India and the Global Economy

14

CHAPTER

The big story of the last decade for India has been its arrival on the global scene. The Indian economy had broken free of the low-growth trap from the early 1980s. By the mid-1990s, following the economic reforms of 1991-3, India began to appear as a player of some significance in the global economy. Then, following the East Asian crisis of the late 1990s, and from the first years of the first decade of the 21st century there was no looking back. India's exports began to climb, its foreign exchange reserves, which for decades had hovered around 5 billion dollars, rose exponentially after the economic reforms and in little more than a decade had risen to 300 billion dollars. Indian corporations that rarely ventured out of India were suddenly investing all over the world and even in some industrialized countries. When, in 2009, the Group of 20 (G-20) was raised to the level of a forum for leaders, India was a significant member of this global policy group.

14.2 The globalization of India has given rise to new opportunities but it has also brought with it new challenges and responsibilities. It means that the global economy can no longer be viewed from a spectator's standpoint. What happens there has large implications for India. Every time there is a major financial crisis anywhere in the world, there is need to take brace position. And, in turn, the rise and fall of India's growth rate has an impact on global growth and there is need for India to take this responsibility seriously. This chapter, a new addition to the Economic Survey, is a recognition of this fact. It examines the state of the global economy and India's position therein. It analyses the current global slowdown and eurozone crisis, what this means for India and the policy challenges that these international matters give rise to on domestic soil. The chapter also discusses G-20 imperatives and India's role as a constructive player in the evolving global order.

State of the Global Economy

14.3 The developments over the last year in major economies of the world have not been encouraging. There is an apprehension that the process of global economic recovery that began after the financial crisis of the 2008 is beginning to stall and the sovereign debt crisis in the eurozone area may persist for a while. There is an effort to build firewalls around these danger zones, but the world has little experience with this; so we need to be prepared for breaches in the walls. The US economy has shown some improvement but economic growth remains sluggish. The global economy is expected to grow by 3.3 per cent in 2012 compared to 3.8 per cent in 2011 as per the International Monetary Fund's (IMF) January 2012 update of the World Economic Outlook (WEO). Gross domestic product (GDP) growth in advanced economies declined to 1.6 per cent in 2011 compared to 3.2 per cent in 2010 and is expected to be even lower at 1.2 per cent in 2012. Growth in emerging

Table 14.1 : Growth of the GDP (%) (Y-o-y)

	World	Advanced economies	US	EU	UK	Eurozone	Germany	Japan	B	R	I*#	C*	S
2010	5.2	3.2	3.0	2.0	2.1	1.8	3.6	4.4	7.5	4.0	9.9	10.4	2.9
Q1			2.2	1.0	1.2	1.0	2.4	5.0	9.3	3.0	9.4	11.9	1.6
Q2			3.3	2.2	2.5	2.1	4.1	4.5	8.7	5.2	8.8	10.3	3.0
Q3			3.5	2.4	3.0	2.1	4.0	5.2	7.0	3.4	8.9	9.6	3.3
Q4			3.1	2.2	1.7	2.0	3.8	3.2	5.3	4.4	8.3	9.7	3.6
2011	3.8	1.6	1.8	1.6	0.9	1.5	3.0	-0.9	2.9	4.1	7.4	9.2	3.1
Q1			2.2	2.4	1.6	2.4	4.6	0.1	4.2	3.8	7.8	9.7	3.7
Q2			1.6	1.7	0.5	1.6	2.9	-1.7	3.3	3.5	7.7	9.5	3.3
Q3			1.5	1.4	0.4	1.3	2.6	-0.6	2.2	4.9	6.9	9.1	2.9
Q4			1.6	0.9	0.7	0.7	2.0	-1.0	na	na	6.1	8.9	na
2012 (P)	3.3	1.2	1.8	-0.1	0.6	-0.5	0.3	1.7	3.0	3.3	7.0	8.2	2.5

Source **: Organization for Economic Cooperation and Development (OECD) Principal Global indicators and IMF WEO.**

Notes **: P Projection from IMF World Economic outlook January 2012 update.**

na: not available. Growth rates may not necessarily correspond to country sources.

*** Country website. Y-o- y is year-on-year. EU is European Union. B,R,I,C,S stand for the separate countries of the BRICS grouping, i.e. Brazil, Russia, India, China, and South Africa. Q1, Q2, Q3, and Q4 stand for the first, second, third, and fourth quarters**

Aggregations for World and Advanced Economies use purchasing power parity weights.

 # India's GDP growth is in terms of factor cost whereas for other countries it is in terms of market prices.

economies slowed to 6.2 per cent in 2011 compared to 7.3 per cent in 2010 and is projected to be 5.4 per cent in 2012.The US economy seems to have revived somewhat and is projected to maintain its growth rate at 1.8 per cent for 2012. Even so, economic growth in the US remains sluggish despite extensive use of both fiscal and monetary policy tools. The eurozone is expected to contract by 0.5 per cent in 2012 (Table 14. 1).

14.4 The predominant reason for the subdued growth in advanced economies at this juncture remains the sovereign debt crisis that started in the peripheral economies of the eurozone, but from the latter half of 2011, started to adversely affect the major economies there, as well (see Box 14.1). Issues relating to medium-term fiscal consolidation, the exposure of European banks to public and private debt, and recurring differences in the ways to resolve the crisis have continued to weigh on the global economic outlook as the eurozone accounts for close to one-fifths of global GDP.

14.5 Volatility in capital flows resulting from the spillover effects of monetary policy choices and other uncertainties in the advanced financial markets further impacted exchange rates and made the task of macroeconomic management difficult in many emerging economies. This has brought out a new dimension of globalization in the post financial crisis world, where easy monetary policy in one set of countries may result in inflation elsewhere due to cross-border capital flows.

14.6 Unemployment situation in advanced economies in general, and the peripheral economies of the eurozone in particular, which had deteriorated in the wake of global crisis has not improved. The OECD Employment Outlook 2011 observed that with the recovery stalling, OECD unemployment remained high, with close to 44.5 million persons unemployed. The extent of unemployment has been varied across OECD countries, with Spain exhibiting the highest unemployment rate (21.7 per cent). As per the OECD report, the main losers have been youth and temporary workers, some of whom have been getting out of the job market. The unemployment rate in the US has shown some improvement (8.7 per cent in Q4 2011 compared to 9.1 per cent in Q3 2011), but nevertheless remains high. The persistently high rates of unemployment in advanced countries, especially in the crisis-affected countries of the eurozone, the inherent contradiction of fiscal consolidation (without worsening the contractionary tendencies) is having a social fallout in the peripheral economies and has

Box 14.1 : The Eurozone : A Crisis after a Crisis

The eurozone crisis: The eurozone (a currency union of 17 European countries) has been going through a major crisis which started with Greece but spread rapidly to Ireland, Portugal, and Spain and subsequently Italy. While it got sparked off by fear over the sovereign debt crisis in Greece, it went on to impact the peripheral economies as well, especially those with over-leveraged financial institutions. These economies (especially Greece) have witnessed downgrades in the ratings of their sovereign debt due to fears of default and a rise in borrowing costs.The sovereign debt crisis has made it very difficult for some of these countries to re-finance government debt. The banking sector in these countries also stands adversely affected.

Good times: After the launch of the euro, the eurozone witnessed not only a decline in long-term interest rates (especially from 2002 to 2006), but an increasing degree of convergence in the interest rates of member countries. A common currency, similar interest rates, and relatively strong growth provided a basis for a rise in public and private borrowing with cross-border holdings of sovereign and private debt by banks.

Trigger: In the aftermath of the global financial crisis in 2008, sovereign debt levels started to mount. The revelation that the fiscal deficit in Greece was much higher than stated earlier set off serious concerns in early 2010 about the sustainability of the debt. The downgrade of ratings led to a spiral of rising bond yields and further downgrade of government debt of other peripheral eurozone economies as well, that had high public debt or a build-up of bank lending or both.

How it spread: Concerns intensified in early 2010 as cross-border holdings of sovereign debt and exposure of banks came to light. The financial markets quickly transmitted the shocks which not only led to a sharp rise in credit default swap (CDS) spreads but later impacted capital flows elsewhere.

Underlying weaknesses: The crisis has been difficult to resolve due to certain specificities:

- *The eurozone lacks a single fiscal authority capable of strict enforcement;*
- *Economies with different levels of competitiveness (and fiscal positions) have a single currency;*
- *These economies cannot adjust through a depreciation of the currency;*
- *There is no lender of last resort, i.e. a full-fledged central bank.*

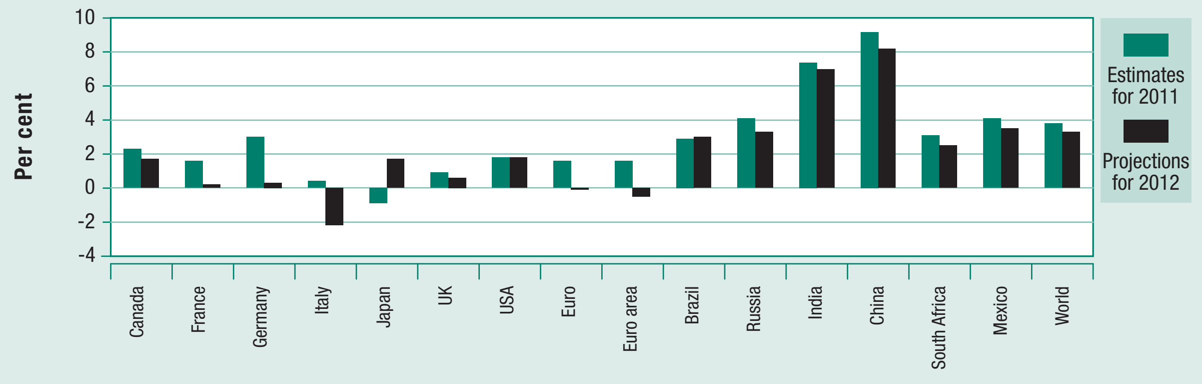
Steps to resolve it: In May 2010, the European finance ministers agreed on a rescue package worth •750 billion to ensure financial stability by creating the European Financial Stability Facility (EFSF). In October 2011, the eurozone leaders agreed to a package of measures that included an agreement whereby banks would accept a 50 per cent write-off of Greek debt owed to private creditors, an increase in the EFSF to about •1 trillion, and requiring European banks to achieve 9 per cent capitalization. The date for starting the European Stability Mechanism was brought forward to July 2012. To restore confidence in Europe, EU leaders also agreed to a fiscal compact with a commitment that participating countries would introduce a balanced budget amendment. In December 2011, the European Central Bank (ECB) took the step of offering a three-year long-term refinancing operation (LTRO) at highly favourable rates to alleviate funding stress which helped bring down the yields somewhat during January and February 2012. But overall uncertainty about the effectiveness of all these measures and how further resources would be raised, their adequacy, and doubts about sovereign debt levels coming down and the ability of Greece and other economies to undertake further fiscal austerity remain, *especially* due to the low-growth scenario.

