Globalisation, Money and Finance – Uncertainties and Dilemmas*

Dear friends,

I am honoured to be invited to deliver the valedictory address at the 2006 FICCI-IBA Conference. I would like to begin by complimenting the hosts for their choice of the theme: "Global Banking: Paradigm Shift". Many distinguished speakers have participated already in the deliberations and hence I will attempt a broader overview of globalisation issues at the current juncture. My address is on "Globalisation, Money and Finance – Uncertainties and Dilemmas". These are in the nature of random thoughts - to provoke thinking and not to provide answers or practise preaching.

Globalisation – Is There a Rethink?

In the recent period, a reassessment of the costs and benefits associated with globalisation seems to be taking place. Already, the share of the emerging countries in world exports has surged to 43 per cent from 20 per cent in 1970. Domestic structural reforms in the emerging economies are unlocking the pent-up domestic demand and, in turn, enabling a greater realisation of the huge potential for growth. So, what is causing the rethink in both – the developed and the emerging economies? Several factors seem to be at work.

Firstly, the traditional postulate that the capital flows from the capital-surplus or developed countries to the capital-scarce or developing countries, seems to have been disproved in recent years. Today, we are confronted with the puzzle of capital flowing uphill (Prasad, Rajan and Subramanian, 2006) that is, from the developing to the developed countries. The world's largest economy, the United States, currently runs a current account deficit, financed to a substantial extent by capital exports from the emerging market economies.

Further, the level of financial development *per se* does not seem to determine the direction of capital flows. Prasad *et al* argue that the phenomenon

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* Valedictory address by Dr. Y. V. Reddy, Governor, Reserve Bank of India at the FICCI-IBA Conference held in Mumbai on September 28, 2006.

mainly reflects the limited absorption capacity of the developing countries in the context of relatively lower financial development. However, this explanation can be turned around. The US, which has perhaps the most well developed financial system, is currently importing capital. As the developing countries catch up in terms of sophistication and depth in their financial systems, would the pattern of capital flows change, and how? In the interregnum, the export of capital from the developing to the developed countries has no doubt revitalised global growth. But will this or can this go on?

Secondly, in a globalising world, the policy makers seem to be confronted with new realities, sometimes hard to fully comprehend. In a way, the context in which monetary policy is set leads to a confrontation with the impossible trinity – independent monetary policy, open capital account and managed exchange rate. The theory holds that at best, only two out of the three would be feasible. In practice, however, there is a shift in preference away from the corner solution with respect to financial imbalances. Currently, intermediate solutions, which were earlier regarded as 'fuzzy', are now becoming increasingly relevant. Moreover, in recognition of the differences between trade and financial integration – first pointed out by Jagdish Bhagwati – there is less certainty today about the corner solutions than in the past.

Thirdly, at a practical level, the recent experience seems to indicate that globalisation may have had accentuated potential conflicts that can impact the fabric of our societies. Outsourcing to low-wage countries to derive benefits of lower cost, has generated restiveness in the labour markets of the advanced countries, particularly in the skilled segment of tradable services that are more exposed to foreign competition. The geographical fragmentation of production base has increasingly been used by big firms as a bargaining tool with workers. Increased emigration from the developing and emerging countries has depressed wages in the advanced economies and heightened social tensions. In recent years, the contractionary effects of cooling of the housing markets may also be building up further pressure against globalisation.

Fourthly, there are wide-spread concerns about the gaps in international trade rules and regulations, the impasse in multilateral trade negotiations and consequently, a rising number of regional and bilateral trade arrangements which could rule out the use of the very policy measures that were instrumental in the development of today's mature economies and late industrialisers.

