

Indian Institute of Technology Kanpur

Finatics 2011

The Global Financial Crisis, Sustainable Growth and the Rise of the G 20

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****Views expressed are personal and not those of Ministry of Finance, GOI***

Alok Sheel MOF India

Overview

- Underlying Causes
- How bad is/was global financial crisis?
- What was the policy response to the crisis?
- The Policy Response Aftermath
- Where does the Global Economy Stand Today?
- Structural Changes in the Global Economy?
- The Rise of the G 20?

UNDERLYING CAUSES



Whodunnit?

- **Proximate cause**: US sub-prime housing market
- ***Butterfly effect and globalization***
- **Ultimate causes**: low cost of capital, search for yield through increasing risk tolerance. Analysts divided into two camps
 - Global Imbalances
 - Sharp rise in Chinese surplus and US deficit
 - Savings glut drove down interest rates creating a fertile ground for leverage & risky taking
 - Policy failures
 - Monetary policy too loose
 - Financial regulation and supervision too lax

UNDERLYING CAUSES

PROXIMATE



"I THOUGHT WE WERE JUST BUYING A HOUSE!"

US Sub Prime Mortgage Market

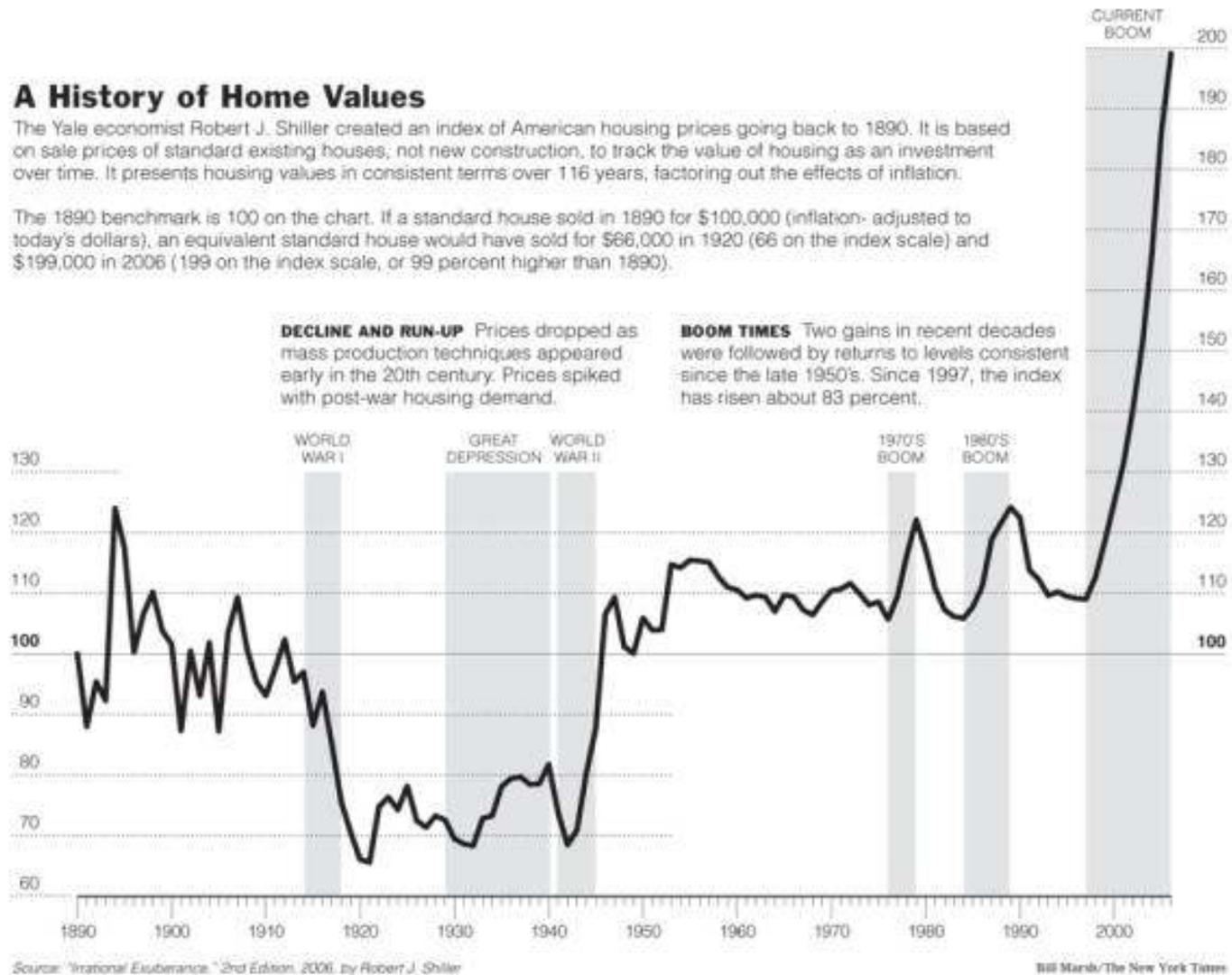
- Mortgages extended to 'NINJA' house buyers who could not afford to pay for the loan from their current income.
- Facilitated by:
 - Rising housing market
 - Low interest rates
 - Financial innovation and search for yield
 - Government support through SOAs to promote house ownership
- A small segment of the US housing market

History of US Home Values

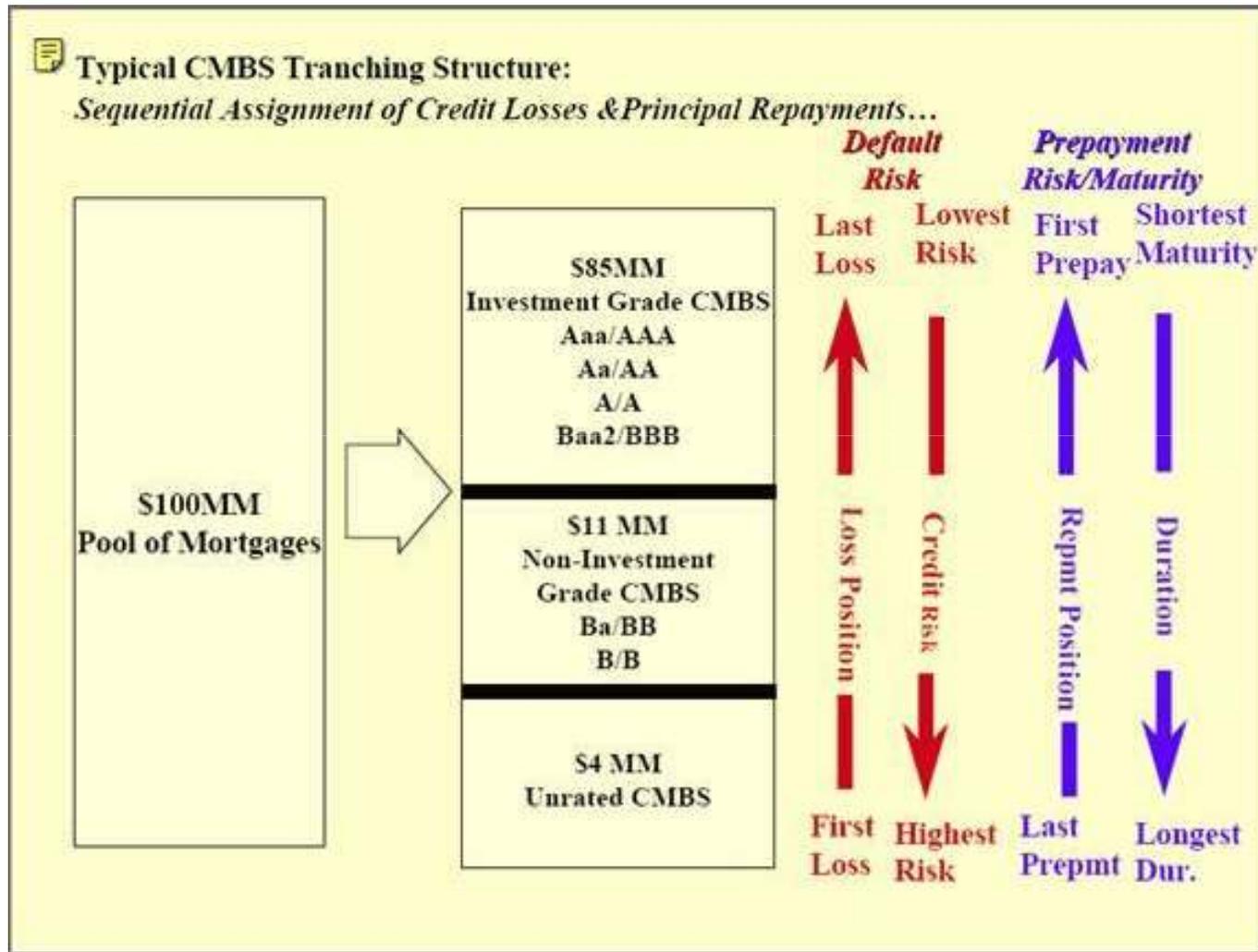
A History of Home Values

The Yale economist Robert J. Shiller created an index of American housing prices going back to 1890. It is based on sale prices of standard existing houses; not new construction, to track the value of housing as an investment over time. It presents housing values in consistent terms over 116 years, factoring out the effects of inflation.

The 1890 benchmark is 100 on the chart. If a standard house sold in 1890 for \$100,000 (inflation-adjusted to today's dollars), an equivalent standard house would have sold for \$66,000 in 1920 (66 on the index scale) and \$199,000 in 2006 (199 on the index scale, or 99 percent higher than 1890).