The Euro zone and India: The eurozone, though distinct from the European Union (EU) is a major subset of the EU. The eurozone and EU account for about 19 and 25 per cent respectively of global GDP. The EU is a major trade partner for India accounting for about 20 per cent of India's exports and is an important source of foreign direct investment (FDI). The IMF has forecast that the eurozone is likely to go through a mild recession in 2012. A slowdown in the eurozone is likely to impact the EU and the world economy as well as India.

sharply polarized public debate on the appropriate economic policies to be adopted.

14.7 The petering out of the revival of global growth in 2011 came on top of disruptions in supply-chain networks resulting from the devastating earthquake and tsunami in Japan (in March 2011). Later in the year (October and November), severe flooding in Thailand also disrupted some supply chains. Political uncertainties in some Middle East and North African countries have been another source of uncertainty apart from their obvious implications for oil prices. The severe uncertainty in the eurozone impacted the global financial markets leading to capital reversals to safe havens in December 2011.

Figure 14.1 GDP growth estimates and projections



14.8 At this juncture, in the short run, the global economy is being buffeted by multiple shocks emanating from various sources, economic, social, and geopolitical. The lower global growth forecast by the IMF for most countries in 2012 *perhaps* reflects the repeated bouts of uncertainty arising from these diverse sets of factors (Figure 14.1).

14.9 Nevertheless, India is projected to be the second-fastest-growing major economy (7 per cent) after China (8.2 per cent) as per the IMF. In the medium term, challenges for the global economy continue to emanate from the way the eurozone crisis is addressed. The high deficits and debts in Japan and the United States and slow growth in high income countries in general, have not been resolved. The looming risk to the global outlook is also on account of the geopolitical tensions centred on Iran that could disrupt oil supply and result in a sharp increase in oil prices and even disrupt supply routes.

14.10 While the current conjuncture is important for anticipating outcomes in the short to medium term, the current global situation is also a manifestation of certain long-term developments and changes in the relative positions of the major economies that have now perhaps reached certain critical proportions.

Global Economy and the Shifting Balance

14.11 A few traditional metrics like the shares of major economies in global GDP, manufacturing, and trade suggest that there has been a marked change in the configuration of the world economy, especially over the last decade.

Table 14.2 : Share in world GDP

	Advanced economies	US	EU	Euro-zone	UK	Germany	Japan	B	R	I	C	S
						(current prices)						
1980	76.2	26.0	34.1	na	5.1	7.7	10.0	1.5	na	1.7	1.9	0.8
1990	79.7	26.1	31.7	na	4.6	7.0	13.8	2.3	na	1.5	1.8	0.5
2000	79.7	30.9	26.4	19.4	4.6	5.9	14.5	2.0	0.8	1.5	3.7	0.4
2005	76.1	27.7	30.2	22.3	5.0	6.1	10.0	2.0	1.7	1.8	5.0	0.5
2010	65.8	23.1	25.8	19.3	3.6	5.2	8.7	3.3	2.4	2.6	9.3	0.6
						(PPP basis)						
1980	69.0	24.6	31.4	na	4.3	6.7	8.6	3.9	na	2.5	2.2	1.0
1990	69.2	24.7	28.7	na	4.1	6.2	9.9	3.3	na	3.2	3.9	0.9
2000	62.8	23.5	25.0	18.3	3.6	5.1	7.6	2.9	2.7	3.7	7.1	0.7
2005	58.6	22.3	23.0	16.5	3.4	4.4	6.8	2.8	3.0	4.3	9.5	0.7
2010	52.1	19.5	20.4	14.6	2.9	4.0	5.8	2.9	3.0	5.5	13.6	0.7

Source **: IMF, WEO database.**

Note: PPP is purchasing power parity.

14.12 Over the last 20 years sustained growth of a number of large emerging economies, especially the BRICS economies, has resulted in an increase in their share in the global GDP as seen from Table 14.2. As a consequence, the value addition in the world economy has been moving away from advanced countries towards what have been termed emerging economies. The decline in share is particularly marked in the case of the EU. The shift towards Asia has been significant and, within Asia, away from Japan to China and India. The fivefold increase in share of China in the global GDP has placed it as the second largest economy in the world. The increase in share of India, though less dramatic, is nevertheless of an order that places her as the fourth largest economy in PPP terms (Table 14.2).

14.13 The reduction in share of advanced economies, particularly from 2005, has been accentuated by the slowdown that followed the subprime crisis in the United States, the crisis in the eurozone in 2010, and the near stagnation in Japan for nearly two decades on the one side and the significantly higher rate of growth in low and middle income countries (particularly the large countries like India and China) on the other.

14.14 From the perspective of whether there has been a 'catch up' (or convergence) in per capita incomes across a larger set of countries, it is seen that the standard deviation of per capita income (at PPP constant 2005 dollars) of 131 countries from 1980 to 2009 continued to increase for most of the period since the mid-1980s (indicating divergence rather than convergence), except in the last two-three years (Figure 14.2). This indicates that despite a reduction in the share of advanced countries, the inequity between the developed and developing countries might have increased for most of the time period.

14.15 Whether the recent reduction in standard deviation is associated with the 'catching up' process of countries (including low income countries), or a slowing down of developed countries following the financial and economic crisis, and whether this is likely to be a temporary phase are issues that need further investigation.

14.16 The foregoing dimension of inequality does not capture interpersonal inequality. According to a study based on consumption data undertaken by Branco Milanovic of the World Bank, global inequality has been quite high, with the bottom 50 per cent of the people accounting for only 6.6 per cent of world income / consumption on PPP basis in 2005 while the top 1 per cent accounted for 13.4 per cent and top 10 per cent for as much as 55 per cent.

14.17 As far as India is concerned, it has achieved faster growth from the 1980s. Not only was this growth higher compared to its own past, it was also much faster than that achieved by a large number of countries.

14.18 Between 1980 and 2010, India achieved a growth of 6.2 per cent, while the world as a whole registered a growth rate of 3.3 per cent. As a result, India's share in global GDP, (measured in terms of constant 2005 PPP international dollars) more than doubled from 2.5 per cent in 1980 to 5.5 per cent in 2010 (Figure 14.3). Consequently, India's rank in per capita GDP showed an improvement from 117 in 1990 to 101 in 2000 and further to 94 in 2009, out

Figure 14.2 Standard deviation of global per capita income (Based on 2005 PPP US$)

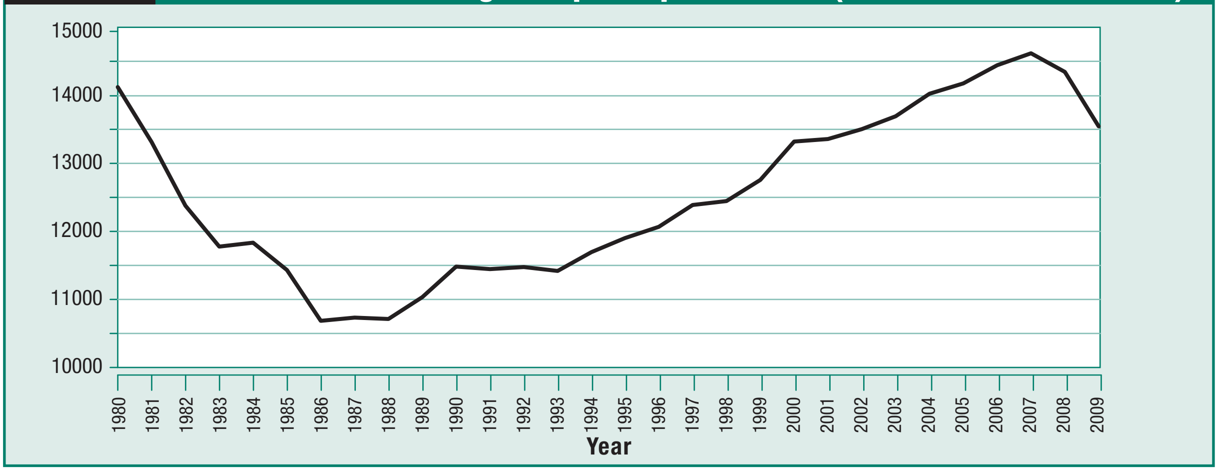
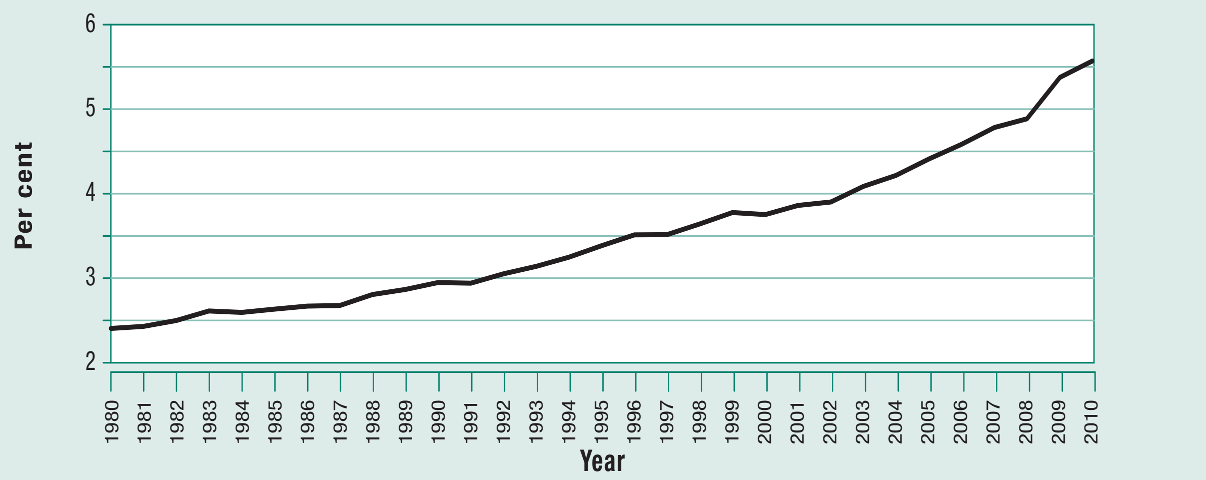