Fifthly, the rapid pace of globalisation in monetary and financial relationships has not been accompanied by an improvement in the international financial architecture. The provision of liquidity to enable the countries to weather payments difficulties has arguably been inadequate. Managing financial crisis remains largely a national responsibility. As the UNCTAD's *Trade and Development Report, 2006* has noted: ''*The bulk of adjustment in case of external imbalances is often concentrated on a group of developing and transition economies, despite the fact that the source of such imbalances may occur in the developed world''* (Overview, p. 38-39). This seems to have provoked an accumulation of foreign exchange reserves in the emerging countries.

In the wake of these developments, there is a growing expression of heightened sensitivity to the costs associated with globalisation. In the ultimate analysis, public policy has important role in managing the costs and benefits of globalisation. When the going is good, public policy is viewed with disfavour. In the face of adverse conditions, however, public policy intervention is often the only sought-after solution. Accordingly, it is the public policy which has the best chance of preserving the benefits of globalisation and ensuring that these are widely shared so as to maintain support for free trade and to stem protectionism, thereby providing globalisation with the popular legitimacy which, at present, seems to be sometimes lacking. "Making Globalisation Work" is the challenge for the policy makers so that the benefits of globalisation are sufficiently shared and demonstrably exceed the attendant costs. To quote Chairman Bernanke: *''Further progress in global economic integration should not be taken for granted…as in the past, the social and political opposition to openness can be strong… much of it arises because changes in the patterns of production are likely to threaten the livelihoods of some workers and the profits of some firms…The natural reaction of*

those so affected is to resist change, for example, by seeking the passage of protectionist measures'' (Jackson Hole, 2006).[1]

Globalisation and Monetary Policy

While considerations relating to maximising output and employment weigh as much upon monetary authorities as maintaining price stability, particularly in the developing countries, domestic inflation has increasingly become less sensitive to the domestic output gap and potentially more sensitive to the world output gap. It is, therefore, necessary for each country to take a holistic approach to the trinity of free flows of capital, freely floating exchange rates and independent monetary policy. At a practical policy level, the trinity can be regarded as implausible and difficult, but manageable through intermediate solutions that adapt to the country-specific situations. For monetary authorities, the new realities provide, perhaps, unknown challenges in an uncertain future, heightening the dilemmas in policy-making.

Central banks are often concerned with the stability / variability of inflation rather than the level of prices. However, inflation processes have become highly unclear, with soaring commodity prices co-existing with low consumer prices in an environment of high asset prices. Amidst these uncertainties, central banks are faced with the need to recognise the importance of inflation perceptions and inflation expectations as distinct from inflation numbers. The distinction between inflationary expectations and inflation perceptions in the context of inflation policy is also worth bearing in mind. More often than not, the expected change rather than the actual change in real interest rate, following a change in the policy rate, often drives the actions of the economic agents. Thus, the ability to condition inflation expectations, rather than the decisions on the policy rates, is of fundamental importance to monetary policy making now. In this context, credible communication and creative engagement with the market and economic agents

[1] Bernanke, B. (2006), ''Global Economic Integration: What's New and What's Not?'', Remarks at the Federal Reserve Bank of Kansas City's Thirtieth Annual Economic Symposium, Jackson Hole, August 25.

has emerged as the critical channel of monetary transmission as against the traditional channels.

The presence of administered interest rates, even in segments of a financial system, could hold back appropriate adjustments in real rates as a sequel to changes in the policy rates. What is surprising, however, is that the financial market rates could also display such impervious behaviour and thereby, act as the source of nominal rigidities in the economy. The recent ‘conundrum’ in the financial markets *a la* Greenspan is a case in point. As a result, long-term real rates in the financial markets have changed but not in the desired direction, posing challenges to the effectiveness of monetary policy even in a market-based system. Therefore, not only the change in real rates but also the direction of change following changes in the policy rates is important for the effectiveness of monetary policy.