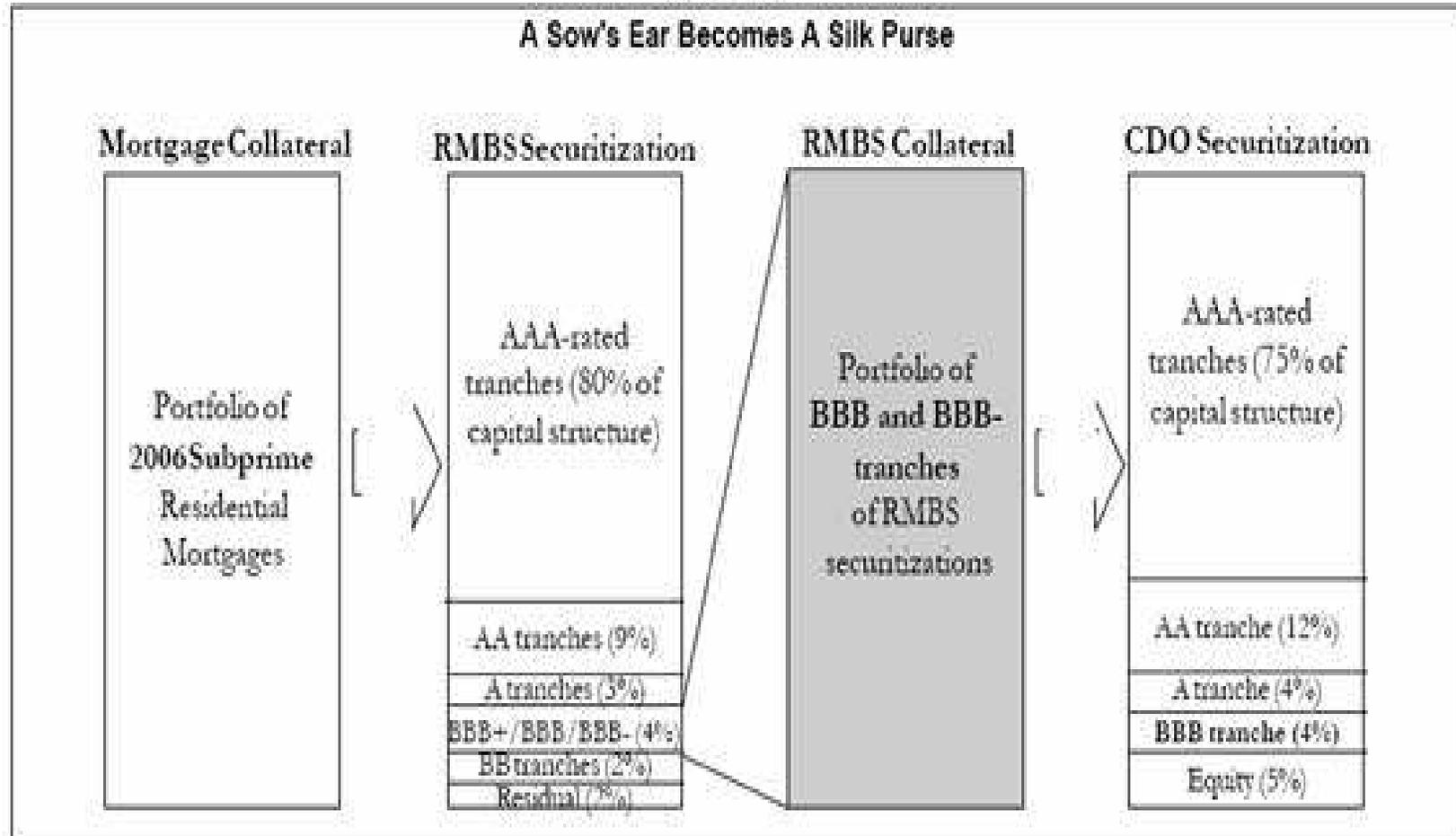


Structured Finance: Alchemy



Structured Finance: Alchemy Squared

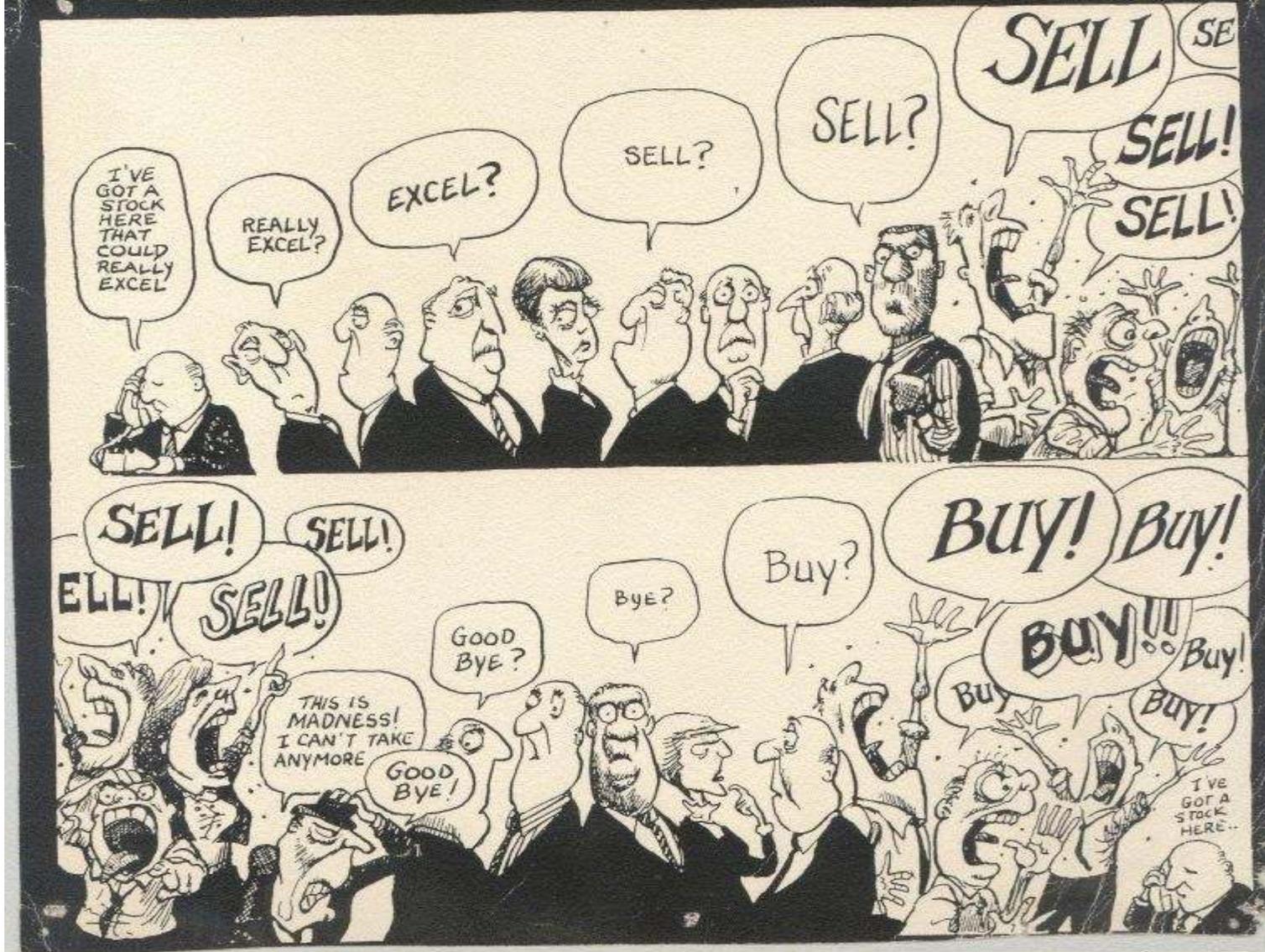
CHART 43



The Sub Prime Crisis

- Interest rates rise
- Housing prices fall
- ARMs reset at higher 'floating' interest rates
- Home equity turns negative making it difficult to buy cheaper second/third mortgages
- Sub prime defaults rise
- Foreclosures increase

A week on the wild side



Contagion

- Prices of ALL CDOs fall
 - Sub prime mortgages were repackaged with highly rated paper
 - Wide dispersion of asset backed paper
 - Information asymmetries regarding risk distribution
- CDO market collapses and ABX index plunges
- Leveraged CDO investors like hedge funds and PEFs face margin ('haircut') pressures leading to distress selling pressures
- SIVs face redemption pressure
- Cost of rolling over ABCP rises as market dries up
- Banks forced to take CDOs back on balance sheets
- Banks book losses by marking to market
- Capital adequacy norms makes bank hoard liquidity leading to credit freeze, de-leveraging and and re-pricing of risk
- LBO market dries up:banks unable to take debt off their balance sheets
- Tremors in the CDS market on account of counter-party fears
- Devastating lagged impact on the real economy as the world entered the worst synchronized recession since the Great Depression



Video Clip on Sub Prime financial crisis

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UNDERLYING CAUSES

Ultimate

Global Growth and Globalization

- **Close link between rising trend growth and globalization.**
- **Post War boom led to increasing prosperity of the American middle class: US economy over 20% of global GDP.**
- **Since the 1970s inequalities in the US rose sharply: returns to capital rose while returns to labour stagnated on account of entry of big developing countries like China and India into the international labour market .**
- **Since capital was internationally mobile and labour was not, profitability was maintained by outsourcing production and services abroad: jobless growth.**
- **Global growth and US Middle class living standards maintained by**
 - **Import of cheap East Asian/Chinese goods, and later Indian services.**
 - **Global savings glut deriving from Bretton Woods II/global imbalances lowered cost of capital and inflated asset prices.**
 - **American households reduced savings and borrowed against assets for consumption making them global consumer of last resort**

The Eurozone microcosm

- The US-China imbalance replicated in Europe in the form of the North-South imbalance
- Currency Union enabled poorer Southern Europe to borrow cheaply at German Sovereign rates
- Being more productive, given the same exchange rate, Germany more competitive than Southern Europe
- Dis-savings, housing bubbles and leveraged demand fuelled German current account surpluses, and Southern Europe deficits, even as the Euro zone as a whole remained a balanced economy.

The Goldilocks Economy

Growth and Globalization			CP Inflation	
Year	Global Growth	EGS/GDP*	Advanced	Developing
1991-00	3.1	21.5%	2.70%	44.50%
2001	2.3	23.9%	2.20%	7.70%
2002	2.9	24.1%	1.60%	6.90%
2003	3.6	25.0%	1.80%	6.70%
2004	4.9	27.0%	2%	5.90%
2005	4.5	28.4%	2.30%	5.90%
2006	5.1	30.2%	2.40%	5.60%
2007	5.2	31.2%	2.20%	6.50%
2008	3.0	32.4%	3.40%	9.20%
2009	-0.6	27.1%	0.10%	5.20%
IMF, World Economic Outlook, April & Oct.2009 & April 2010				
* <i>Export of Goods & Services as a ratio of Global GDP</i>				

The Great Moderation & Macroeconomic Anomalies

- Policy Tools getting blunt
 - Greenspan's conundrum and capital flows
 - Fiscal stimulus leakages through trade
- Inflation
 - CPI stability despite record growth
 - CPI stability alongside asset price inflation
 - Increasing impact of non-domestic factors
- Imbalances and the Dollar puzzle
 - Not responding to growing US deficits: IMF's failed forecast
 - Capital flowing 'uphill'
- LTCM rescue
 - Systemic risk and leverage outside regulated system
- Trade
 - Tradable-Non-tradable divide collapsing: proximate source of crisis lay in the non-tradable sector
 - Tariffs lose relevance because of global production chains

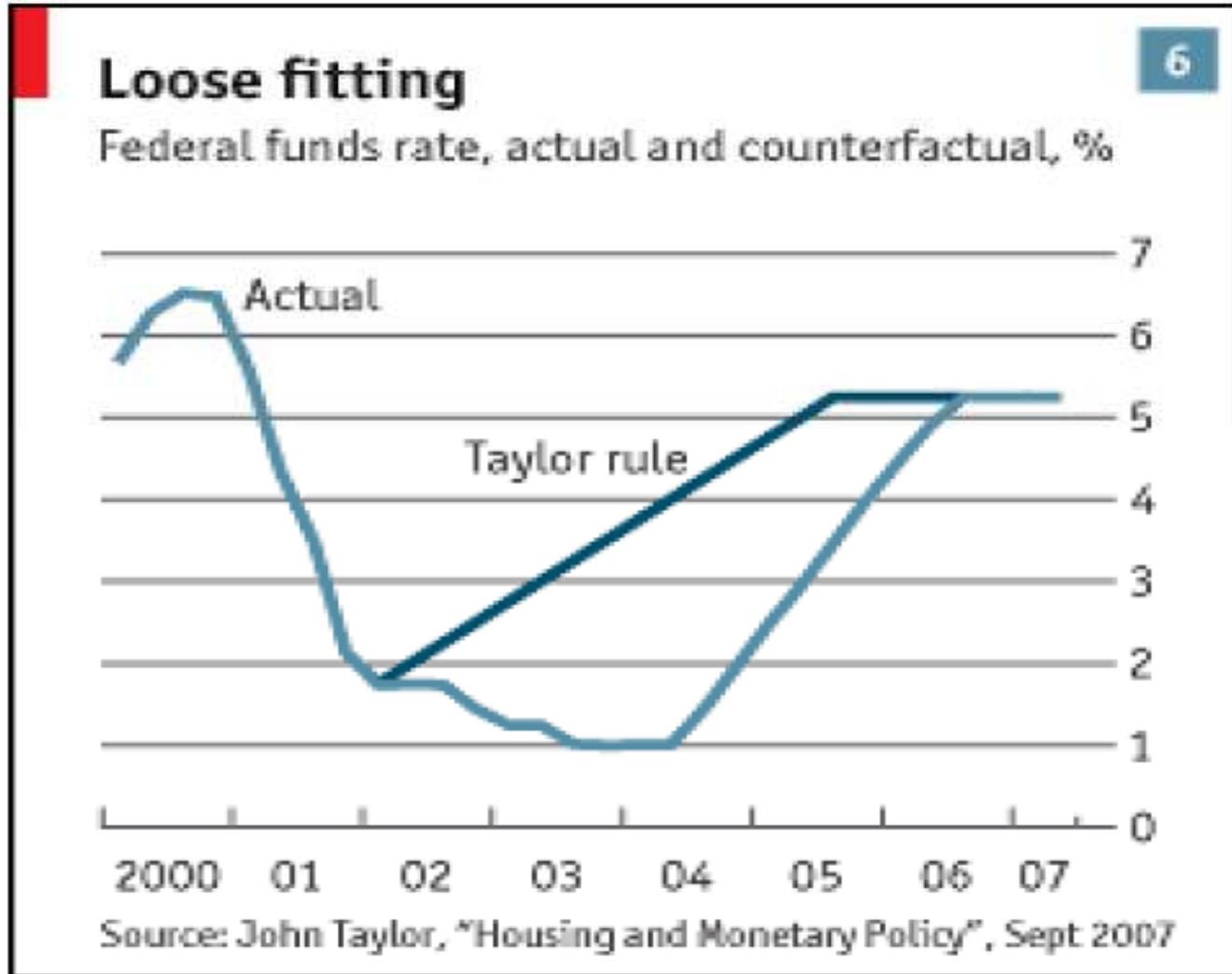
Policy Response to Anomalies

- No macroeconomic policy changes
- Economic integration far ahead of political integration
- Rise of the G 20 a post crisis response to policy challenges in the era of globalization
- G 20 policy co-ordination moderated the impact of the financial and economic crisis?