Figure 14.3 India's share in global GDP (Constant 2005 PPP international Dollar)



of 131 countries for which comparable data are available for all points in time. China improved her rank from 127 to 74 during the same period.

14.19 Underlying the relative decrease in share of advanced economies in the global GDP, there has been a marked shift in the location of manufacturing. This process was on in the 1990s too but got accelerated in the current decade. Again, the rise in share of China is particularly significant while other emerging economies, namely Brazil, India, Indonesia have also moved up in terms of their share in world manufacturing value added (Table 14.3).

Table 14.3 : Manufacturing Value added : as percentage of World MVA (Top 15 in 2009)

	Country	2000	2009
1	United States	25.6	18.7
2	China	6.7	18.1
3	Japan	18.0	10.1
4	Germany	6.8	6.4
5	Italy	3.6	3.5
6	France	3.3	2.8
7	UK	4.0	2.4
8	Russian Fed.	na	1.7
9	Brazil	1.7	2.4
10	Korea, Rep.	2.3	2.3
11	Spain	1.7	1.9
12	Mexico	1.9	1.6
13	Canada (for 2007)	2.3	2.0*
14	India	1.1	2.1
15	Indonesia	0.8	1.6

Source **: World Bank database.**

Notes **: MVA is manufacturing value added in terms of current US dollar**

14.20 Even with the change in distribution of global GDP and manufacturing across countries, it needs to be noted that the advanced countries still account for a large share of industrial output apart from being the repositories of technology and value added in services.

14.21 Global Trade (Exports): The changes in distribution of manufacturing value added, to some extent, get reflected in the relative shares in world merchandise trade (which also includes non-manufactured products). Again, there is a perceptible decline in the share of developed countries and rise in the importance of emerging economies, most significantly China. The share of India in global merchandise exports increased from about 0.5 per cent in 1990 to 1.5 per cent in 2010. Yet India's share remains miniscule and it ranks 19th in the global order of exporting countries (Table 14. 4).

14.22 Even in service exports, the high income countries have witnessed a declining share but they continue to account for an overwhelming 79 per cent of global service exports. While India, by virtue of its information technology (IT) industry, has seen its share of service exports rise to 3.3 per cent, China has moved in from behind and now accounts for 4.5 per cent (Table 14.5).

14.23 Financial services play a major role in some of the developed economies and, of the top 10 financial centres, most are located in advanced markets. This is reflected in exports as well as

Table 14.4 : Share in World Merchandise Exports (%)

Share in global exports	Developed economies	US	EU	UK	Euro zone	Germany	Japan	B	R	I	C	S
1980	66.3	11.1	41.5	5.4	30.8	_	6.4	1.0	_	0.4	0.9	1.3
1990	72.4	11.3	44.5	5.3	35.2	11.8	8.3	0.9	_	0.5	1.8	0.7
2000	65.7	12.1	38.0	4.4	29.7	8.5	7.4	0.9	1.6	0.7	3.9	0.5
2005	60.4	8.6	38.7	3.7	30.3	9.2	5.7	1.1	2.3	0.9	7.3	0.5
2010	54.2	8.4	33.9	2.7	26.4	8.4	5.1	1.3	2.6	1.5	10.4	0.6

Source **: United Nations Conference on Trade and Development (UNCTAD).**

Table 14.5 : Share in World Service Exports (%)

Country	High income	US	EU	UK	Euro area	Germany	Japan	B	R	I	C	S
1980	86.9	11.7	56.0	9.0	41.6	8.1	5.0	0.4	na	0.7	0.0	0.6
1990	87.8	17.0	50.7	6.6	39.7	7.3	4.8	0.4	na	0.5	0.7	0.4
2000	84.8	18.4	44.1	7.8	31.0	5.4	4.5	0.6	0.2	1.1	2.0	0.3
2010	78.8	14.3	42.9	6.3	30.5	6.3	3.7	0.8	0.6	3.3	4.5	0.4

Source **: Computed from World Bank database.**

imports and India figures in the top ten both as an exporter of financial services with a share of 2.4 per cent and an importer with a share of 6.7 per cent (see Table 14.6). In general, the foregoing distribution of economic activities and trade has a bearing on where nations stand in terms of their position on various issues that get discussed in major economies global forums.

Table 14.6 : Top 10 Exporters and Importers of Financial Services in 2010 and their Shares

Exporters		Importers	
EU (27)	53.0	EU(27)	60.0
US	23.6	US	15.6
Switzerland	6.4	India	6.7
Hong Kong	5.1	Canada	3.6
Singapore	4.9	Hong Kong	3.5
Japan	1.5	Japan	3.1
India	2.4	Singapore	2.3
Canada	1.3	Switzerland	1.7
Korea	1.2	Brazil	1.7
Norway	0.6	Russia	1.7
Top 10	100.0	Top 10	100.0

Source **: World Trade Organization (WTO).**

14.24 Demographics play a critical role in shaping the size of the labour force and economic productivity and demographic structure has a bearing on economic growth. As compared to the 1980s, it is clear that a number of advanced countries have ageing populations. At the same time, their share in the global GDP is reducing in relative terms (Table 14.7).

14.25 Another dimension that is going to be crucial in the context of demography is international migration. As per the UN Population Division, of the 6.9 billion global population in 2010, 214 million or 3.1 per cent were international migrants. What is not so well known is the fact that South-South migration is also becoming important.

14.26 Without international migration, the working-age population (persons in age group 20-64 years as per UN classification) in the developed countries would decline by 77 million or about 11 per cent of the population in that age group. This could increase the dependence of the developed countries on international migrants or on outsourcing of work. At this juncture, there is an underlying resistance on both counts in advanced economies that may well make the revival of growth more challenging. With regard to economies like India, the availability of a larger proportion of working-age population is likely

Table 14.7 : Share of World Population

	OECD	US	Europe	UK	Germany	Japan	B	R	I	C	S
1980	22.2	5.1	10.4	1.3	1.8	2.6	2.7	3.1	15.5	22.1	0.6
1990	20.2	4.7	9.0	1.1	1.5	2.3	2.8	2.8	16.1	21.5	0.7
2000	19.0	4.6	8.0	1.0	1.4	2.1	2.9	2.4	16.7	20.8	0.7
2005	18.5	4.6	7.6	0.9	1.3	2.0	2.9	2.2	16.9	20.2	0.7
2010	18.1	4.5	7.3	0.9	1.2	1.9	2.8	2.1	17.1	19.6	0.7
	Total dependency ratio (ratio of population aged 0-14 and 65+ per 100 population 15-64)										
	WORLD	**US**	**Europe**	**UK**	**Germany**	**Japan**	**B**	**R**	**I**	**C**	**S**
1980	70.3	51.2	52.8	56.1	51.7	48.4	72.4	46.8	75.9	68.5	80.7
1990	63.8	52.0	49.7	53.2	44.7	43.4	65.6	49.6	71.7	51.4	72.8
2000	59.0	51.0	47.8	53.4	47.0	46.6	54.0	44.1	63.8	48.1	59.6
2005	55.0	48.9	46.6	51.3	49.9	50.7	51.0	40.5	59.1	41.7	55.8
2010	52.4	49.6	46.2	51.4	51.2	56.4	48.0	38.6	55.1	38.2	53.3
	Old-age dependency ratio (ratio of population aged 65+ per 100 population 15-64)										
	WORLD	**US**	**Europe**	**UK**	**Germany**	**Japan**	**B**	**R**	**I**	**C**	**S**
1980	10.1	17.1	18.9	23.3	23.7	13.4	6.9	15.0	6.3	8.7	5.6
1990	10.2	19.0	19.1	24.1	21.5	17.1	7.4	15.3	6.5	9.0	5.5
2000	10.9	18.7	21.8	24.3	24.0	25.2	8.5	17.9	6.9	10.4	5.9
2005	11.3	18.4	23.3	24.2	28.6	29.9	9.5	19.3	7.3	10.7	6.4
2010	11.6	19.5	23.7	25.1	30.8	35.5	10.4	17.7	7.6	11.3	7.1

Source **: United Nations Population Division, World Population Prospects 2010.**

to play a central role in driving economic growth. As the dependency falls, opportunities for economic growth tend to rise, creating what is termed as a 'demographic dividend'.