In a relatively more stable economic environment, the need, the extent and the duration of the policy interventions becomes less and less. Central banks are now taking baby steps – sometimes more frequent steps and at other times after a long gap, and in both directions – to respond to, what appear to be, ripples rather than huge waves in the sea of economic activity. For instance, what is considered as a ‘neutral rate’ of interest, in the present period, appears to be much lower compared to several years before. The issue of significance here is whether the neutral rate in respect of the emerging market economies, which has been coming down in tandem with global rates, will tend to be distinctly higher than in the developed economies. If so, how much higher would be appropriate?

Even a moderate inflation rate poses a dilemma in an increasingly open-economy framework. If the domestic inflation rate of an economy, however low it may be, is higher than the average inflation rate of its trading partners, it puts pressure on the exchange rate. In this context, the question of simultaneous balance of the internal and external sectors becomes a major issue. The conduct of monetary policy inevitably involves a careful judgment on the relative weights

assigned to the domestic and the global factors and constant reassessment of these in response to evolving circumstances.

In a dynamic setting, when the financial markets are continually evolving, and payment systems and technology are changing rapidly, one may not find a clear-cut evidence of stability in monetary rules and intermediate targeting. In such circumstances, monetary authorities are being constrained to look at all relevant indicators, following a menu or a 'check list' approach. Discerning news from noise is a persistent dilemma for conducting monetary policy.

Since external capital flows to emerging economies cannot be easily predicted and can also reverse even in the presence of sound fundamentals, monetary authorities have to make choices in regard to exchange rate and monetary management, very often. The appropriate management of monetary policy may require the monetary authorities to consider offsetting the impact of foreign exchange market operations, partly or wholly, so as to retain the intent of monetary policy. The monetary authority has to decide on the extent of off-set as also the means of off-set – market based or non-market based or a combination of the two.

Financial stability considerations may require the use of interest rate tool, in conjunction with other prudential measures. Some times, there could be even a trade-off between raising the short-term interest rate and tightening of prudential norms, if the risks are perceived to originate from certain segments of the market. The highly leveraged lending operations in the backdrop of asset-price bubbles might require adjustments in the lending margins and risk-based capital requirements. An issue in this regard is the extent to which these should be considered akin to the erstwhile selective credit controls.

Globalisation and the Financial Sector

The international financial markets are currently dominated by private equity funds like hedge funds, which are largely operating outside the 'Know-your-customer'/ 'Know-your-investor' (KYC/KYI) norms. Hedge funds have long used

arrangements that allow them to execute trades with several dealers but there is now an increasing tendency on their part to consolidate the clearing and settlement of their trades at a single firm, the "prime broker". Prime brokerage poses some unique challenges for the management of counterparty credit and operational risk.

It is commonly observed at the global level that hedge funds are "opaque" – that is, information about their portfolios is typically limited and infrequently provided. The information a fund provides may also vary considerably depending on whether the recipient of the information is an investor, a counterparty, a regulatory authority, or a general market participant. From a policy perspective, transparency to investors is largely an issue of investor protection, which, in turn, depends on the nature of investors. The need for counterparties to have adequate information is a risk-management issue. Concerns about hedge fund opacity and possible liquidity risk have motivated a range of proposals for regulatory authorities to create and maintain a database of hedge fund positions.

There are some uncertainties associated with the settling of trades in newer types of over-the-counter (OTC) derivatives, particularly credit derivatives. As part of recent financial innovations, the credit-derivative and structured-credit markets have grown rapidly during the past few years, allowing dispersion of credit risk by financial players. Perhaps, it is necessary to evolve mechanisms to ascertain the size and structure of risk components, the scale and direction of risk transfers, and, therefore, the distribution of risk within the economy.