Current Account Imbalances

- **Current account surplus** between 2000 & 2007
 - of developing Asia and Middle Eastern countries rose from \$ 110 to \$ 660 billion
 - of Japan rose from \$ 120 to \$ 211 billion.
 - of Germany from \$ - 33 to \$ 250 billion
- **US current account deficit** meanwhile rose from \$ 417 billion to US \$ 731 billion.
- **Foreign currency reserves** of developing and emerging economies rose from \$ 0.8 to 4.3 trillion.
- **Private Capital** inflows and outflows to and from developing countries rose from \$ 0.55 to \$ 3.4 trillion.

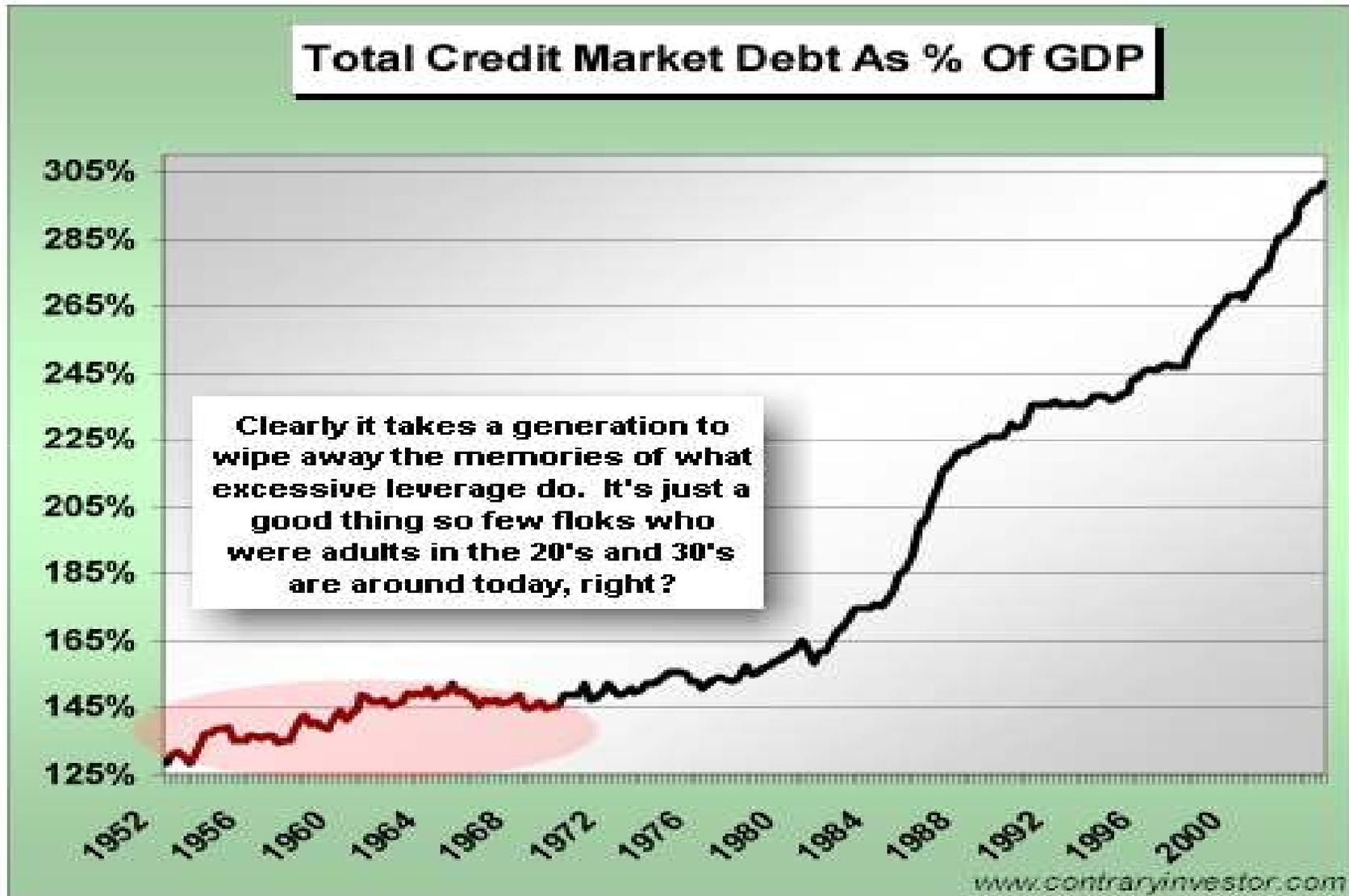
US FED: Loose Monetary Policy



Financial Deregulation

- Regulatory philosophy that permitted risky behaviour
- Repeal of Glass-Steagall Act
- Micro-prudential regulation & migration to shadow (non-deposit) banking system , OTCs and tax havens
- No lender of last resort for shadow banking
- Overleveraging, capital inadequacy & liquidity
- Financial Innovation: structured finance, originate & distribute, CDS, CDO, LBO, etc.
- Accounting policies : mark to market
- Perverse compensation policies
- Role of Credit rating agencies
- Moral hazard and SIFIs too big to be allowed to fail.

Runaway Leverage

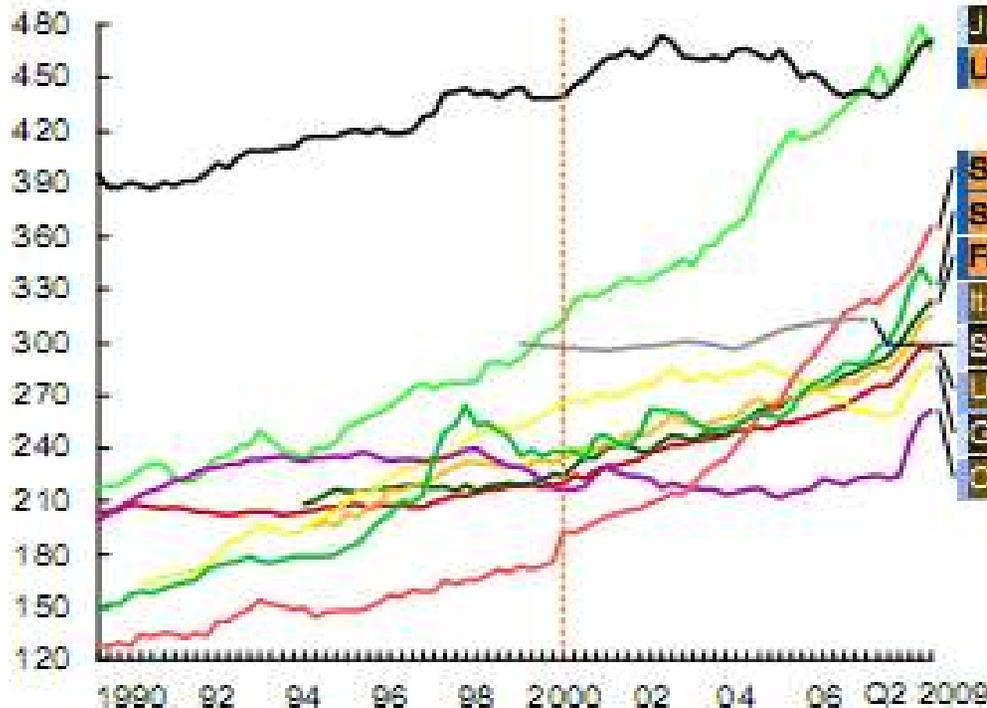


Runaway Leverage

Exhibit 5

Debt grew in most mature economies

Domestic private and public sector debt¹ by country
% of GDP



	CAGR ² , %		Change, p.p.
	1990-00	2000-08	
Japan	1.2	0.5	18
UK	3.3	5.2	157
Spain	4.1	7.4	150
S. Korea	4.3	4.2	93
France	1.2	3.9	83
Italy	2.8	3.1	34
Switzerland	N/A	0.8	17
US	0.6	3.5	70
Germany	5.6	0.3	7
Canada	0.3	1.5	28

1 "Debt" is defined as all credit market borrowing, including loans and fixed-income securities.

2 Compound annual growth rate. Where data are unavailable, the longest possible period is used.

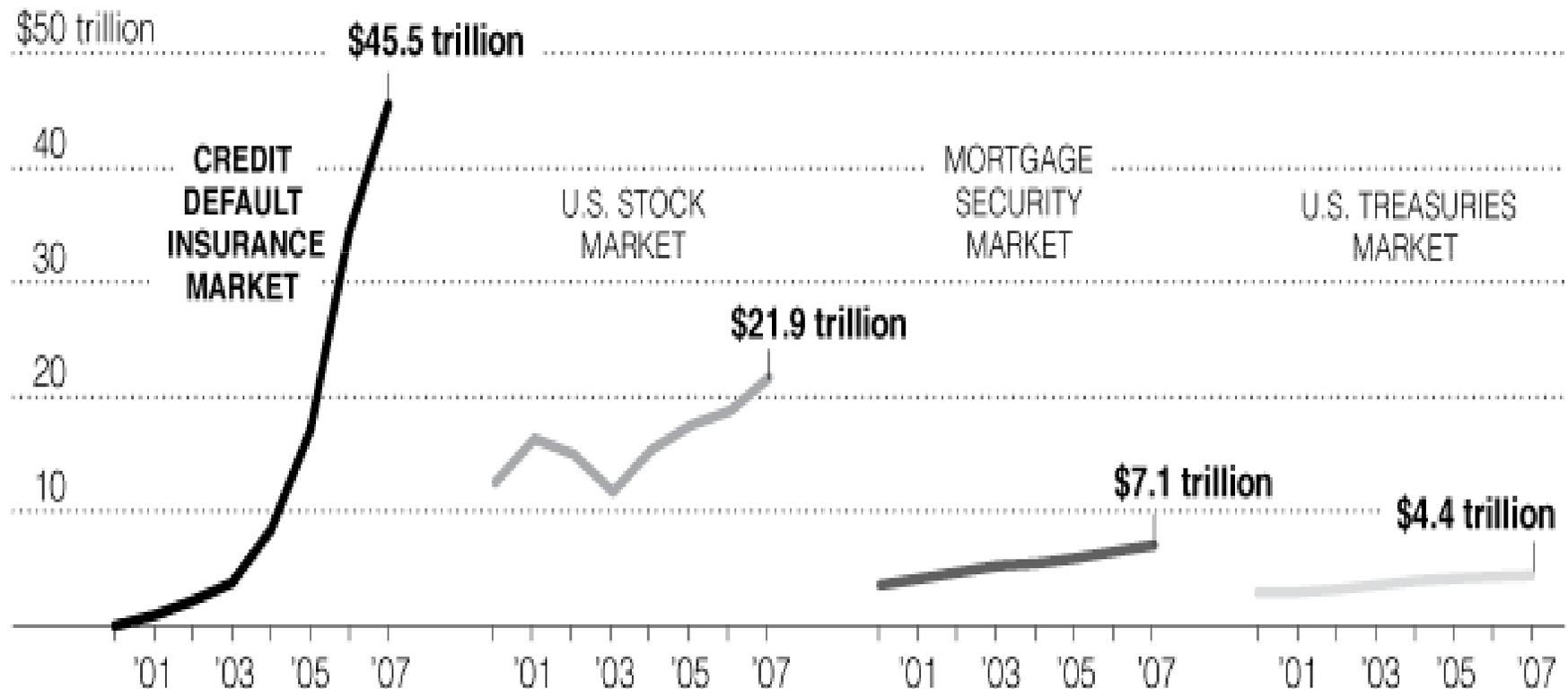
3 Even after removing foreign lending by UK banks, UK debt/GDP remains higher than every country's except Japan.