14.27 Public Debt and Deficits: While demographic changes are incremental, the cumulative change in demographic structure has started to impinge on the fiscal capacity of many developed economies, particularly in Europe. With an increase in share of retirees, existing social compacts in many developed countries have come under strain as their capacity to service public debt has diminished and private debt has also risen. The recourse to automatic stabilizers during the financial crisis has stretched their fiscal capacity as public debt in relation to GDP has reached close to or exceeded the benchmark of 100 per cent of GDP and, in case of Japan, touched a whopping 220 per cent of GDP. An interesting point to note is that as compared to most of the major economies, expenditure of the general government in India is much lower as is the case in respect of revenue (Table 14.8).

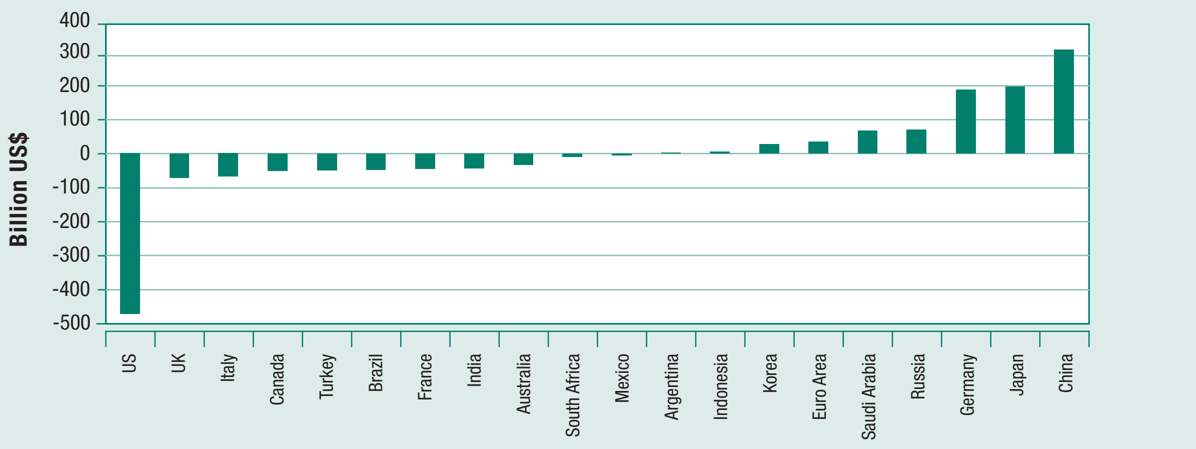
Table 14.8 : General Government : Revenue, Expenditure, Balance, and Debt as Percentage of GDP - 2010

	AE	US	EU	EA	UK	Germany	Japan	B	R	I	C	S
Revenue	35.9	30.9	43.4	44.6	36.6	43.7	30.6	37.5	35.0	17.6	20.4	27.0
Expenditure	43.3	41.3	49.8	50.6	46.8	47.0	39.8	40.4	38.5	26.0	22.7	32.0
Balance	-7.6	-10.5	-6.6	-6.3	-9.9	-4.3	-9.3	-2.8	-3.5	-8.9	-2.3	-5.1
Debt	100.0	94.4	79.8	85.8	75.5	84.0	220.0	66.8	11.7	64.1	33.8	33.8

Source **: IMF, WEO Database, September 2011/ Fiscal monitor update 12 January.**

Note **: AE is advanced economies. EA is euro area.**

Figure 14.4 Current account balance (2010)



14.28 Current Account Balances and Reserves: In response to a series of financial crises, especially after the East Asian crisis of 1997, many emerging and developing economies adopted new strategies for managing their external economy. These involved greater reliance on exports (resulting in current account surpluses) and the accumulation of foreign exchange reserves, in part to check currency appreciation and also as self-insurance against capital flow reversals.

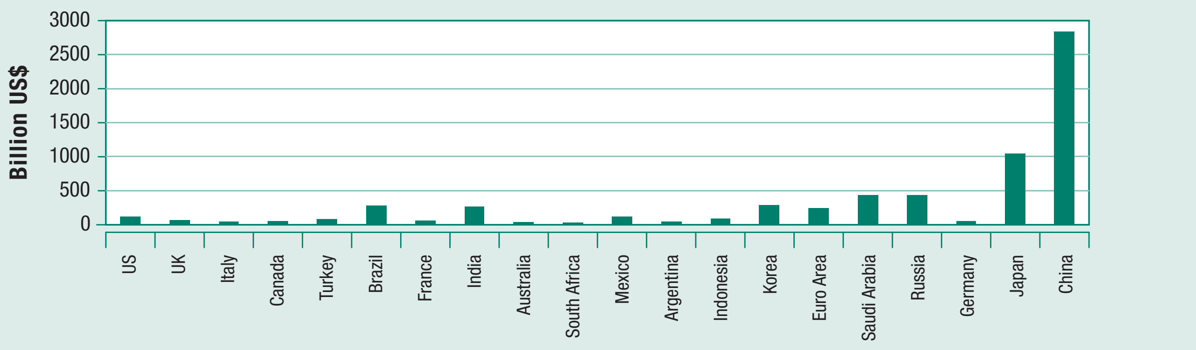
14.29 These strategies led to a shift from being net importers of financial capital to net exporters. As reserves got invested in developed economies, it led to a contradictory phenomenon of capital flowing from emerging countries to capital-rich countries (especially the US). In an accounting sense, this was equated to high saving rates in the emerging market economies (EMEs), especially China. The position of current account balances and reserves for the major G-20 economies is shown in Figures 14.4 and 14.5. India, in this regard, is somewhat of an outlier as even while holding substantial reserves, it has essentially had a structural current account deficit and is therefore not a contributor to global imbalances in the foregoing sense.

14.30 Regardless of the merits of holding reserves, it is by now agreed that the relatively stronger external financial position (reserves) of the EMEs made them less vulnerable to the capital reversals following the global financial crisis of 2008 and in that sense a vindication of the strategy of maintaining high reserves.

14.31 While holding reserves has been acknowledged to be useful in dealing with the crisis, it has also been argued that excessive reserves involve (quasi-fiscal) costs apart from yielding low returns as countries invest abroad rather than in high-return domestic investments. Furthermore, large fluctuations in the exchange rate could result in significant losses to the value of reserves. For example, if the US dollar weakens, it could result in a loss in value of reserves denominated in dollars.

14.32 Apart from the holding costs to the economy, high build-up of current account surpluses

Figure 14.5 Foreign Exchange Reserves (2010)



and reserves has been seen as a major indicator of global imbalances and potential source of instability in the international monetary system. In the global context, it has been argued that reserve accumulation was an outcome of resisting currency appreciation and an attempt to stimulate export-oriented production at the expense of domestic demand. The reserve accumulation by key emerging current account surplus economies, mostly held as dollar assets, supported a strong US dollar in spite of a growing current account deficit in the US. By thwarting exchange rate adjustment, this practice has been contributing to global economic imbalances.

14.33 On the other hand, it has also been argued that the build-up of reserves is a consequence of loose monetary policies followed by reserve currency-issuing countries. Be that as it may, the fact remains that the issue of exchange rate management, build-up of current account surpluses and of reserves cannot be viewed in isolation and these issues are embedded in a wider ongoing debate on the deficiencies of the international monetary and financial system. For the present, the asymmetry in the balances in terms of current account surplus and reserves is there for the global economy to contend with.

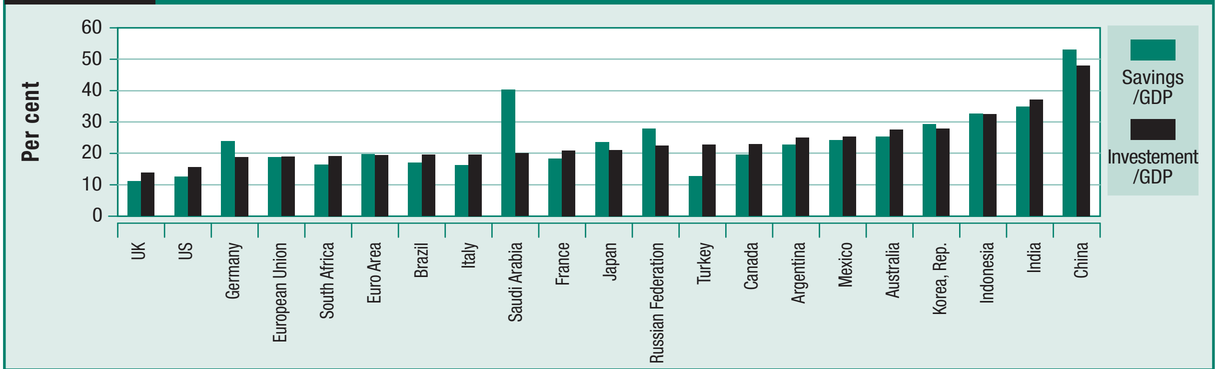
14.34 Savings and Investment: One of the features of the 'new normal' in the world economy is the way savings as well as investment rates are distributed between the advanced and emerging economies. As seen in Figure14.6, most advanced economies (which appear to the left of the graph) have gross saving rates below 20 per cent while the opposite is true of the EMEs. Investment trends drive growth and the divergence seen in savings is almost symmetrically reflected for the investment rates. India's investment rates, for example, have risen some 12 percentage points of GDP from the mid-1990s to around 35.1 per cent in 2010-11.

14.35 Implications of the Global Shift: The changes in composition of the global economy discussed thus far suggest a perceptible shift in the global balance of output of goods (especially manufacturing). While services (in particular financial services) continue to be largely concentrated in advanced economies, a larger share in world population, coupled with higher growth, implies that the EMEs and developing countries will increasingly account for incremental growth in the global market for goods, services, and commodities. A change in the global economic balance driven by supply and demand forces therefore appears to be the 'new normal' and is likely to accentuate in the years to come (see Box 14.2).

