16 Global rebalancing: An Indian perspective

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This chapter explores the story of global imbalances as told from the perspective of India. It argues that India should resist being labelled together with China as its interests are more fundamentally aligned with the deficit countries. India's fundamental policy challenge is less one of external adjustment than one of an internal adjustment facilitated by a buoyant global economy.

Before the global crash of 2008 there was wide divergence in opinion among professional economists on whether high and rising US trade and current account deficits represented a benign side effect of increased global economic integration, or whether they were a source of risk and instability for the world economy. Following the crash, however, it has become part of the policy consensus (articulated, for example, by the leaders of the G20 countries) that such imbalances are unsustainable, dangerous, and in need of attention.

The pre-crisis imbalances assumed several distinct, if inter-related, forms. At their most basic level, these had to do with the growing absolute size of current account deficits and surpluses across major economic blocs in the world, notably the US, Japan, the EU, the major oil exporters, and Asia (excluding Japan). The current account is conceptually the most useful measure of imbalances, as it offers an insight into the underlying saving and investment behaviour of the economy. An equally important focus of attention has in fact been merchandise trade imbalances, particularly in manufacturing, the most politically visible and sensitive sector.

These current account imbalances in turn have implied counterpart financing flows, the nature of which have also been important in the unfolding of the crisis. The combination of rising current account surpluses, capital account surpluses and competitiveness concerns meant that the financing counterpart of Asian imbalances was increasingly channelled through official intermediaries into US sovereign assets, requiring the Federal government in the US in turn to take on the transformation and credit risk associated with financing financial deficits elsewhere in the domestic economy, in particular the household sector.

It is also somewhat misleading to concentrate exclusively on net financing flows. One of the features of the build-up to the crisis was the large growth in gross flows, particularly from the private sector, which were sharply unwound as a result of the crisis, and provided a significant channel for transmission of shocks across financial systems.

This deconstruction of the various forms of "imbalance" is of particular relevance in discussing India's role and interests in the rebalancing of the global economy. India's growth model has been qualitatively different from East Asia's, whether one considers the earlier wave of successful industrialisers, Japan and the "newly industrialised economies" of Korea, Taiwan, Hong Kong and Singapore (by now developed countries); the ASEAN countries which followed, notably Malaysia and Thailand; or more recently and spectacularly, the case of China. While the degree of openness to foreign direct investment has differed across these countries and over time, all of these countries have been characterised by fast growth in output and employment in manufacturing (on the supply side) and an important role for net exports as a source of demand.

The "honorary" member

India's rapid growth in the first decade of the 21st century has caused it to be considered an "honorary" member of this Asian fraternity. While there are some characteristics which are similar, there are others, particularly in the last decade, which are distinctive and which have an important bearing on India's participation in global rebalancing. India remains significantly poorer than most of its peers, despite sustained rapid growth for almost three decades. For the present discussion, the most relevant difference on the supply side is the relatively poor performance of manufacturing, particularly manufacturing in the so-called "formal" sector, and on the demand side the relatively unimportant share of net exports as a source of final demand. Over the last two decades India has emerged with a chronically weak fiscal position and a relatively high debt stock, one that remains tolerable only because of relatively rapid growth. These structural characteristics have an important bearing on India's role in the global rebalancing that purportedly awaits us in the new decade.

These structural differences reflect themselves in the structure of India's balance of payments. In the decade since the Asian financial crisis most of the countries of East Asia have tended to run surpluses on current account. In the case of the ASEAN countries, these surpluses reflect the fact that investment rates did not recover after the Asian crisis even as saving rates remained relatively strong. In the case of China they famously reflect the fact that despite a towering (and possibly inefficiently high) investment rate, corporate and household savings are even higher, generating a large surplus on current account.

With the exception of a couple of years in the middle of the last decade when it ran a small surplus, India has typically run a deficit on current account of around 2% of GDP, which is financed by a net surplus on private capital flows, particularly portfolio flows, and, more recently net foreign direct investment. Yet this relatively tranquil picture masks a large and growing deficit on merchandise trade, now approaching 10% of GDP, which is offset by a surplus on invisibles account including both services exports and large, relatively stable remittance flows. Given India's dependence on imported oil – about 70% of domestic

consumption – the trade account is heavily affected by movements in the international oil price.