SOURCE: Central banks; Haver Analytics; McKinsey Global Institute

Credit Default Swaps

In the Shadow of an Unregulated Market

The value of the credit default insurance market is now much larger than the domestic stock market, mortgage securities market and United States Treasuries market.



Sources: Thomson Proprietary Research; International Swaps and Derivatives Association

THE NEW YORK TIMES

How Bad Was/Is It?

Comparing Recessions

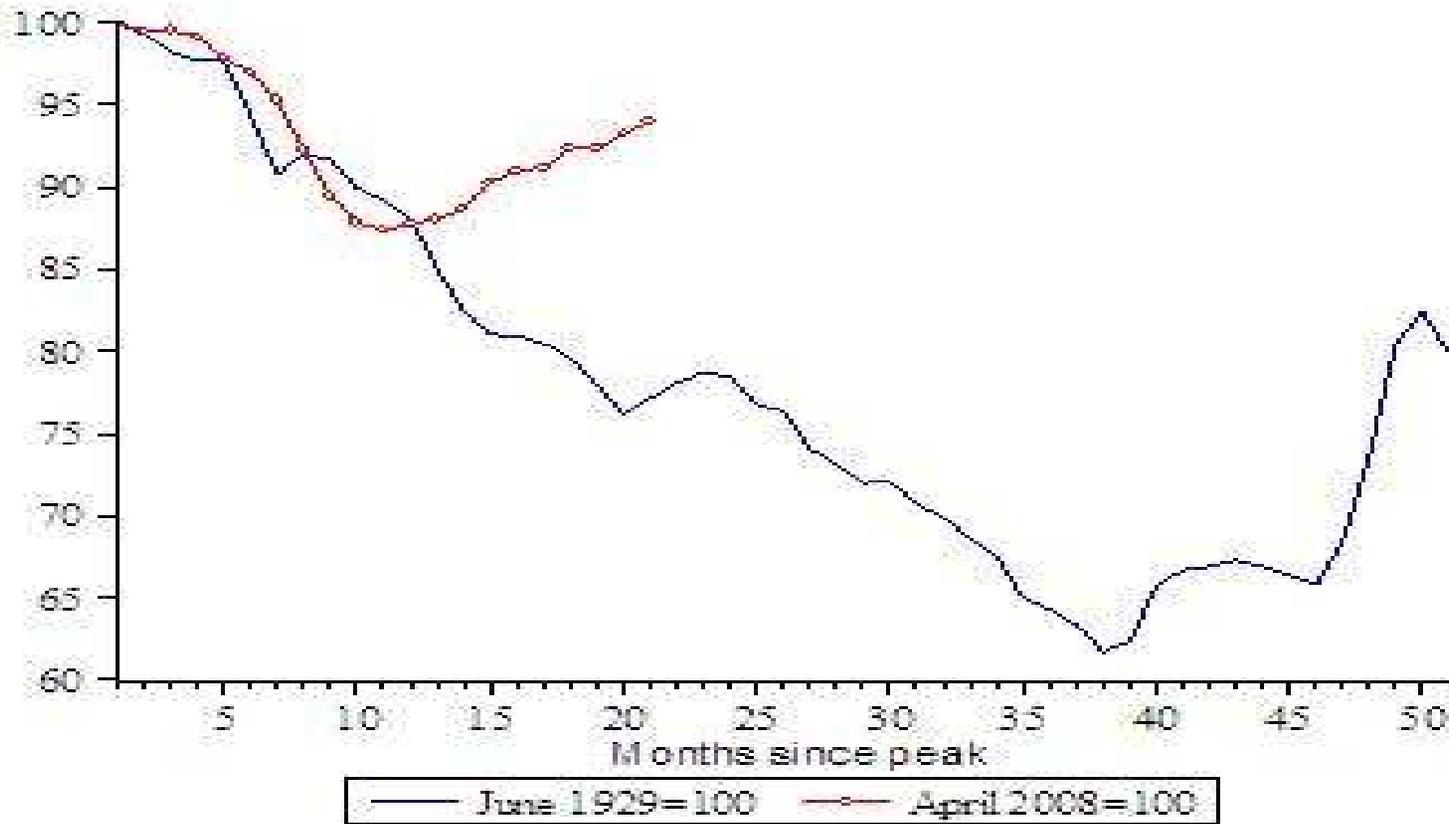
Comparing Recessions				
<i>% change</i>	1975	1982	1991	2009
Output per capita (PPP)	-0.13	-0.89	-0.18	-2.5
Consumption per capita	0.41	-0.18	0.62	-1.11
Investment per capita	-2.04	-4.72	-0.15	-8.74
Industrial production	-1.6	-4.33	-0.09	-6.23
Trade	-1.87	-0.69	4.01	-11.75
Capital Flows/GDP	0.56	-0.76	-2.07	-6.18

Parallels with the Great Depression

- Preceded by
 - **Asset price booms: stocks then, housing now**
 - **Both bubbles created by easy FED policy and credit**
 - **Problems in the international monetary system: post WWI bankruptcy in Europe made it dependent on easy US Credit then; bankrupt US dependent on Asian credit now?**
- Run on banks:
 - **Conventional then: deposit banking**
 - **Digital run now: capital market based shadow banks now**
- Collapse of financial institutions and credit
- Globally synchronized with origins in the US
- Difference: policy response

A Tale of Two Depressions*

World industrial production

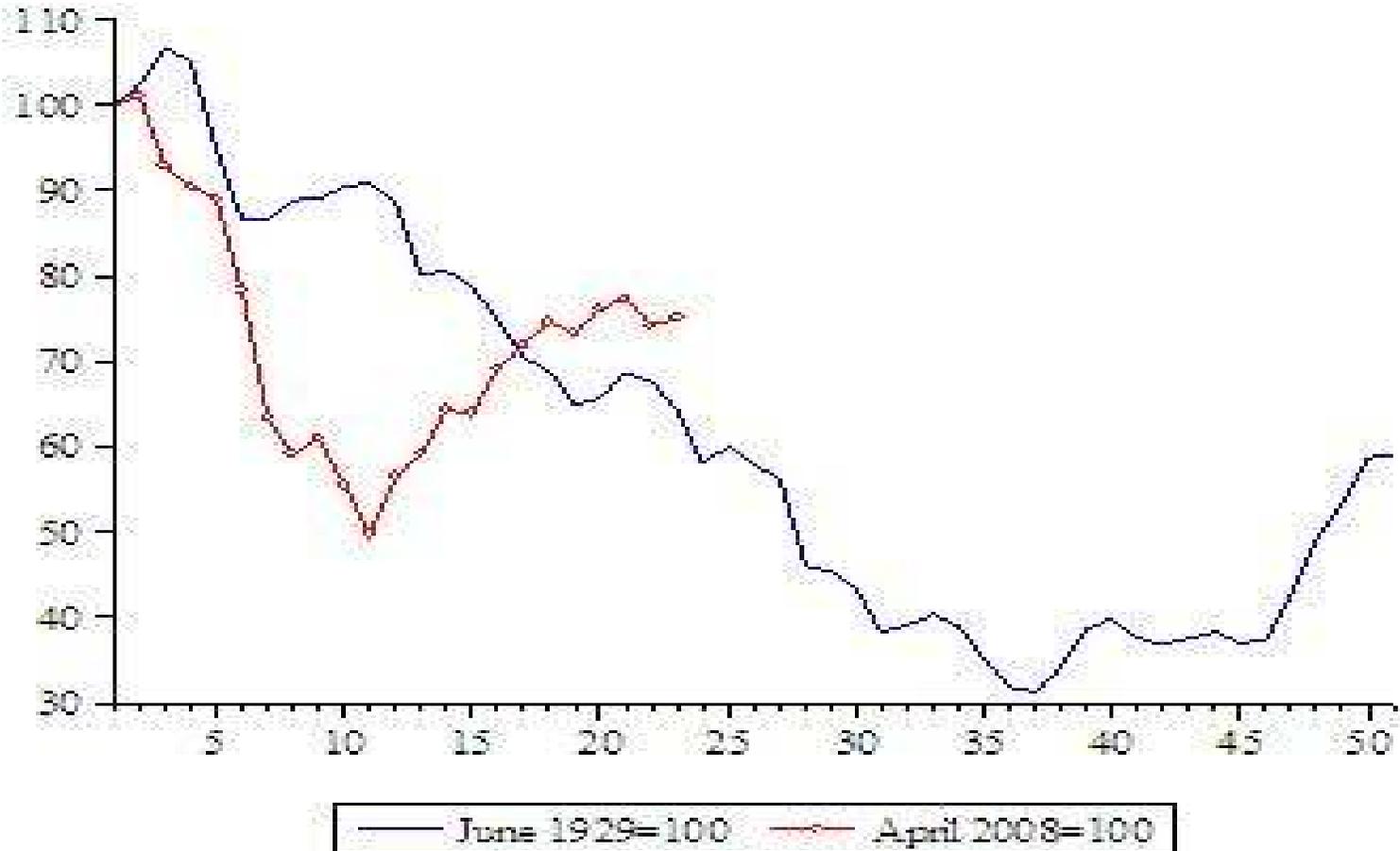


* Eichengreen and O'Rourke (*February 2010*)

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A Tale of Two Depressions*

World stock markets

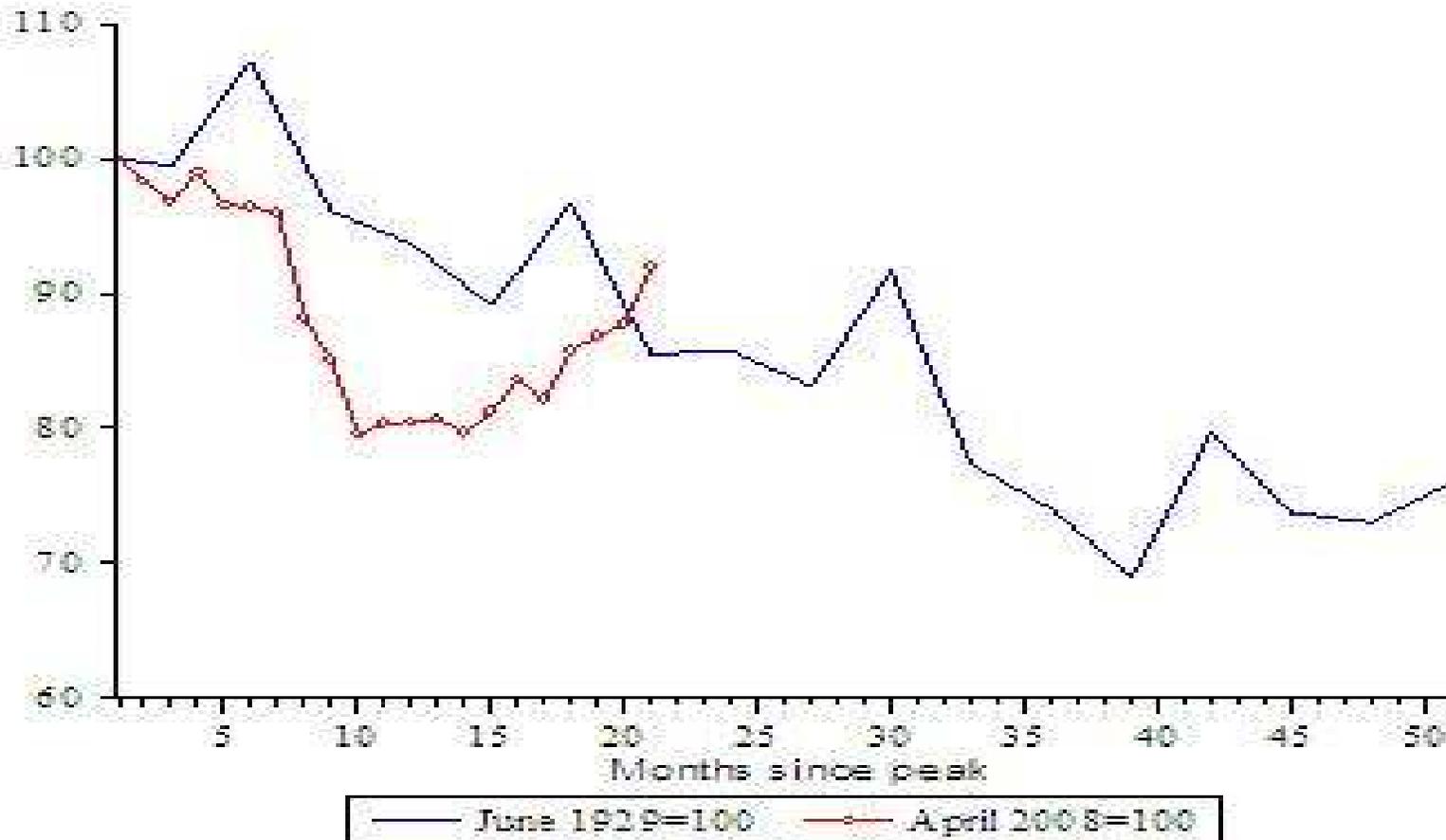


* Eichengreen and O'Rourke (*February 2010*)

