reserves are a consequence of current account surpluses and countries with current account deficit like India whose reserves are a result of capital inflows in excess of their economy's absorptive capacity. On the reserve currency debate, we need to explore all options for protecting ourselves from the vulnerabilities that we confront as a consequence of a single reserve currency.

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.

Since global imbalances clearly contributed to the financial crisis, they will remain a potential risk to global monetary and financial stability in the future, unless globally coordinated country-specific national policy measures are implemented to limit at least the policy induced part of the imbalances. At the same time, the global governance systems need to be able to provide the requisite comfort to member jurisdictions that their interests will not get compromised in times of crisis, something which was found lacking during the crisis.

Going forward, a critical counterfactual that needs to be answered is whether more effective regulation and supervision of the financial sector, both at the global as well as national levels, could have mitigated some of the adverse fallout of the global imbalances. After all, the financial sector emerged as the ultimate receptacle for the negative externalities arising out of the imbalances. Therefore at least part of the adverse fallout of imbalances could have been addressed through the propagation channel i.e. the financial sector. It is in this context that macroprudential national policy frameworks are significant.