14.36 At this juncture, many of the advanced economies are geared to very high levels of private consumption and government expenditure in relation to their GDP. A prolonged slowdown could place further pressure on their budgetary balances and household savings (that are already low) and adversely impact investment and their potential growth. Thus the possibility of low growth setting off a vicious cycle of higher debt and low growth cannot be ruled out.

14.37 Therefore, even when the emerging economies (including India) witnessed a slowdown in growth in 2011 due to the renewed bouts of uncertainty in the global economy, there are reasons to suggest that the growth prospects of most of these economies remain robust in the medium to long run. This is due to various factors that drive growth such as demographics and size of the domestic market, apart from more conventional economic drivers such as high rates of investment and savings.

Figure 14.6 Saving and investment rates – 2011



Box 14.2 : Tectonic Shifts

When small economic crises crop up repeatedly over a relatively short period of time, policymakers in each country may treat each such episode as an independent event requiring independent action but, in reality, such 'cluster crises' may be a sign of some fundamental shift taking place in the global economy. Hence, faced with cluster crises, it is important to occasionally step back and take a more holistic view of the situation. There has been some research trying to do precisely that.

At one level, it is not difficult to see what is happening. With rapid globalization since the end of World War II, goods and services and also capital have begun moving much more freely across nations. In addition, and maybe even more importantly, the advance of IT has meant that it is possible for people with a modicum of skills to sit in one country and do work for another country. In brief, one of the most precious resources for economic progress, namely skilled labour, which earlier sat walled in within the boundaries of their respective nations, has suddenly become available to needs arising in distant parts of the world.

What this has meant is that all emerging economies with a little ability to organize their workspace and impart skills to their workers are now capable of taking advantage of this windfall. As a consequence, the bottom end of the skilled-labour spectrum in the US and Europe is now coming under competition from the top end of the skilled labour band of India, China, the Philippines, Indonesia, and several other emerging economies. This has energized large corporations in rich and poor countries and caused booms in various regions, like Silicon Valley in the United States. But this is also causing inequality to rise in both industrialized nations and emerging economies.

In a recent paper, Spence [1] highlights how this process is one of the causes of growth and employment trends, within the US economy, diverging and inequality rising. And 'the major emerging economies are becoming more competitive in areas in which the U.S. economy has historically been dominant, such as the design and manufacture of semi-conductors, pharmaceuticals, and information technology services'. ([1], p. 29). By the same argument, the skilled end of the labour markets in India and China is competing with its counterparts in industrialized nations and, as a consequence, its salaries are rising, resulting in growing inequality in these countries.

There are other domains where these kinds of inter-country tensions have been building up. Disparities in savings rates across nations have often led to acrimonious debate and search for first cause. It has been suggested (see for instance [2]) that China's huge savings rate may not be entirely because of domestic structural factors in China but a response to the fact that the savings rate in the U S dropped sharply between 1960 and 2010.

These adjustments give rise to economic turmoil and crisis and, in addition, are politically sensitive matters that can lead to protectionism, which can do more harm than good. It is important for us to recognize that none of these structural shifts are caused by the actions of any one individual or nation. Millions of little actions and thousands of scientific discoveries over decades and human inventiveness in general have given rise to globalization and we have inherited the world we have. It is for us to take the givens as given and use collective bodies such as the G-20 to ensure that we do not fall victim to protectionism. It is important to remember that through all this turmoil the global pie is expanding. Hence, by having effective coordinated action, it is possible to convert what appears at first as adversity into advantage.

Source **:** [1] Spence, A. M. (2011), 'The Impact of Globalization on Income and Employment: The Downside of Integrating Markets', *Foreign Affairs*, vol. 90. [2] Zagha, R., 'Global Imbalance: Policies, Structure and Finance', in S. Kochhar (ed.) *Policymaking for Indian Planning*, New Delhi, Academic Foundation.

14.38 In 2011, out of 184 countries listed in the IMF's WEO, there were only 26 with a population of at least 10 million and growth rate of over 6 per cent. Most, if not all, are the so called emerging markets. Quite understandably, the dim view about the growth prospects of advanced economies has put the spotlight on emerging and developing economies as the new growth drivers of the global economy.

14.39 The underlying shift in global economic setting raises the question as to whether future changes in the world economy would unravel in a smooth manner, or be disruptive. Needless to say India, even while carefully responding to the immediate economic challenges emanating from domestic and global sources, will also have to craft and calibrate its policies keeping both outcomes in view.

14.40 As for the present, the global situation is marked by volatility in world financial markets, uncertain growth in the advanced economies, and possible disruptions in supplies of energy apart from other geopolitical tensions. There is contradiction between the short-term need for growth and maintaining demand and the need for fiscal consolidation that marks the current policy environment. But even as the world economy, three years after the global financial crisis of 2008, continues to move from one uncertainty to another, there have been continuing efforts in multilateral fora such as the G-20 to bring about greater understanding and coordination in dealing with global imbalances and addressing the weaknesses that might have led to the global crisis, to arrive at measures to revive global growth. Before turning to this it is however, worth while locating India in the global economy.

Locating India in the New Global Economy

14.41 India has over the years become a more open economy. The total share of imports and exports accounts for close to 50 per cent of GDP while that of capital inflows and outflows measures up to 54 per cent of GDP. Yet economic outcomes and their impact on growth and development arising from the interaction between the domestic and external economies are contingent on a large number of factors. Though economic outcomes are to some extent contingent on choosing policies appropriate to the conditions characterizing an economy, the relative position of an economy vis-à-vis other countries in a global setting could facilitate (or even constrain) policy choices. This section flags a few features that characterize India that may be relevant in its further engagement with the global economy as also for its future development.

14.42 India has moved up the Ranks but is still the poorest among the G-20: India has emerged as the fourth largest economy globally with a high growth rate and has also improved its global ranking in terms of per capita income (as mentioned earlier). Yet the fact remains that its per capita income continues to be quite low (at current US $ 1527 in 2011). Addressing this is perhaps the most visible challenge. Nevertheless, India has a diverse set of factors, domestic as well as external, that could drive growth well into the future.

14.43 Demographics: With over 1.2 billion people, India accounts for nearly one-sixth of global population. While the rate of growth of population has consistently declined, India's population increased by nearly 180 million persons during 2001-11 (the highest in the world in absolute terms). However, India is also passing through a phase when its dependency ratio will decline from an estimated 74.8 in 2001 to 55.6 in 2026 with a corresponding increase in the share of persons in working-age group. With labour being a key factor of production, a demographic dividend is a clear positive for growth. It has, however, been pointed out that much of the growth in population will occur in states that are currently poor. Therefore, for this dividend to accrue, it will be necessary to build human capital in adequate measure.

14.44 On this count, India has shown some improvement in terms of its human development index (HDI). The UNDP's HDI, which captures the progress of a country in terms of economic indicators as well as education and health indicators increased from 0.344 in 1980 to 0.547 in 2011. India moved up from a rank of 82 in 1980 to 72 in 2011 (in a group of 100 countries for which HDI is available for these points of time. Even though India's score has improved, her HDI rank has not moved very significantly. A possible reason could be that some other countries may have registered faster improvement in these indices. India therefore needs to benchmark her achievements (on various fronts) not only in absolute terms but also in relation to other countries.

14.45 Exports and External Demand: The process of globalization has been marked by a rising share of exports (as also imports) that reached 27.9 per cent for the world as a whole in 2010, with some countries showing much higher dependence of exports. A stylized fact of the so called East Asian miracle economies was that an export-led, investment-fuelled strategy propelled growth and helped them acquire manufacturing capabilities. This strategy was supported by a favourable exchange rate, cheap credit, and relatively low wages which helped to gain competitive advantage. Global demand for goods, particularly in the advanced markets, lent support to this growth strategy. As a result, these economies moved up the value chain in manufacturing (Table 14.9).

Table 14.9 : Exports of Goods and Services (% of GDP)

Year	World	High income	USA	UK	EU	EA	Germany	Japan	B	R	I	C	S
1980	19.1	19.9	10.1	27.1	25.5	24.7	20.2	13.5	9.1	na	6.2	10.6	35.4
1990	19.2	19.3	9.6	24.0	27.0	27.1	24.8	10.4	8.2	18.2	7.1	16.1	24.2
2000	24.7	24.3	11.0	27.6	35.8	36.7	33.4	11.0	10.0	44.1	13.2	23.3	27.9
2005	26.7	25.6	10.4	26.4	36.9	38.0	41.3	14.3	15.1	35.2	19.3	37.1	27.4
2010	27.9	27.8	12.6	29.4	39.7	40.6	46.8	15.2	11.2	30.0	21.5	29.6	25.5

Source **: World Bank Database.**

14.46 This leads to the question of how far export can be a driver of growth for India at this point in time. With a slowdown in advanced economies, the prospect of their growth fuelling demand for imports (i.e. exports from other countries), seems somewhat bleak at this juncture. Second, the large build-up of capacity in some countries (including China) suggests that they *might* act as barriers to new entrants for some time. Third, the costs of energy are rising and there are growing concerns about climate change.

14.47 In this regard, India's export (of goods and services) to GDP ratio increased from 6.2 per cent in 1990 to 21.5 per cent in 2010. Yet India accounts for only 1.5 per cent of world exports. India's exports are also evenly balanced between merchandise and services. Moreover, the change in direction of exports suggests that India has been diversifying the destination of its exports away from traditional markets (Figure 14.7).

14.48 There is therefore some scope for exports to grow, particularly to the fast growing economies, many of which are in Asia and Africa and to some extent Latin America, while some of the mature markets may remain important, albeit with declining shares on the whole for the group. Moreover, the main advantage of a presence in the global market is of being able to benchmark to global standards and therefore worth pursuing in its own right. Additionally, the advantage of having the twin engines of domestic and export demand is that it lends the economy greater resilience to fluctuations in global demand.