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A Tale of Two Depressions

Volume of world trade



* Eichengreen and O'Rourke (*February 2010*)

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THE POLICY RESPONSE TO THE CRISIS

Modern Macroeconomic Policies

- Policy limitations of the Gold Standard
- Lessons from the Great Depression
 - Lord Keynes : Fiscal policy
 - ‘Helicopter Ben’ : Monetary policy
 - ‘Smoot-Hawley’ : Trade Policy
- Tempered by Stagflationary Seventies
 - Milton Friedman and Paul Volcker
 - Lord Keynes and Friedman/Bernanke
 - Monetary Policy the first line of defence
 - Taylor Rule
 - Pure Inflation targeting
- Policy tools blunted by globalization

The case for policy stimulus

- **Monetary Policy:** Fisher's Equation:

$$M*V = P*Q$$

M= money supply V=Velocity of Money

P= nominal prices Q= GDP

- **Fiscal Policy:** National Income equation:

$$GDP = PFCE+GFCE+I+(X-M)$$

PFCE: Private Consumption
consumption

GFCE: Government

I: Investment

X-M: Exports minus imports

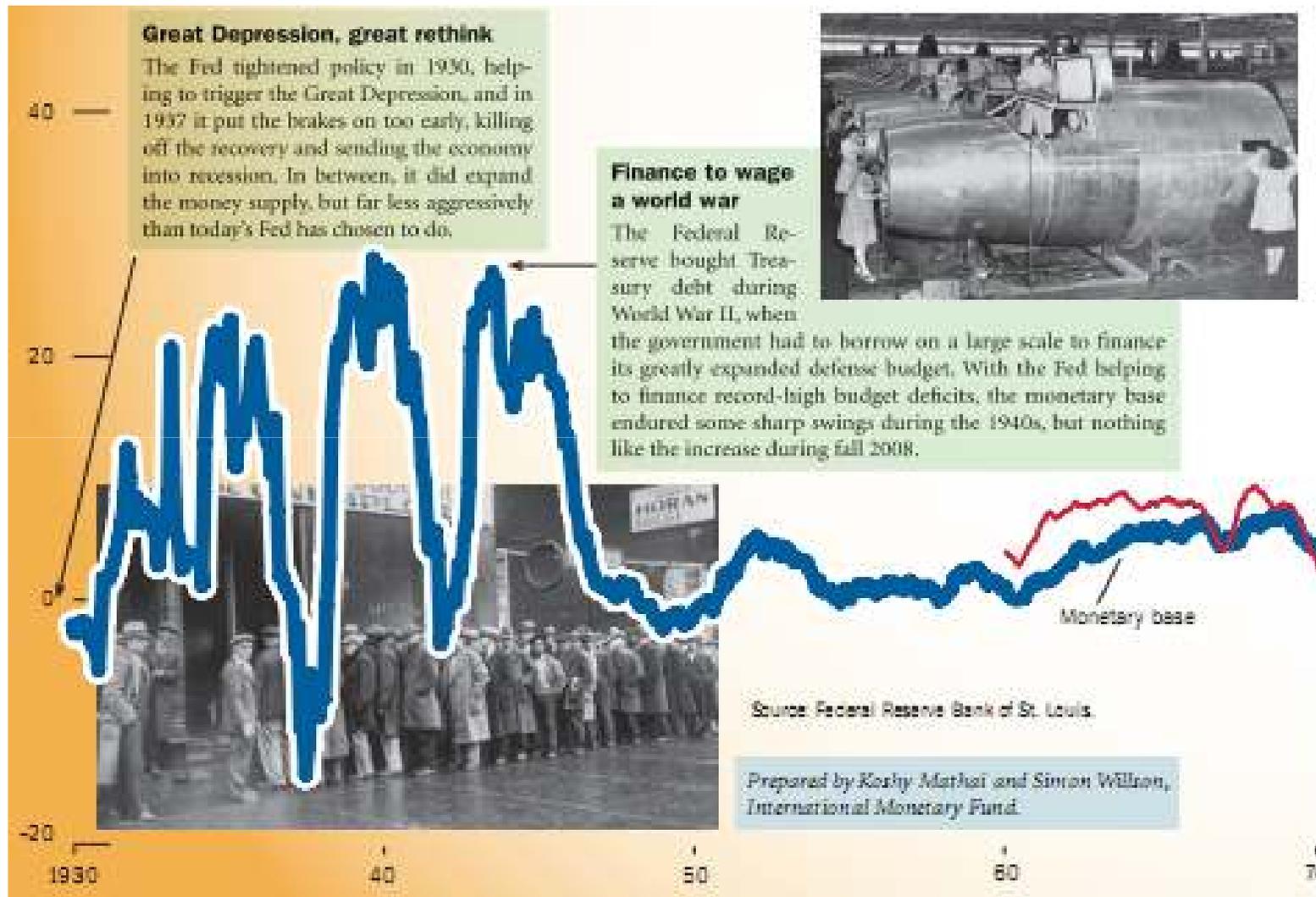
Policy Response to the Crisis

- Lower zero bound interest rates
- Unconventional monetary policy
 - Quantitative Easing
 - Credit Easing
- Re-emergence of fiscal policy as monetary policy transmission falls into liquidity trap
- Divide between fiscal and monetary policies blurred
- Virtual nationalization of the financial system: FDIC too small and SIFIs renders Bagehot Rule (lend freely in crisis, but only at penal rates and only when illiquid not insolvent) irrelevant
- Globally Coordinated Response through G 20
- Averted a Second Great Depression?

Quantitative and credit easing

- **Policy rates cannot dip below zero**
- **Deleveraging reduces velocity of money**
- **Since $M*V = P*Q$, at any given money supply a reduction in the velocity of money would lead to either a decline in nominal prices (deflation) or output, or both.**
- **Hence increasing money supply should stabilize GDP**

Monetary Policy in the Great Depression



Quantitative Easing



US Federal Reserve Balance Sheet

Date	Depository Institutions funds with US Fed in US\$ Trn			Monetary Base in US\$ Trn	TOTAL Assets in US\$ Trn
	<i>TOTAL</i>	<i>Own</i>	<i>Required</i>		
Mar-07	0.04	0.04	0.04	0.81	
Nov-07	0.04	0.04	0.04	0.83	0.9
Mar-08	0.05	-0.06	0.04	0.82	0.9
Nov-08	0.61	-0.09	0.05	1.43	2.1
Mar-09	0.78	0.17	0.06	1.64	2.1
Nov-09	1.14	0.92	0.06	2.01	2.2
Mar-10	1.18	1.09	0.06	2.1	2.3
Nov-10	1.04	0.99	0.07	1.97	2.3
Mar-11	1.44	1.42	0.07	2.4	2.6

Fiscal Policy in the Great Depression

- Herbert Hoover the Republican President
 - Limited government intervention
 - Balanced budget
 - Smoot Hawley Act and forced migration of Mexican labour
- Franklin Roosevelt, Democratic President in 1932
 - Massive relief programs : New Deal
 - US GDP recovered to 1929 level by 1937
 - Attempts at fiscal and monetary consolidation in 1937 and second dip
- Great Depression ended by WWII stimulus?
- Huge build up of public debt

Current Fiscal Response I

Table 1.1. Fiscal Balances, 2007–11
(Percent of GDP)¹

	2007	2008	2009	Projections	
				2010	2011
Overall Balance					
World	-0.4	-2.0	-6.8	-6.0	-4.9
Advanced Economies					
United States	-2.7	-6.7	-12.9	-11.1	-9.7
Euro Area	-0.6	-2.0	-6.3	-6.7	-5.1
Germany	0.2	0.0	-3.1	-4.5	-3.7
France	-2.7	-3.3	-7.6	-8.0	-6.0
Italy	-1.5	-2.7	-5.2	-5.1	-4.3
Spain	1.9	-4.1	-11.2	-9.3	-6.9
Japan	-2.4	-4.1	-10.2	-9.6	-8.9
United Kingdom	-2.7	-4.9	-10.3	-10.2	-8.1
Canada	1.6	0.1	-5.5	-4.9	-2.9
Others	4.3	1.9	-0.9	-0.7	0.0

Current Fiscal Response II

Emerging Economies	0.0	-0.6	-4.8	-4.2	-3.3
Asia	-0.8	-2.3	-4.7	-4.5	-3.9
China	0.9	-0.4	-3.0	-2.9	-1.9
India	-4.2	-7.6	-10.1	-9.6	-8.8
ASEAN-5	-1.2	-0.7	-3.6	-3.0	-2.9
Europe	2.1	0.3	-6.1	-5.1	-4.0
Russia	6.8	4.3	-6.2	-4.8	-3.6
Latin America	-1.2	-0.6	-3.7	-2.6	-2.2
Brazil	-2.6	-1.3	-3.2	-1.7	-1.2
Mexico	-1.3	-1.4	-4.9	-3.6	-3.0
Low-Income Economies	-1.8	-2.0	-4.4	-3.4	-3.2
Oil producers	2.2	1.9	-4.7	-3.2	-2.2

Fiscal support for financial sector

Table 1.3. Selected Advanced Economies: Recovery of Outlays and Net Cost of Financial Sector Support¹
(As of end-June 2010; Percent of GDP unless otherwise indicated)

	Direct Support		Recovery	Net Direct Cost
	Pledged	Utilized		
Germany ²	6.8	4.7	0.0	4.6
United Kingdom	11.9	7.3	1.2	6.1
United States	7.4	5.3	1.7	3.7
Average (end-June 2010)	7.9	5.4	1.4	4.1
In billions of U.S. dollars	1,549	1,074	265	809
Average (end-Dec 2009)	7.9	5.1	1.1	4.0
In billions of U.S. dollars	1,544	1,006	210	796

Sources: Country authorities; and IMF staff estimates.