India has accumulated significant stocks of international reserves despite this deficit on the current account primarily because of a fluctuating surplus on the net private capital account. It has done so for the combination of motives characteristic of many emerging markets: as a financial safety-net in case of a "sudden stop" in capital flows, and to avoid nominal appreciation of the exchange rate.

Relatively little "rebalancing"

It is for these reasons that it is important for India that the debate on global rebalancing be conducted with greater precision. If the focus is on the adjustment of current account balances, India has little "rebalancing" to do. It may nonetheless have considerable and legitimate concerns on the impact of global policies designed to reduce imbalances elsewhere.

If the focus is more on imbalances in the trade account, however, (as seems to be the case, for example, in the bilateral dialogue between the US and China) then India's interests are perhaps more closely aligned with those of the advanced countries, particularly the UK and the US, than with its peers in China. And if the focus of policy coordination is to reduce the accumulation of official reserves by emerging market countries, then India's interests lie with those concerned to strengthen so-called "safety-net" policies and any associated disciplines on capital movements and exchange rate regimes, to avoid becoming a victim of sudden stops in net movements of foreign capital.

India's fundamental policy challenge is accordingly less one of external adjustment than of internal adjustment, but it is an internal adjustment which would be greatly facilitated by a buoyant global economy. As reflected in the current account, both the absolute levels and the relationship between aggregate saving and aggregate investment are broadly appropriate and do not require change. Equally, aggregate growth is at healthy levels and is likely to be sustained. What is needed is therefore an improvement in the quality of this growth.

Much as with the deficit advanced countries (the US, the UK or the peripheral countries of Europe), India would move to a better development trajectory if it could depreciate its real exchange rate such as to improve the competitiveness of its tradables-producing sector. Yet the paradox, and the challenge for domestic economic management, is that it needs to do so even while improving the supply of key non-tradables, including infrastructure provision in both the public and private sector, as well as a broad range of human capital enhancing interventions, such as better public education and public health.

Switching without reduction

Thus the appropriate policy shift for India is one that promotes expenditure switching without requiring expenditure reduction. Political economy considerations aside, the most appropriate policy mix for achieving the desired outcome is through a combination of fiscal consolidation, public expenditure reform and additional trade liberalisation. Fiscal consolidation in turn could legitimately include both revenue and expenditure elements, along the lines of major reforms of the systems of direct and indirect taxation currently under consideration. Of perhaps greater importance is a fundamental restructuring of government subsidies on food and fuel, which has been endlessly talked about but which keeps foundering on the shoals of vested interests and political timidity. Reduction or removal of fuel subsidies in particular should help reduce the oil import bill, releasing resources for domestic expenditure. Finally, unilateral trade liberalisation, which has been of decisive importance in reducing anti-export bias in the last decade, has now ground to a halt, partly because of the desire to retain bargaining chips for the stalled multilateral negotiations, and partly out of fears, real or imagined, about unfair competition from China.

The hypothesis underlying this policy prescription is that the real exchange rate is more durably influenced by policies, such as taxation, that affect the real economy. The issue nonetheless arises: what is the role of nominal policies, such as the nominal exchange rate, in bringing about the desired shift? In the case of China, it has after all been argued that a nominal appreciation would be important in shifting demand impulses away from external to domestic. Shouldn't the same argument apply in reverse to India? While the argument is superficially attractive, my own inclination is to be cautious. The Reserve Bank of India has gained valuable experience and credibility in managing an increasingly flexible exchange rate, which gives it all-important freedom in conducting monetary policy for domestic Indian conditions. One important by-product of this flexibility is the shifting of exchange risk assessment to private agents, and the development of hedging instruments to allow them to do so.

To conclude, India's primordial interest as a member of the G20 is the restoration of buoyant global economic activity, as that will give it more space for the necessary domestic adjustments. It should resist being clubbed together with China in the debate on global rebalancing as its interests are more fundamentally aligned with the deficit countries. Its goal should be further trade deepening of its economy, if possible through multilateral trade liberalisation – avoiding protection in the advanced countries is therefore critical. But the fundamental economic challenges for India are domestic, and this is where the bulk of its attention must remain directed.

About the Author

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After schooling in India and the UK, Mr. Bery graduated from Magdalene College, Oxford with a first class degree in Politics, Philosophy and Economics (PPE). His graduate work was at the Woodrow Wilson School of Public and International Affairs at Princeton University, from which he holds the degree of Master of Public and International Affairs. His Ph.D. dissertation research (also at Princeton) was on the monetary policy instruments of the Reserve Bank of India.