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The Global Economy:

Promises and Perils of an Uncertain Frontier

Global Monetary & Financial Issues in Uncertain Times

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Overview

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Introduction

- Monetary and Financial issues as opposed to merchandise and invisible trade (Below the line/Capital account of BOP)
- Uncertainties
  - Globalization, while stimulating economic growth and efficiency , has also induced structural uncertainties, with external events outside the control of policy makers increasingly impacting the domestic economy.
  - Conjunctural uncertainty on account of current global downturn, war on terrorism and crisis in the middle east, and Corporate governance concerns in the US.

Globalization

- Clear trend towards greater global convergence manifest in price and actual movements of financial assets, interest rates, growth and inflation rates.
- TNCs and multilateral institutions like the WTO and the IMF drivers of globalization of merchandise, services and financial markets.
- Three super-imposed levels of Globalization:
  - Firstly, merchandise trade and investment through improvements in transportation technology.
  - Secondly, Monetary and Financial assets through improvements in communications technology.
  - Thirdly, other services through improvements in Information technology.

Financial Sector

General

- Traditional link between merchandise trade balance and strength of currency weakening because of the increasing importance of invisible trade and capital flows. Thus, over the last ten years, the share of invisible trade in India's current account has risen from 15% to 35%. This, together with rising equity flows, has led to currency appreciation despite no significant change in trade balance. America's burgeoning trade deficit not significantly impacting the $.
- Time lag in supply-demand adjustment to price changes in merchandise goods, and also other services, because of structural constraints. Impact of policy or environmental change in adjustments in financial and monetary services is immediate: crises can develop rapidly because financial transfers are immediate.
- With greater liberalization and opening of the financial sector, including foreign currency markets, domestic imbalances more likely to spill over into external sector, and vice-versa. International rating agencies such as Moody's and S&P have gradually revised their criteria accordingly.

Financial Sector

Developing Countries

- Developing countries poor because of lower productivity per capita; capital flows expected to play a critical role in supplementing domestic savings to enhance productivity through investments in physical and human capital.
- Trade and investment gap bridged through hard currency debt and equity flows: mostly debt prior to Latin American debt crisis of the eighties, but increasingly equity.
- Merchandise goods always subject to competition and foreign investment of variable levels, therefore no large gaps in technology. Financial services in developing countries much more protected and State-controlled, hence,
  - Big technological gap between developed and developing financial markets in terms of products and services.
  - Riddled with considerable non-performing assets because of directed lending.
  - Too rapid opening up in advance of effective independent regulation likely to result in scams. Need to improve prudential and supervisory standards to meet global best practices with respect to accounting and disclosure to maximize capital flows.

External Economic Shocks

- Traditionally used to describe sharp variations in foreign currency income/expenditures on account of volatility of commodity prices and/or loss of absorptive capacity in major export markets. The shock transmitted to the financial sector through sharp movements in the real exchange rate: Oil price shocks of the seventies and the gulf war.
- Policy making in an open economy becoming much more complex because global monetary and financial movements respond to macro-economic management/policies not only in host, but also in other countries. Monetary policy becomes increasingly less effective when the eco opens up. Thus interest rate movements in the US can sharply impact developing countries through volatile capital movements.
- Transmission of contagion through increasingly convertible capital accounts globally and geographical location.

Managing volatility

- Sound macro-economic management centred on fiscal balance, sound monetary policies targeting inflation and growth, a self-adjusting market-determined exchange rate, and prudent reserve management calibrated to external risk profile.
- Sound regulation of financial markets and corporate governance.
- Careful and sequenced opening up of financial sector and capital convertibility.
- Lower proportion of debt, especially short-term, in capital flows, not because it is less expensive, but because foreign equity absorbs more risk.
- Policy towards volatile portfolio flows versus FDI and debt..
- IMF bail-outs to manage shocks and risky lending behaviour.
- Taxation concerns that the volatility in capital flows might be transmitted to sovereign tax bases. Tobin tax: but all short-term flows are not regressive, trade-credits, those that help hedge various risks, etc.

India's External Sector

SWOT Analysis

- Strengths
  - Invisible Exports on current account
  - Equity flows on capital account
  - Adequate Liquidity to defend currency and absorb shocks
  - Self-adjusting Market determined exchange rate
  - Low NPV of long-term debt and negligible short-term debt.
- Opportunities
  - Capital account convertibility
  - Pre-payment of costly debt
  - Supplement domestic savings to boost growth rates
  - Boost infrastructural investments
  - Upward revision of credit rating
- Weaknesses
  - Dependence on POL imports
  - Merchandise exports
  - Increase in public debt to sterilize increased money supply
  - Ability of domestic investment to absorb large FC inflows.
- Threats
  - Instability in Middle East
  - Volatility induced by portfolio flows
  - Rupee appreciation
  - Fiscal deficit

India and Current Uncertainty

- Build up of strategic oil and FC reserves in case of dependence on oil imports.
- Policies that stimulate growth and demand, as opposed to fiscal and monetary tightening.
- Diversification of current account income: broader geographical spread and greater invisible income.
- Stringent regulation of Financial markets on FATF lines.
- Restrictions and regulations should not crowd out legitimate flows from the formal to informal sector that is impossible to regulate because it is illegal in the first place.

- No significant oil reserves, but FC reserves exceed 13 months import cover at current oil prices ($ 35/barrel) or over 10 months cover @ $ 70/Barrel (India imports about 2/3 of its crude oil, but self-sufficient in products)
- Movement towards a low interest rate regime. Fiscal tightening deferred.
- Shift towards greater merchandise trade with Asia, and invisible trade outside US. Impact of recession in export markets cushioned by growth in demand for cost-cutting services.
- Anti-money laundering Act makes India mostly FATF compliant.
- Quantitative restrictions removed, tariffs lowered, interest rates market determined, currency floated.