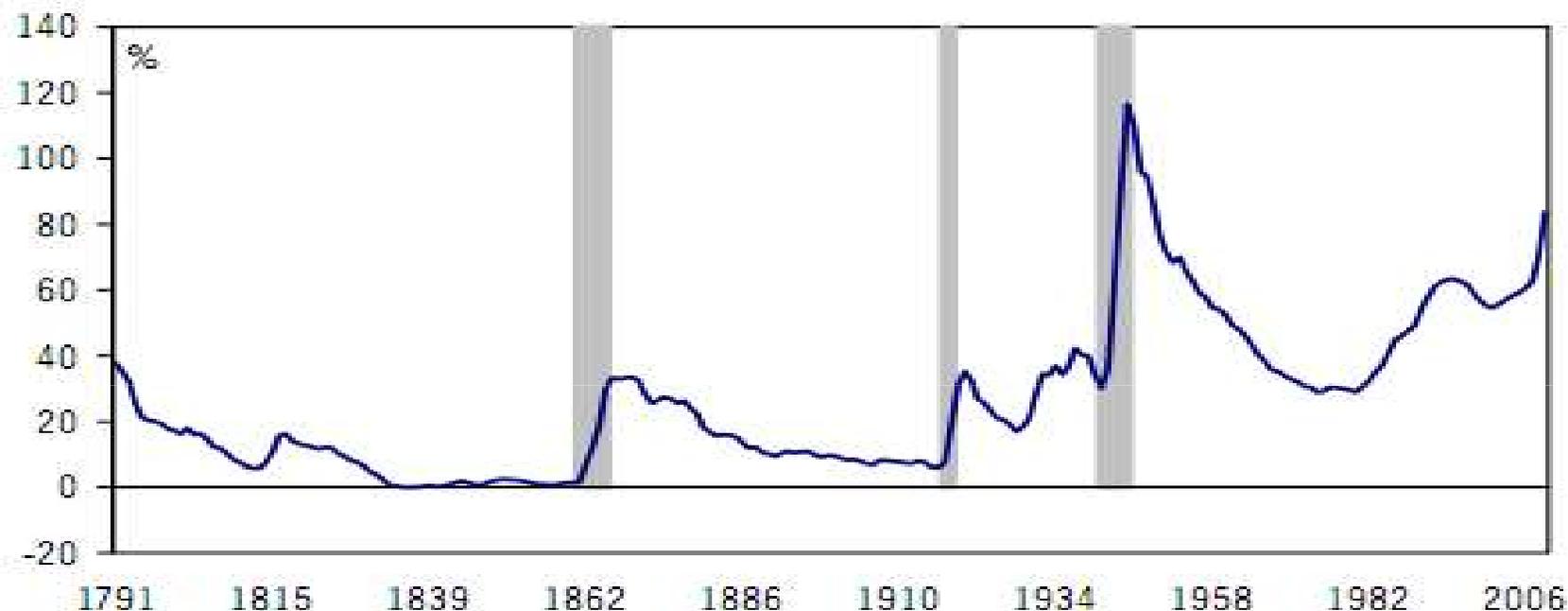
Note: Updates reflect new measures, as well as some reclassification indicated by the authorities.

¹ The three countries shown in the table account for about three-quarters of worldwide financial sector support. For more details on the support measures provided by advanced G-20 economies, see Table 5 of the May 2010 *Fiscal Monitor*.

² For Germany, the pledged amount includes €85 billion (3½ percent of GDP) for asset purchases.

Biggest Peacetime Increase in US Public Debt

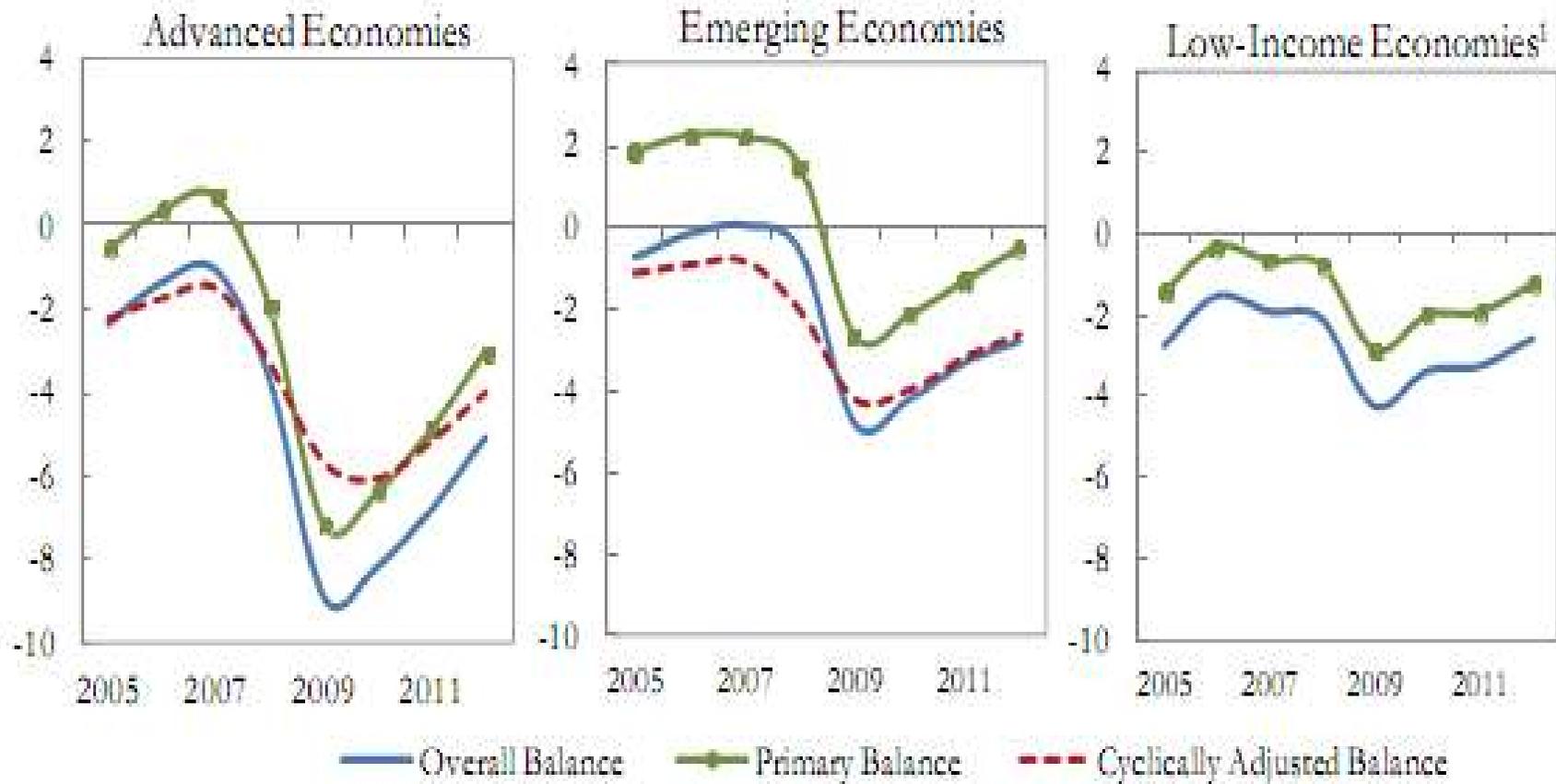
Figure 6. US – US Treasury Debt (% of GDP), 1790-2009



Note: Shaded areas represent American Civil War (1861-1865), World War I (1917-1918) and World War II (1941-1945). Sources: US Nominal and Real GDP, 1790-2009: Louis D. Johnston and Samuel H. Williamson, "What Was the U.S. GDP Then?" Measuring Worth, 2009. URL: <http://www.measuringworth.org/usgdp/> US Treasury securities outstanding: US Treasury and Citi Investment Research and Analysis

William Buiters, **Sovereign Debt Problems in Advanced Industrial Countries**. Citigroup Global Markets Global Economics View. 26 April 2010

Figure 1.1. Fiscal Balances, 2005-11
(Percent of GDP)



Source: October 2010 *WEO* and IMF staff calculations.

¹ Cyclically adjusted data are not available for several countries.

THE POLICY RESPONSE AFTERMATH

Pre-Crisis Fiscal Policy

- Fiscal policy in developed countries was not countercyclical prior to the crisis, indeed, ageing and rising welfare costs were leading to rising deficits, constraining aggressive fiscal response to the crisis.
- EU fiscal rule of capping deficit at 3% too rigid and not countercyclical
- Developing country fiscal policies on the other hand were countercyclical – case of Chile.
- Reversal of past trends: developed countries had forgotten the golden fiscal rule even as developing countries embraced it.

The Fiscal Aftermath

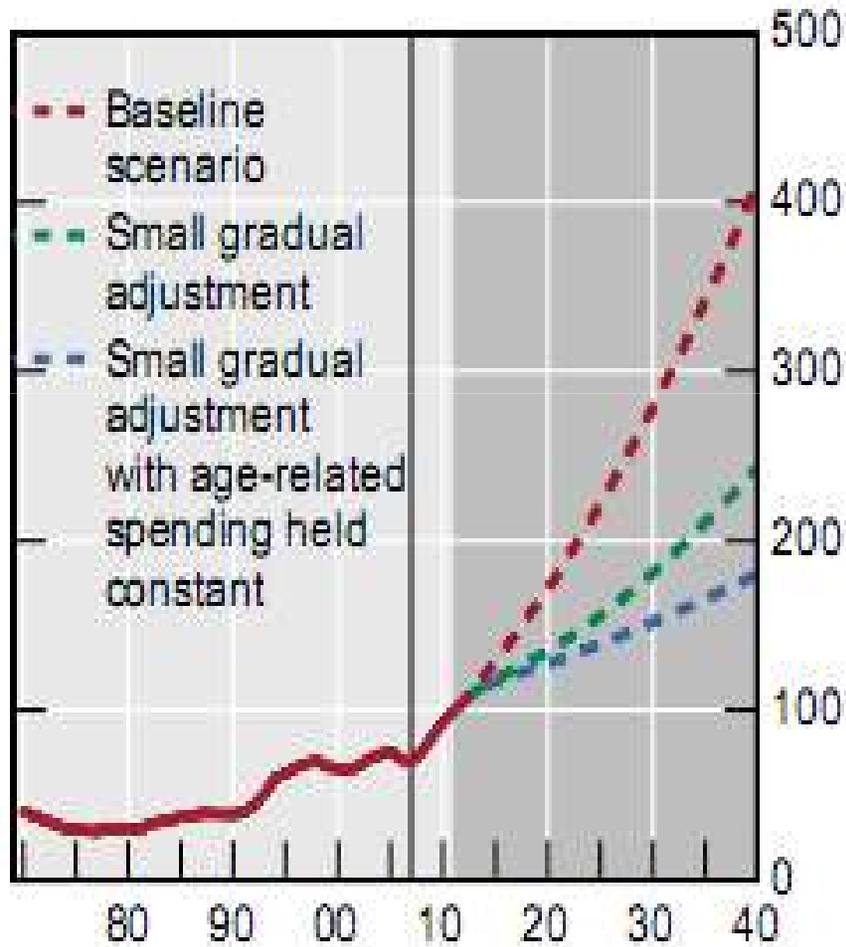
- Cyclical deficits widen and public debt typically rises after deep recessions.
- Effective macroeconomic management entails growing out of cyclical deficits and debt.
- Instead of counter-cyclical fiscal policy, structural deficits growing and trend growth declining in several advanced countries on account of ageing and welfare spending prior to crisis.
- Sovereign debt problems compounded by market response to irresponsible macroeconomic management in some euro-zone countries: PIGS
- Fears of debt trap and inflationary outcomes extends beyond PIGS.