14.49 **Investing in Research and Development (R&D) and Innovation:** The World Bank Study titled 'Unleashing India's Innovation' (2007) observed that India had increasingly become a top global innovator in high–tech products and services. Yet the country is underperforming in terms of its innovation potential. India spends less than 0.9 per cent of its GDP in the area of R&D, which covers basic research, applied research, and experimental development. This fact emerges from the OECD Fact Book 2010 that lists 41 countries with Israel

Figure 14.7 Direction of exports from India – Percentage shares

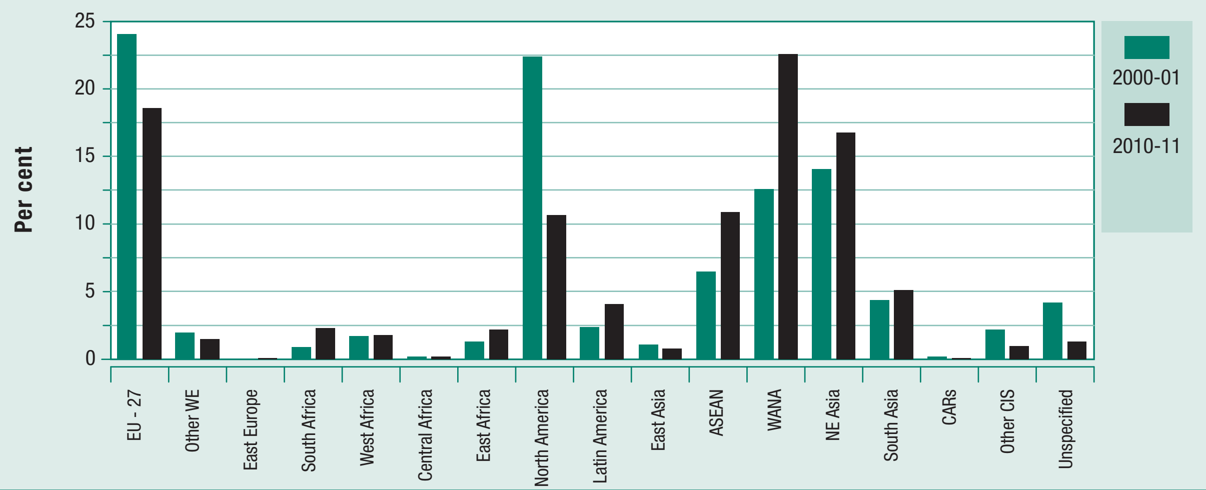
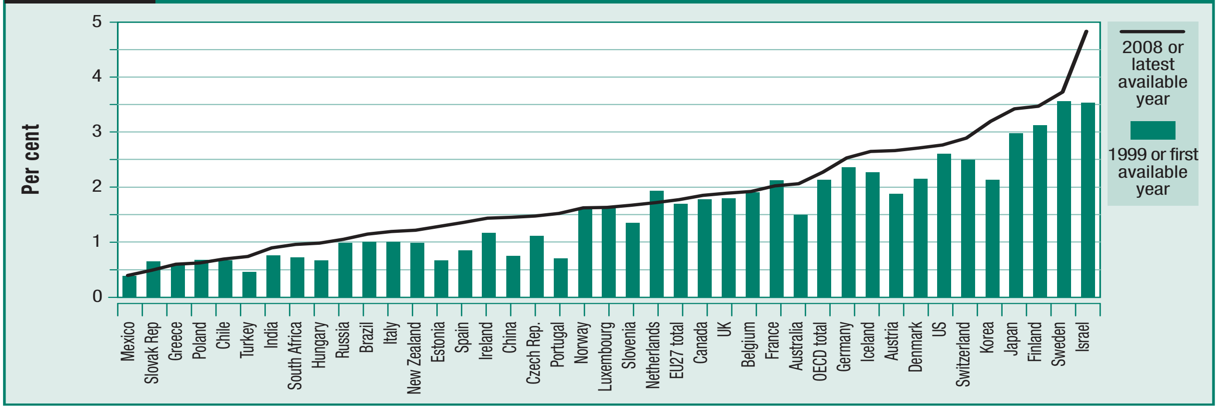


Figure 14.8 Gross Domestic Expenditure on R&D as per cent of GDP



topping the list on this count and most developed countries spending over 2 per cent of their GDP on R&D. While more resources into R&D would be needed, equally critical would be to harness existing institutions and organizations set up for formal R&D and also to encourage grass-roots level innovation (Figure 14.8).

14.50 Given the increasing acceptance of the fact that land, water, and energy are likely to be in short supply and environment a major concern, India is well placed to advance through the route of frugal innovation and devising of specific applications suited to the bottom of the pyramid that would not only open new market segments within India but also in other countries in the developing world. That apart, with regard to frontier areas, India is well placed to take advantage of its vast diaspora to jump-start its R&D efforts. Strategically positioning India as a hub for FDI in R&D may well be a way for it to leapfrog into the next generation of technologies and products.

14.51 **Energy Security and Growth:** India is characterized by a relatively lower energy intensity of GDP as compared to China, South Africa, and Russia but higher than that of Brazil. Advanced countries, in particular EU countries and Japan, have been witnessing a decline in the energy intensity of GDP due, apart from technological improvements, to various factors, the main one being a shift in the structure of their economies towards services (Table 14.10).

14.52 As regards dependence on imported energy sources, at an overall level, India' energy dependence appears modest at 25.7 per cent in terms of total energy usage. (Table 14.11) However, this masks the fact the around 80 per cent of the crude oil consumed is imported, whereas the bulk of coal is domestically produced. Even with respect to coal, the country is importing on the margin to meet domestic demand. On the other side, there is a large fraction of population that has little or no access to commercial sources of energy and depends on traditional sources.

Table 14.10 GDP per unit of energy use

Country name	1980	1990	2000	2009
China	0.9	1.4	3.1	3.7
EU	5.4	5.9	7.1	8.2
India	3.0	3.3	3.9	5.1
Russian Federation	na	2.1	2.0	3.0
Brazil	8.1	7.7	7.3	7.6
United States	2.8	4.2	4.9	5.9
United Kingdom	5.2	6.6	7.8	10.1
South Africa	3.7	3.0	2.9	3.2
Japan	6.4	7.3	7.0	7.9

Note **: * Constant 2005 PPP dollars. *Source*: World Bank database.**

Table 14.11 : Energy Imports, Net (% of energy use)

Country name	1980	1990	2000	2009
United States	13.9	13.7	26.7	22.0
EU	44.9	42.2	43.9	50.6
United Kingdom	0.3	-1.0	-22.2	19.2
Germany	48.0	47.0	59.9	60.1
Japan	87.4	82.9	79.6	80.1
Brazil	43.5	25.7	21.6	4.1
Russia		-47.1	-57.9	-82.6
India	8.9	7.9	19.9	25.7
China	-2.8	-2.7	2.8	7.6
South Africa	-12.0	-22.0	-27.3	-11.5

Source **: World Bank database.**

14.53 A rise in the price of oil in international markets has mostly been a source of vulnerability for the macroeconomy of India on account of its impact on the current account deficit. High international prices of fossil fuels also result in a higher import bill, which either gets passed on to the consumers or results in higher subsidy thereby affecting fiscal health. That apart, the growing tensions in many oil- producing economies are a source of vulnerability for the energy security of India. In this one area, the strategic advantage for India would lie in diversifying its energy sources.

14.54 **Food Security:** Food security in the Indian context would imply meeting minimum energy and protein norms along with requisite micro-nutrients for all at affordable prices. With the increase in income, the demand for food in India is bound to further rise. It has also been observed that even marginal shortages in specific food items in India tend to have a disproportionately large impact on the relevant prices even in the international market. Even though India, for most food products, is not an importer in most years, dependence on global markets could imply greater vulnerability both in terms of prices and availability. The link between financialization of commodities and its impact on commodity prices and their volatility has been an issue of international concern, even though there has been no clear consensus on the cause-effect relationship.

14.55 **Resources for Development and the Availability of Capital:** A case is often made for the virtues of a minimalist state and the need to disengage from a number of activities. The actual facts speak otherwise. India's general government expenditure in relation to GDP is actually lower even in comparison to many market economies by a factor of at least half. More importantly, the ratio of general government revenues to GDP at 17.6 per cent (refer to Table 14.8) is one of the lowest in emerging economies and certainly very low vis-à-vis the advanced economies. Therefore, even if fiscal consolidation is needed, the priority has to be on raising resources. Recent developments in the developed economies reveal how important it is to maintain the revenue base and keep government finances in shape. As India becomes more exposed to the external economy, its fiscal strength based on a large revenue base would become even more critical.

14.56 **FDI—Playing Strategically:** Many of the advanced economies, with deep technological strengths, are now aging societies and need to invest overseas and rely on factor incomes. At the stage at which India is placed, the need for sustained investment has already been stressed elsewhere in the survey. There is an inherent complementary relationship between India's requirement for more 'real' investment and the need for some of the advanced economies, including some of the Asian industrialized economies, to invest in production facilities in friendly countries overseas in order to diversify their supply chains.

14.57 **Remittances** are an important source of financial flows and, as per World Bank estimates, remittance flows into developing countries in 2011 were to the tune of US $ 351 billion. Remittance flows into India are estimated to be of the order of US $ 58 billion. In 2010, remittances into the country accounted for 3 per cent of GDP. One of the reasons for such high inflows could be higher oil prices that helped the Gulf countries and other oil exporters, where a large number of Indian workers are employed. The depreciation of the Indian rupee in the latter half of 2011 might also have helped.