In the recent years, the issue of institutional mechanisms for the prevention and resolution of financial crises at the multilateral level has assumed importance. On the question whether the international financial architecture is now in a position to give comfort if a country were to have a problem, there are four aspects. Firstly, undoubtedly, the resilience of the world today and the private capital markets in particular, has improved enormously since 1997. Macro-economic policies and approaches of international financial institutions as well as the resilience of markets have improved. Secondly, even though in terms of magnitude, the official/bilateral flows of funds are miniscule, the very intent of such

flows, guided by broader societal consideration, gives them strength in the face of private flows. Thirdly, as we are aware, risks are never eliminated but are only mitigated. The existing international financial architecture is not adequate to prevent or mitigate the domestic and external effects of financial crisis, particularly in large economies like China and India. Fourthly, the impact of instability in times of crisis appears largely to be borne by the home or domestic public sector rather than the global private sector. Avoiding crisis is ultimately a national responsibility. In such a milieu, the policy makers are often confronted with competing positions and need to make choices in the face of daunting dilemmas.

Concluding Remarks

In a recent survey of the world economy, The Economist (September 16, 2006) predicted that the emerging economies are set to give the world economy its biggest boost since the industrial revolution. A greater integration into the global system of production and trade, supported by buoyant capital flows, is driving a widening wedge between the emerging and the developed countries in terms of growth rates. Already accounting for more than half of the world GDP, in purchasing power parity terms, they will raise their share to two-thirds of the global output in 20 years' time. It took 50 years for Britain and America to double real income in the 19th century when they were industrialising; China is achieving the same feat in nine years! Over the next decade, almost a billion new consumers will enter the global marketplace, providing an enduring stimulus to economic activity across the world.

In all humility, it needs to be recognised that despite soaring economic growth, real per capita incomes and therefore, standards of living in the developing countries remain well below those in the developed countries. As the BRIC report of Goldman and Sachs (2003) had thoughtfully projected, the average per capita income in America would still be three or four times higher than in China even in 2040. The IMF has estimated that if India's relative per capita income rises by under 2 per cent, it will take more than a 100 years to close half the distance from the developed countries' per capita income levels. If India's per capita income grows by three per cent in real terms, it will still take 69 years to close half the gap. More important, faster growth alone will not automatically

eradicate poverty; it depends on how inclusive that growth is and how the benefits of globalisation are shared.

The future will, in all likelihood, call for some radical thinking, perhaps new vistas of development in operational and institutional frameworks of monetary policy. So far, it is claimed, the emerging economies have made the work of monetary authorities a lot easier than before by subduing inflation - both commodity prices and wages - and have, in fact, gifted credibility to monetary policy. Yet, the question that is often asked is whether the emerging economies have facilitated holding of interest rates at very low levels by the central banks in the developed countries. In the face of the consequent build-up of liquidity, elevated asset prices and soaring consumer indebtedness, is there a dark side to the future? The intellectual edifice on which monetary policy is founded is rooted in the management of aggregate demand. But a supply shock arising from globalisation can produce vastly different growth-inflation outcomes, which monetary policy by itself is not fully equipped to manage. Indeed, a question that has been asked in this context is whether price stability is enough as a goal of monetary policy and how sacrosanct it is when, for instance, central banks have to contend with financial imbalances even if it means an overshooting of inflation targets.

In a FICCI-IBA Conference, it will be remiss of me not to address the relationship between the real and the financial sectors in India in the context of globalisation. Economists have for long recognised the strong complementarities between the real and the financial sectors. Financial development contributes to growth in either a supply-leading or a demand-following sequence; that is, either the financial sector development creates the conditions for growth or the growth generates demand for the financial services. It is important to recognise that the financial sector in India is no longer a constraint on growth and its strength and resilience are acknowledged, though improvements need to take place. On the other hand, without the real sector development in terms of the physical infrastructure and improvement in supply elasticities, the financial sector can even misallocate resources, potentially generate bubbles and possibly amplify the risks. Hence, public policy may have a crucial role to play in ensuring a balanced reform in both the real and the financial sectors. The criticality for the policy makers is

not only to ensure that there are no financial sector constraints on the real sector activity but also to assure that the financial sector reforms have complementarity with the pace and process of reform in the real sector in India, along with, no doubt, fiscal empowerment – as consistently emphasised by the Reserve Bank.

Thank you.