Two views on Post Crisis Debt

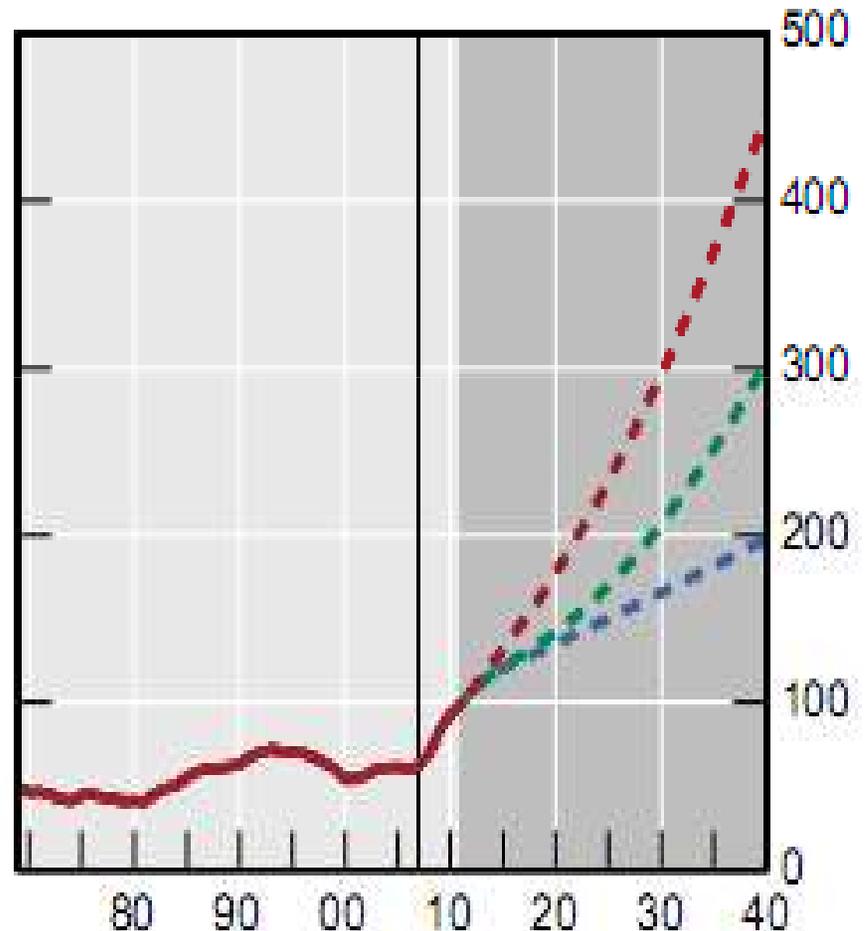
- **Barry Eichengreen:** causal link between elevated public debt post crises and lower growth is from the latter to the former, i.e little evidence of crowding out
 - Low growth means a negative revenue shock
 - Interest rates do not rise as expected because of weak private demand.
 - Deficits aimed at supporting the financial sector may actually help investment
- **Ken Rogoff:** Debt levels in developed countries have reached levels that have impaired growth in the past. At any point the interest demanded by markets on public debt could rise, making existing debt levels unsustainable

The Fiscal Aftermath

France

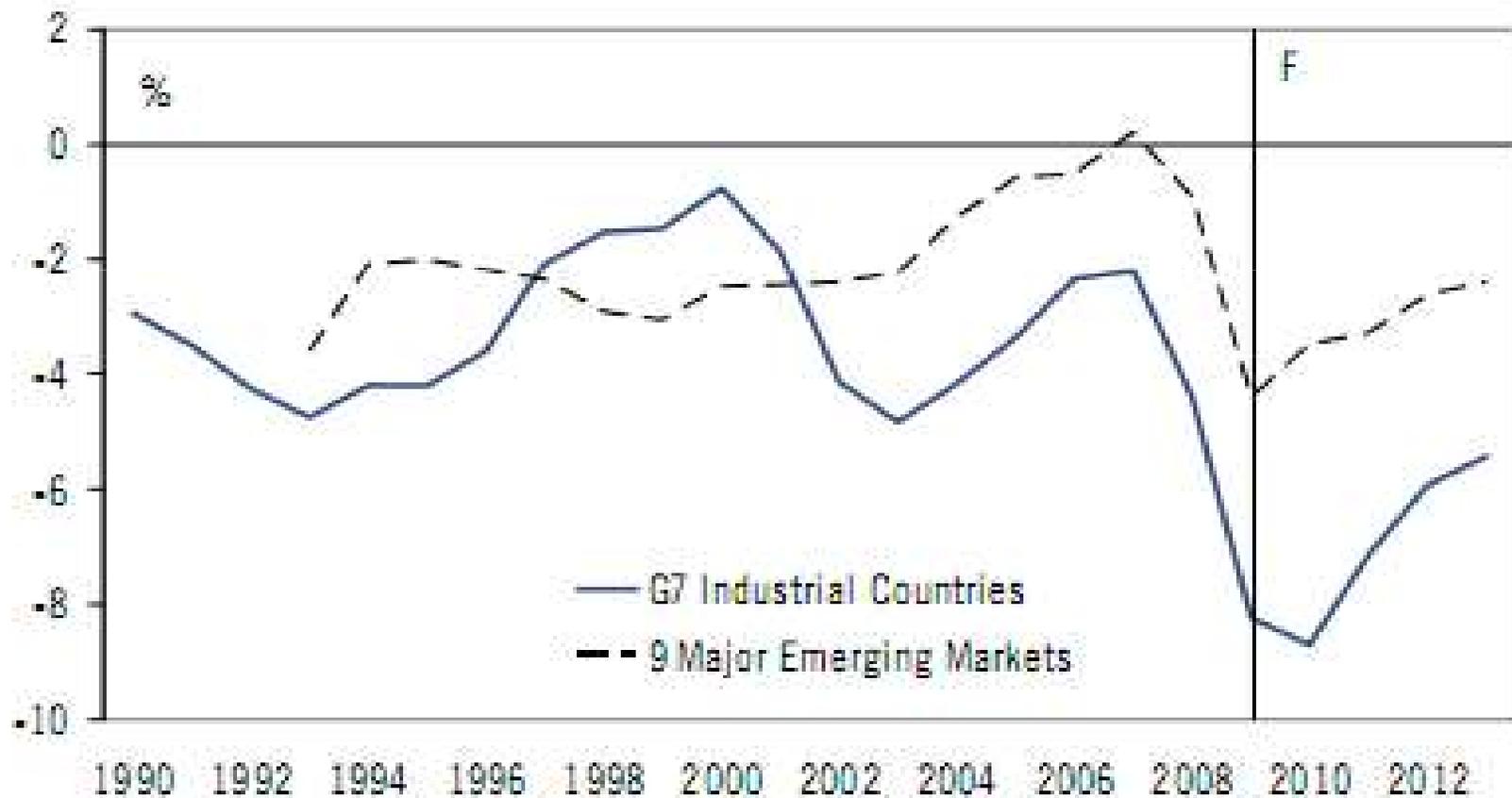


United States



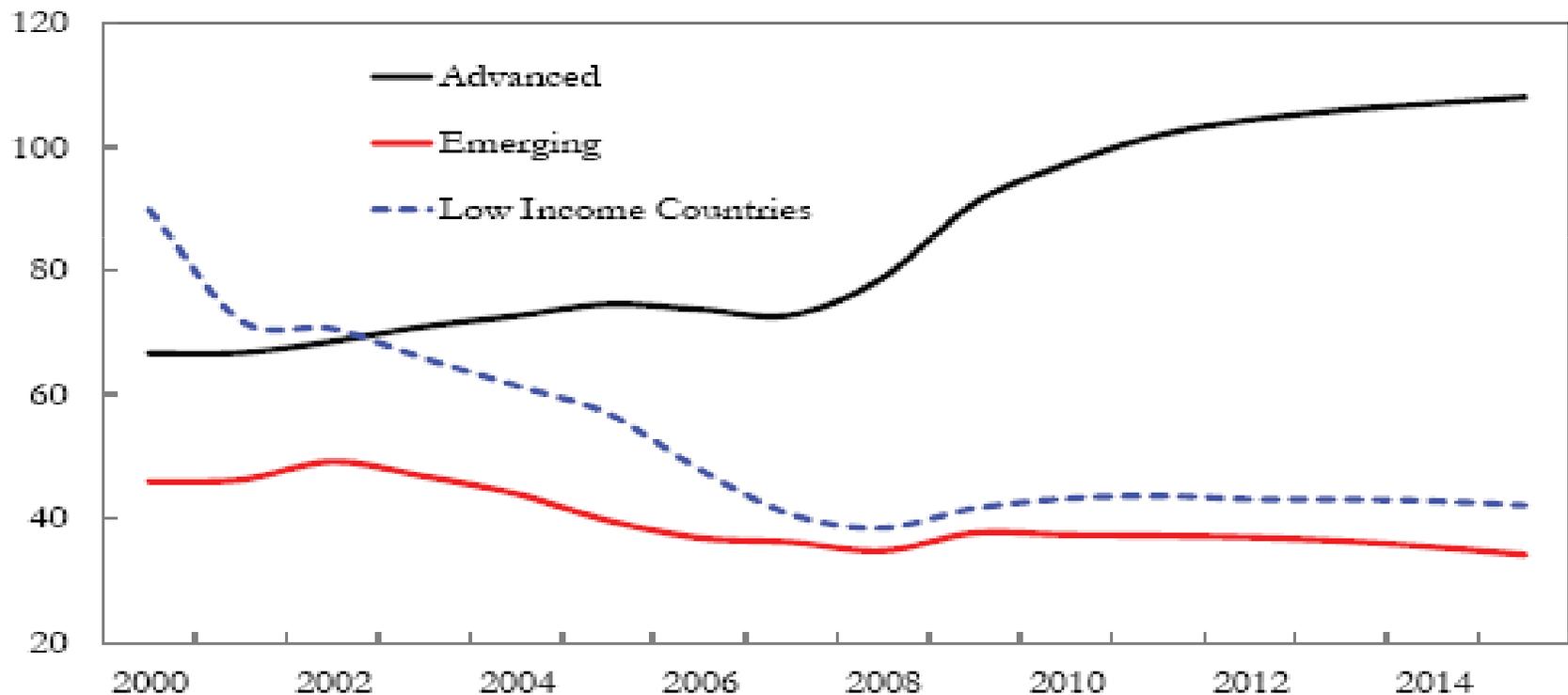
Reversal of Roles I

Figure 4. Global — Fiscal Deficits in Industrial Countries and Emerging Markets, (% of GDP), 1990-2013F



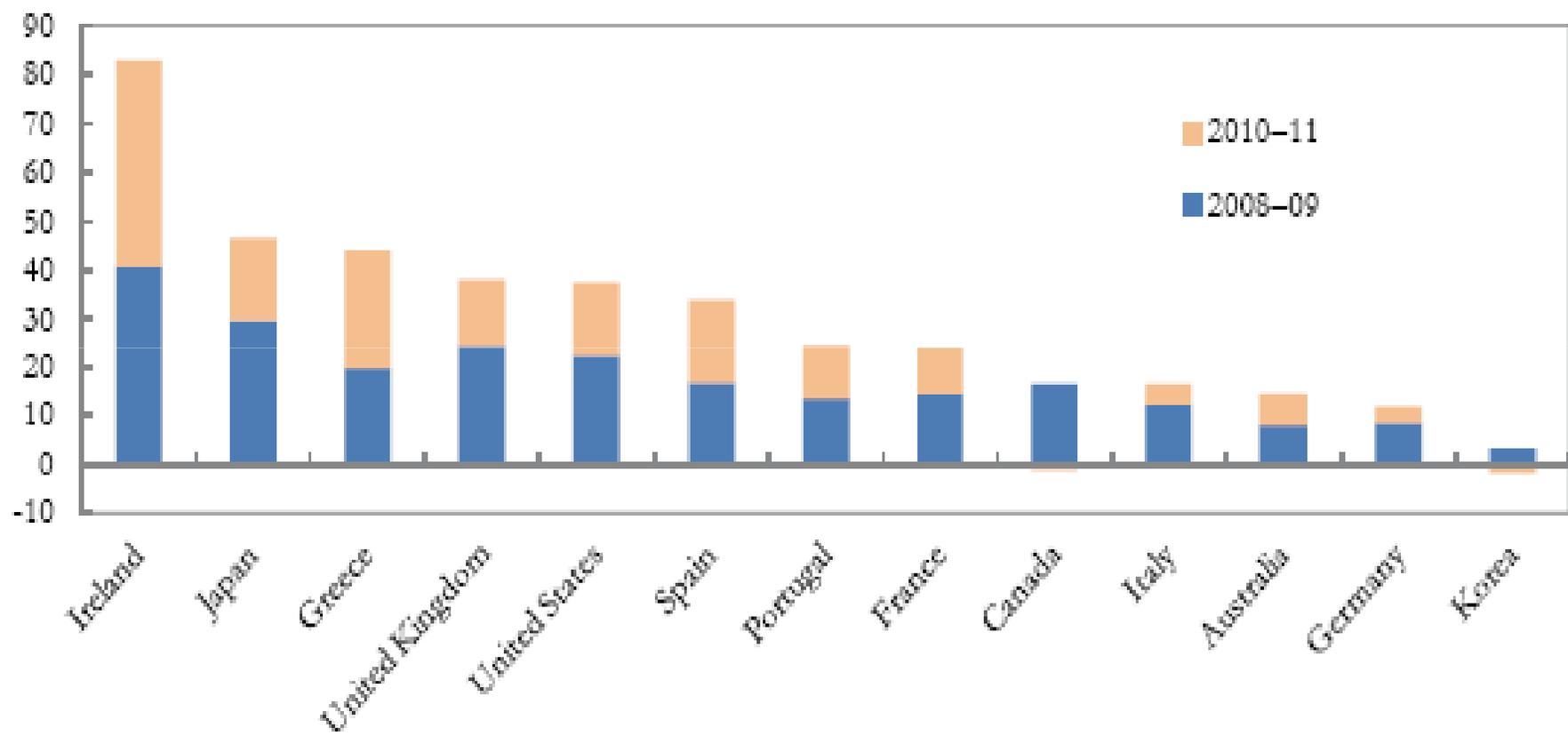
Reversal of Roles II

Figure 1.6. General Government Gross Debt Ratios
(Percent of GDP; 2009 PPP-GDP weighted average)



Source: IMF staff estimates based on October 2010 WEO projections.