14.58 **An Economy in a Democratic Framework:** The global economic crisis opened afresh the debate on the relative role of the market and the state as also the relative advantages of democratic vis-à-vis state-led economies. The challenge of managing a mixed economy within a democratic and federal system is a complex task. However, the challenge of transiting from a state-led monolith to a more representative system may be even more daunting. In either case, for a system to thrive, economic outcomes need to be tangible. The critical question is therefore not of state versus markets but, rather, of how to maximize market outcomes (minimize market failures) and have effective governance (i.e. minimize government failure) with a democratic system as the political basis for governance.

14.59 As already discussed, India enjoys at this juncture the unique advantage of having *multiple drivers of growth—demographic, investment (backed by domestic savings), domestic consumption, as well as exports and ample scope for FDI – all within a pluralistic and democratic system*. This unique combination more or less assures it of strong and sustained growth with the caveat that at every stage and for every section of society, positive economic outcomes in a tangible way will be required.

Reviving the Global Economy

14.60 The explanations for the global financial crisis (that reached a flash point in October 2008 with the collapse of Lehman Brothers) have been all encompassing. At macro level, they have held the loose monetary policies adopted by reserve currency-issuing advanced economies (particularly the US) in the run up to the crisis responsible on the one side and the mercantilist policies adopted by export-led economies leading to accumulation of large current account surpluses and reserves on the other. These policies were facilitated by weaknesses in the international monetary system (IMS), particularly the absence of alternative reserve assets to the dollar. Weak regulation of financial markets and intermediaries and excessive financial innovation and risk taking by finance and banking intermediaries at micro level have also figured as proximate causes of the crisis.

14.61 The debates and discussions in the G 20 (and other fora involving international organizations and financial institutions) have therefore been on wide-ranging issues. The question of how policies for reviving growth of individual countries impinge on the global economy and its imbalances and whether they could somehow be better coordinated has been at the centre of these discussions. These discussions are of some importance as they may, in the years to come, shape the style and substance of governance of the global economy. It is critical that the outcomes, if any, address the concerns of emerging economies (such as India) that are major drivers of global economic growth.

14.62 The following section therefore examines only a few selected issues that have been the subject of international deliberations (mainly in the G 20) and how they are relevant to India. However, this would not necessarily present a formal view of the proceedings or the official stand of India on specific issues, many of which are still evolving.

14.63 **The G-20 in 2011:** The G-20, formed in 1999 in the aftermath of the East Asian Crisis as a forum for Finance Ministers and central bank Governors, came to centrestage following the Leaders' Summit in Washington DC in November 2008. It focused on coordinated measures to address the challenges faced in the immediate aftermath of the global financial crisis. A declaration in the G-20 Summit at Pittsburgh, USA, in 2009 formally raised the forum to the level of leaders and transformed it into the premier forum for international economic cooperation.

14.64 The agenda for the latest (sixth) summit held at Cannes, France, on 3-4 November 2011 followed the priorities laid out by the French Presidency. This agenda got deliberated in 2011 in two channels. The first was the finance channel, which largely focused on the framework for strong, sustainable and balanced growth, reform of the International Monetary System (IMS), strengthening financial regulation, and other issues relating to commodity price volatility. The second set of issues in the Sherpa's channel focused on development-related issues.

14.65 **The Framework Exercise:** During the global financial crisis, collective and coordinated policy action by the G-20 through macroeconomic stimulus (fiscal and monetary) and financial-sector intervention helped avoid a catastrophic meltdown. Building on this, G-20 Leaders launched the 'Framework for Strong, Sustainable, and Balanced Growth' with India and Canada as the co-chairs of the Working Group in 2009. In this signature effort of the G-20, the Mutual Assessment Process (MAP) forms a medium-term exercise to ensure that collective policy actions benefit all and policies are collectively consistent with the G-20's growth objectives.

14.66 At the 2010 summit in Seoul, the G-20 committed to working to address key imbalances that could jeopardize growth and to enhance the MAP with indicative guidelines for key imbalances. In February 2011, the G-20 agreed to include i) public debt and fiscal deficits, ii) private saving and private debt, and iii) the external position—trade balance and net investment income flows and transfers—as the key indicators for assessing external and internal imbalances. Subsequently, it was agreed that the indicative guidelines would be used to identify systemically important countries and assess each other's economic policies, suggest policy remedies, address potentially destabilizing imbalances, and set the stage for assessing the progress toward external sustainability.

14.67 In this regard, measured in terms of share in global GDP, India has been identified as systemically important economy. But it is clearly a net contributor to global demand as evidenced from its current account deficit. While India's exchange rate is largely market determined, its domestic savings are largely oriented to financing domestic investment appropriate at a stage of high growth but not at the cost of curbing consumption. Even if India is not a contributor to global imbalances, its interest clearly lies in smooth resolution of these issues and towards measures that could help revive global growth.

14.68 **Reform of the International Monetary System:** It has been argued that the IMS has no mechanism to prevent a build-up of imbalances on the external account and the burden of adjustment falls on deficit nations. In the run up to the crisis of 2008, it was felt that countries like the US could somehow sustain fiscal and current account deficits by virtue of the privilege of issuing a reserve currency. But this trend instead accentuated the so called external imbalances, even if it was not the primary cause of the crisis that turned global.

14.69 The French Presidency constituted a G 20 Working group on reform of the IMS which focused, among others, on capital flows and their management (CFM), the measurement of global liquidity, holding of international reserves, and future role and composition of the special drawing rights (SDR). While the latter two issues remain areas of continuing work, drawing on the work of the IMS group, the Cannes Summit communiqué mentions that the 'Coherent Conclusions for the Management of Capital Flows' would guide the G-20 in order to reap the benefits of financial globalization, while preventing and managing risks that could undermine financial stability and sustainable growth at national and global levels.

14.70 The issue of volatility in capital flows has been of concern for several emerging markets (including India). The management of capital flows is tempered by two considerations. First, a challenge, common to most developing countries and EMEs at this juncture, arises from the uncertainties in global capital flows and monetary policies pursued in advanced countries. Emerging markets face sudden stops or reversals (witnessed in December of 2011) for reasons not necessarily linked to developments in their own economies but to serious difficulties faced by financial institutions in advanced economies. Quantitative easing pursued by monetary authorities in advanced countries (while understandable in the context of liquidity needed to repair adverse private and public balance sheets) is a relatively new phenomenon that has altered the composition of capital flows and made their management by recipients more difficult.

14.71 The second consideration arises from India's specific situation. Notwithstanding the stability of India's balance of payments after an episode in 1991, India's current account deficit has widened over the last year. The dependence on private capital inflows to finance the same has widened. It is by now known that the burden of adjustment in the current IMS falls predominantly on non-reserve-issuing current account deficit countries (like India). On that count, the Indian economy has moved towards greater openness to capital flows, albeit following a cautious and calibrated approach keeping both domestic and international factors and risks in view and through judicious use of multiple instruments.

14.72 In view of the shift in external vulnerability indicators and India's currently high dependence on imported oil, there is need to reinforce management of the capital account (which has served India well) and also encourage more stable capital flows rather than short-term flows. Countries like India may well need to rely on a matrix of choices comprising macroeconomic and macro prudential tools and other measures as policy instruments without being bound by a prescribed sequence. Under the circumstances, the fact that the 'Coherent Conclusions on Management of Capital Flows' (as endorsed by the G-20) are 'non-binding' needs to be taken note of.

14.73 An issue related to trends in global liquidity is dealing with the build-up of international reserves by some countries. It has been argued that the accumulation of reserves has negative externalities and also entails avoidable costs to the holding countries. The issue is when the holding of reserves can be deemed excessive or rather what the optimal level could be, if any, and whether some kind of 'reserve metrics' could be adopted. While the optimal size and the utility of using reserves to intervene in currency markets may be debatable, the experience, especially in the case of economies like India, has been that reserves have helped graduate to a more open economy and smoothen investment and consumption during periods of external uncertainties caused by extraneous factors. In this context, a distinction needs to be drawn between holding of reserves by countries running a current account deficit (such as India) and reserves accumulated by countries with persistent current account surpluses in addition to large sovereign wealth funds. A related set of issues on which deliberations have been going on in the G 20 concern strengthening of global financial safety nets, cooperation between the IMF and Regional Financial Agreements to help countries deal with exogenous shocks (and access emergency assistance) and the adequacy of IMF's resources to play systemic role for the benefit of its whole membership.

14.74 **Financial Regulation:** The Group of 7 (G-7) countries along with a few more advanced economies with large financial sectors were the most important participants in a grouping that established the Basel Committee on Banking Supervision 1974, whose primary function was to act as a forum for coordination of supervision of the financial sector, particularly large banks, in these economies. In the wake of the major 2007-9 global financial crisis, the most severe since the 1930s, the effectiveness of financial regulation was called into question. Since then, quite significant reforms of financial regulation have taken place both within countries and internationally in terms of international regulatory standards and organizations.

14.75 **Financial Regulation Reforms**: In general, regulating financial markets and intermediaries and striking a balance between the need for maintaining financial stability and good market conduct without stifling innovation have always been a challenge. The global crisis brought home the inherent difficulty in doing that especially where financial institutions have had cross-border operations and exposures. This was because, with financial globalization, many banks and other financial market participants had cross-border operations but were mostly subject to national regulations.

14.76 The weaknesses in financial regulation (apart from global imbalances) were perceived as a major cause of the global crisis. The Cannes Summit communiqué 2011 reiterated the commitment that financial markets, products, and participants be regulated or subject to oversight appropriate to their circumstances in an internationally consistent and non-discriminatory way. The declaration spells out the initiatives taken that include the regulation of banks, over-the-counter (OTC) derivatives, compensation practices, and credit-rating agencies. The Cannes action plan commits to taking these initiatives further based on the work done by the Bank of International Settlements (BIS) and the Financial Stability Board (FSB) on new standards for financial regulation.

14.77 The commitment to implementing the Basel III standards for banks is of particular significance to the global economy. The implementation of Basel III capital and liquidity standards starts in 2013 with full implementation envisaged by 2019.To make sure that no financial firm is 'too big to fail' and taxpayers do not bear the costs of resolution, the FSB framework comprising new international standards for resolution, supervision, cross-border cooperation, recovery, and resolution planning from 2016 was endorsed. The FSB has also published an initial list of Globally Systemically Important Financial Institutions (G-SIFI) and a five-pronged work plan to develop guidelines on shadow banking. In order to prevent excessive risk taking and discourage excessive pay and bonuses, the FSB has developed principles and standards on compensation.

14.78 India is a member of the Basel Committee on Banking Supervision (BCBS) and FSB and is actively participating in post crisis reforms of the international regulatory and supervisory framework. The Indian financial sector is well regulated and India remains committed to adopting international standards and best practices *calibrated to its conditions*. As such, banks in India are well capitalized and it is expected that the Basel III norms are unlikely to put undue pressure on the banking system on aggregate. India had even earlier implemented some countercyclical policies like provisioning norms and differential risk weights (for example for the real estate sector, capital markets, and personal loans) to control build-up of risks even before these were internationally proposed.

14.79 There are, however, some caveats on the implementation of the emerging regulatory standards across countries. Given that the financial sector in many countries has its specificities, and there is likely to be resistance to change from several market participants, it is yet to be seen whether all these reforms will get carried out in all the countries and not diluted. While all G-20 countries have committed to implementing Basel III, major jurisdictions have separately come out with their own regulatory

Box 14.3 : Financial Regulation: New initiatives – the US and UK

US – The Dodd-Frank Act: The financial crisis of 2007–10 led to calls for changes in the regulatory system. In June 2009, a proposal for a 'sweeping overhaul of the financial regulatory system' was introduced in the US that culminated in a legislation called The Wall Street Reform and Consumer Protection Act (also called the Dodd-Frank Act) in July 2010. This is a voluminous and overarching Act (1601 sections) with provisions for comprehensive regulation of financial markets (including the derivatives markets), consolidation of regulatory agencies, and establishing of a new oversight council called the 'Financial Stability Oversight Council' to evaluate systemic risk. The provisions also aim to address the 'too big to bail out' problem and bring in the requirement of large complex financial companies submitting plans for their orderly shutdown. The intent is that the cost arising from liquidation of large interconnected financial companies will not fall on the taxpayers. The Act incorporates what has been termed the 'Volcker rule', whereby depository banks would be prohibited from proprietary trading (similar to the prohibition of combined investment and commercial banking in the Glass–Steagall Act). The Act includes improved standards for regulation of hedge funds and credit-rating agencies, improved accounting standards, investor protection, and norms of executive compensation. As suggested in the title of the Act, it has provisions for consumer protection reforms and the establishment of a new consumer protection bureau and also a new Office of Minority and Women Inclusion as Federal banking and securities regulatory agencies.

UK – Vickers Commission report: The Independent Commission on Banking under Sir John Vickers submitted its report to the UK government in September 2011. The report starts with the argument that one of the *main reasons* for bank failure during the global crisis was that they had too little equity in relation to risk. There were few restrictions on leverage. The weights assigned in the 'risk-weighted' assets turned out unreliable. The erosion of equity led to concerns of solvency and contagion. Though risks in banking have to rest somewhere, they should not fall on the taxpayer. Structural separation and Ring fencing: The main recommendation is that there should be a *structural separation* between retail banking and wholesale/ investment banking. There should be a ring fence to isolate banking activities where continuous provision of service is vital to the economy and to bank customers. Domestic retail banking should be inside the ring fence. Services should not be provided from within the ring fence if they are not integral to the provision of payments services to customers in the European economic area. Banks with both retail and investment activities will need to keep these activities at arm's length but they could share information, infrastructure, etc. Structural separation would help sustain the UK's position as a pre-eminent international financial centre, while UK banking is made more resilient.Loss absorbency: The report is in broad agreement with the direction of Basel III but notes that it does not go far enough since the leverage cap is too lax for systemically important banks and has recommended that retail banks should have equity capital of at least 10 per cent of risk- weighted assets. The Commission has also recommended the introduction of a redirection service for personal and Small and Medium Enterprises (SME) current accounts which, among other things, would transfers accounts within seven working days.

Note: The text in the box is aimed at giving only a very brief overview of these documents and is neither exhaustive nor an interpretation.

standards: the Dodd Frank Act in the United States and the Vickers Commission recommendations in the United Kingdom (see Box 14.3) with the EU too having its own rules. A concern that arises is that if same standards are not implemented in all jurisdictions simultaneously, there could be scope for regulatory arbitrage that could result in financial activity migrating to less-regulated jurisdictions, as well as into shadow banking. In the short run, there are also concerns that tightening of regulatory standards, even while recovery in advanced economies from the past and continuing crisis is not over, may make banks risk averse and adversely impact financial intermediation and lending to the real sector.

14.80 **Development Issues:** The G-20 Development Agenda comprised a Multi-Year Action Plan based on nine pillars announced at the Seoul Summit, of which the French Presidency focused on infrastructure and food security for the Cannes Summit. The other pillars are human resource development; trade; private investment and job creation; financial inclusion; growth with resilience; knowledge sharing; and domestic resource mobilization. Many of these issues have been in the subject domain of a number of developmental agencies.

14.81 While India has assigned high priority to issues relating to development appropriate to country-specific conditions, an issue deserving priority is of recycling global savings for infrastructure investment. Enhancing infrastructure investment in emerging economies and developing countries would have positive implications for rebalancing global demand as also for reviving and sustaining growth. At the same time, high savings would find productive use.

14.82 **The Cannes Summit:** By November 2011, just before the G-20 Summit in Cannes, the global economy found itself in a difficult phase with weakened recovery and intensifying financial stability risks. The eurozone sovereign debt crisis came to loom large just before the G-20 deliberations. Problems in relatively small economies (like Greece) had got transmitted to the global financial markets resulting in a flight to safety. The resolution of the eurozone crisis that simmered through 2011 came to occupy centre stage in the global economic agenda, even though the G-20, as such, did not have a direct role in the matter. Also reflecting the lack of growth and high unemployment, 'growth and jobs' came to be the focus of the Cannes Action Plan

14.83 **The Cannes Action Plan for Growth and Jobs:** The Action Plan announced at the Summit reiterated the leaders' commitment to the spirit of multilateral cooperation that lies at the heart of the MAP. Key policy actions outlined included near-term actions of expeditiously implementing measures announced by euro-zone leaders on 26 October 2011. The G-20 also committed to taking significant strides towards a more stable and resilient IMS and agreed to continue strengthening financial regulation. Under medium-term policy imperatives, the G-20 leaders endorsed policy actions by members that aim to correct imbalances over the medium term and ensure progress toward strong, sustainable, and balanced growth. They also committed to working with greater resolve on pressing social issues, including high unemployment and inadequate social safety nets. The Cannes Action Plan also stresses on the need for further efforts to support capacity building and channelling of surplus savings for growth-enhancing investments in developing countries, including infrastructure development and welcomed the recommendations of the High Level Panel on infrastructure set up by the G 20.

14.84 **G-20 Agenda in 2012**: Mexico has since taken over presidency of the G-20 after the Cannes Summit and released a strategic vision of the G-20 agenda spelling out the following priorities.

1) Economic stabilization and structural reforms as foundation of growth and employment.
2) Strengthening the financial system and fostering financial inclusion to promote growth.
3) Improving the international financial architecture in an interconnected world.
4) Enhancing food security and addressing commodity price volatility.
5) Promoting sustainable development and green growth in the fight against climate change.

14.85 **Role of Finance in Development**: While on one side global forums like the G-20 and international regulatory bodies continued to deliberate on issues relating to financial regulation, the year 2011 was also marked by rising concern across the world that 'finance' had somehow got de-linked from serving the interests of the real economy and that various regulatory and compensation practices are out of sync with the needs of the rest of the economy.

14.86 The issue of compensation in the financial sector has been a major area of debate not just in the G-20 but also in the media in general. Similarly, the issue of financialization of commodities and speculation leading to volatility in commodity prices and the idea of implementing a tax on financial transactions have been contentious issues on which no clear consensus has emerged. Of late, an area of concern even among serious academic researchers has been whether the financial sector has become just too big in some advanced economies and whether its value addition is really genuine and correctly measured.

14.87 Regardless of whether these views and perceptions are correct or misplaced, these debates and the ongoing work need to be taken note of in policy. Fortunately, the Indian financial sector and its banks have thus far been well regulated and to ensure that it serves the real sector has been an abiding policy concern. Nevertheless, given the criticality of the role of finance in development, the Indian regulatory system would also need to maintain and strengthen its vigil to ensure that growth in the financial sector and the intermediation process go towards furthering economic development and financial inclusion.

Engaging the World

14.88 A recently published book notes that India has entered a 'critical decade'. It has emerged as a large and systemically important economy on the global stage. It enjoys the unique advantage of having many economic indicators in its favour, particularly a large domestic market, robust investment-to-GDP ratio, and demographic advantage. However, all of these will need to be leveraged to get the full advantage out of them. Undoubtedly this requires India to address its internal challenges, which include the long-standing problem of poverty and the development of its social and physical infrastructure.

14.89 Given its size and its profile in the global economy, India will inevitably need to play an active role at global level, not just in debates about how to resolve the continuing crisis and prevent the recurrence of similar crises in the future, but in influencing the rules for the global economy on overarching macroeconomic issues such as trade, capital flows, financial regulation, climate change, and governance of global financial institutions.

14.90 It may be argued, and in some ways it may seem the easy option, that India should take a passive stance in the current global debate and just wait out the period of crisis. But that option is no longer realistically feasible. India is already too much a part of the global economy and polity; developments in the world will affect India deeply and what India does will affect the world. There is, therefore, a need for India to engage with the world in terms of action and ideas.