Figure 1.7. Selected Advanced Economies: Changes in Public Debt, 2008–11
 (Percentage points of GDP)



Source: October 2010 WEO.

Fiscal Lessons for Developing Countries

- Social security and safety nets set up following the Great Depression being unwound now.
- Generous welfare schemes back loaded and affordable when population is young and trend growth high.
- They become unsustainable as society ages and trend growth declines.
- However difficult to renegotiate social compacts.
- Shift focus from social welfare to automatic stabilizers?
- Experience of European Stability and Growth Pact indicates that
 - Fiscal Rules should be counter-cyclical
 - hard budget constraints necessary.

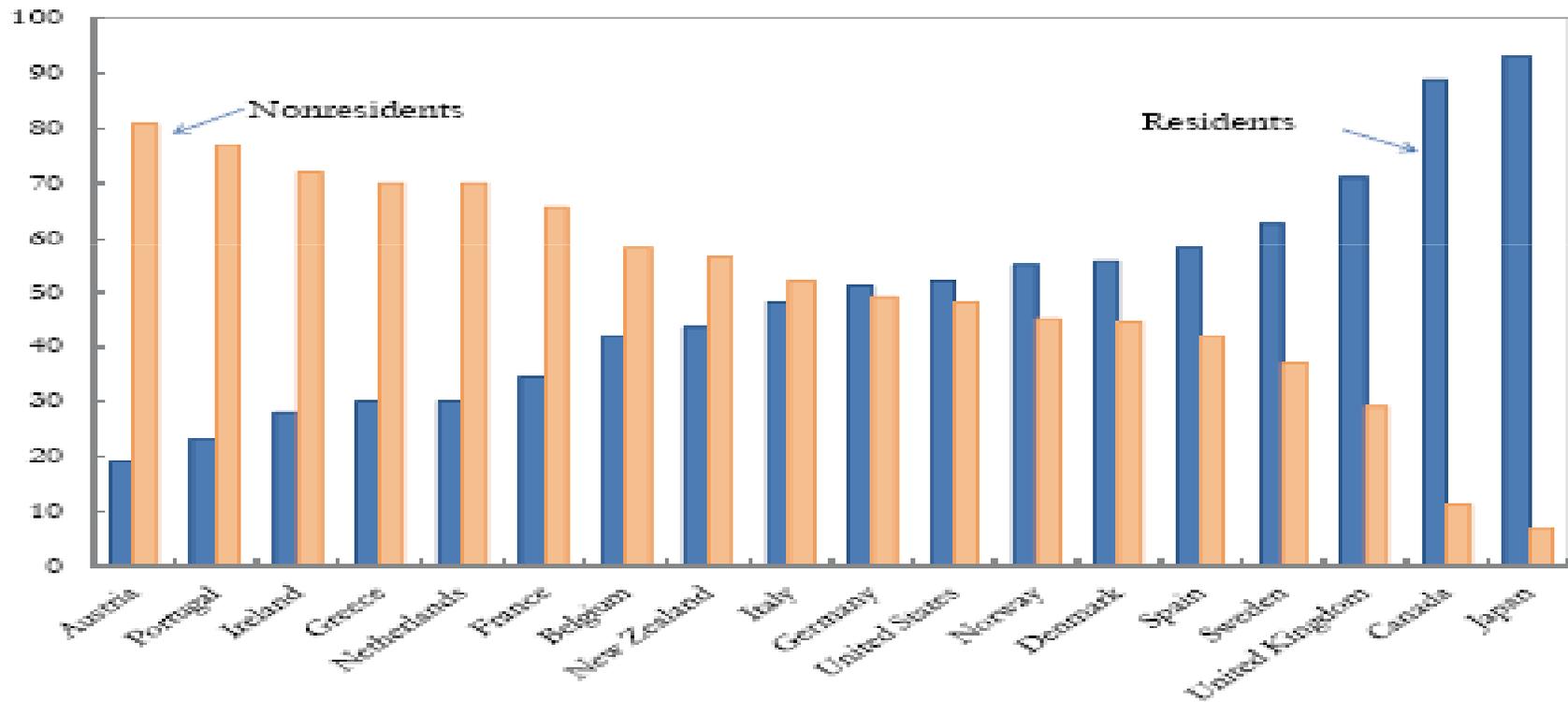
Fiscal Lessons for Developed Countries

- Deficit and debt levels should be calibrated to potential growth
- Growth creates fiscal space.
- Fiscal space likely to be created through revenue increases rather than expenditure reform.
- Fiscal space should be used wisely: for infrastructure not distorting and unsustainable subsidies.

How long can this be sustained?

- Japanese public debt 200% of GDP without crowding out impact because of externally generated private domestic saving. External environment no longer benign.
- US deficits dependent on foreign savings, and hence on continuing global imbalances.
- The tight embrace of US and Chinese economies sustained the pre-crisis 'goldilocks' economy.
- Sustainability of the model hinges on the extant international monetary system where dollar occupies the role of the global reserve currency.
- Strategic depth, first mover advantage and continuing globalization makes it difficult to dislodge the dollar.
 - Current crisis has further underscored its status
 - Chinese attempts to diversify into yen drove Japan to buy dollars to defend its currency: result same if China had bought dollars!
- European sovereign debt crisis indicates that other countries expand their fisc at their own peril.

**Figure 26. Government Debt Holding by Residence
(Percent of total)**



Source: OECD, 2010.

Fiscal Policy: Effectiveness

- New Roles:
 - Macroeconomic policy of last resort
 - Stabilizing the financial sector
 - Addressing global imbalances: China's 12th Plan
 - Major role in new forms of protectionism
- Debate over effectiveness: Fiscal multipliers and Ricardian equivalence. Japanese experience not encouraging.
- IMF's 3 Ts: Timeliness, Targeted and Temporary: Add globally coordinated.
- Fiscal policy more political than monetary. Easy entry difficult exit. Flogging fiscal policy also leads to loss of monetary independence as central bank has to accommodate.
- Monetary Policy should be first line of macro-economic defense and fiscal policy the last resort.

Fiscal Policy: Sustainability

- ‘Growth friendly’ fiscal expansion and consolidation: expenditure v/s taxes.
 - Expansion: spend rather than reduce taxes because latter might be saved? But timely exit politically difficult.
 - Consolidation: European experience shows that expenditure reduction rather than tax increase is more growth friendly.
- Sustainability linked to growth rates (R-G): India able to sustain much higher levels of fiscal deficits (over the European Maastricht norm of 3%) and public debt because potential GDP much higher.
- Developed countries have no fiscal space to respond to a second dip while major emerging countries still do.

Capital Flows

Capital Flows and Growth

- Development Economics: developing countries should run sustainable CADs to top up domestic savings with capital inflows. However:
 - Recent experience indicates capital flowing uphill
 - Recent research shows little positive correlation between capital flows and economic growth

Why Capital Flows Uphill

- Export led growth strategy along with the New 'mercantilism' where holding global reserve currency has replaced bullion as the source of national power.
- Self insurance and 'IMF stigma avoidance' following the East Asian Crisis of 1997
- Demographics : developed ageing societies become net dis-savers.
- Global reserve currency effect in case of the US.

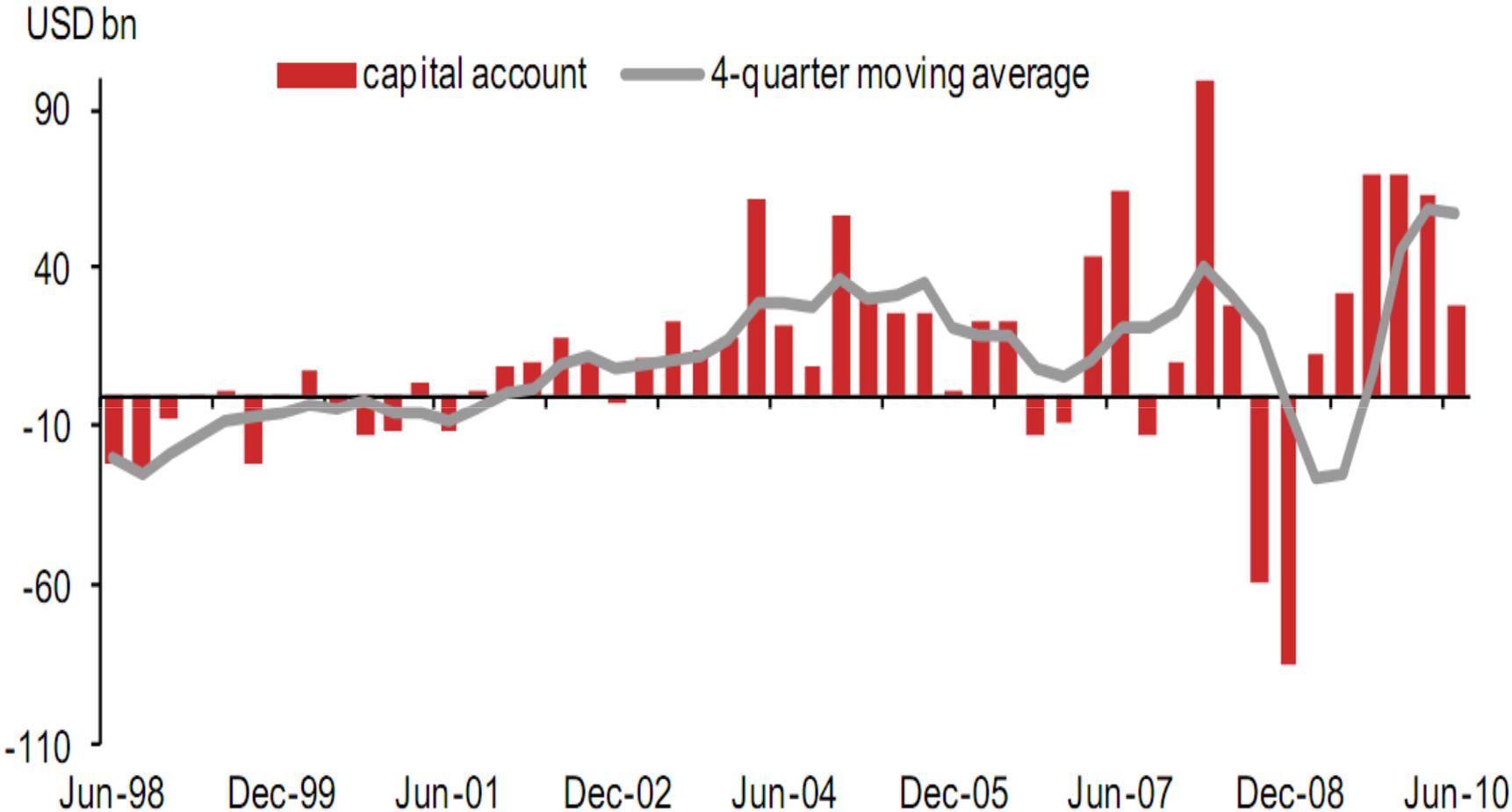
Recent Problems with K Flows

- Capital inflows far in excess of trade flows: India has accumulated reserves of almost \$ 300 billion despite a structural current account deficit of 1-3% of GDP over the last 20 years.
- Volatile (portfolio) component of capital flows increasing
- Adversely impact the real economy through sharp fluctuations in exchange rates
- Queers pitch for monetary management: the impossible trinity
- Awkward timing: Too much when not needed, and sudden stops when required
- US Fed policy impacts direction of flows: IMS debate
- Excess inflows lead to asset bubbles in EMEs

Addressing the Problem

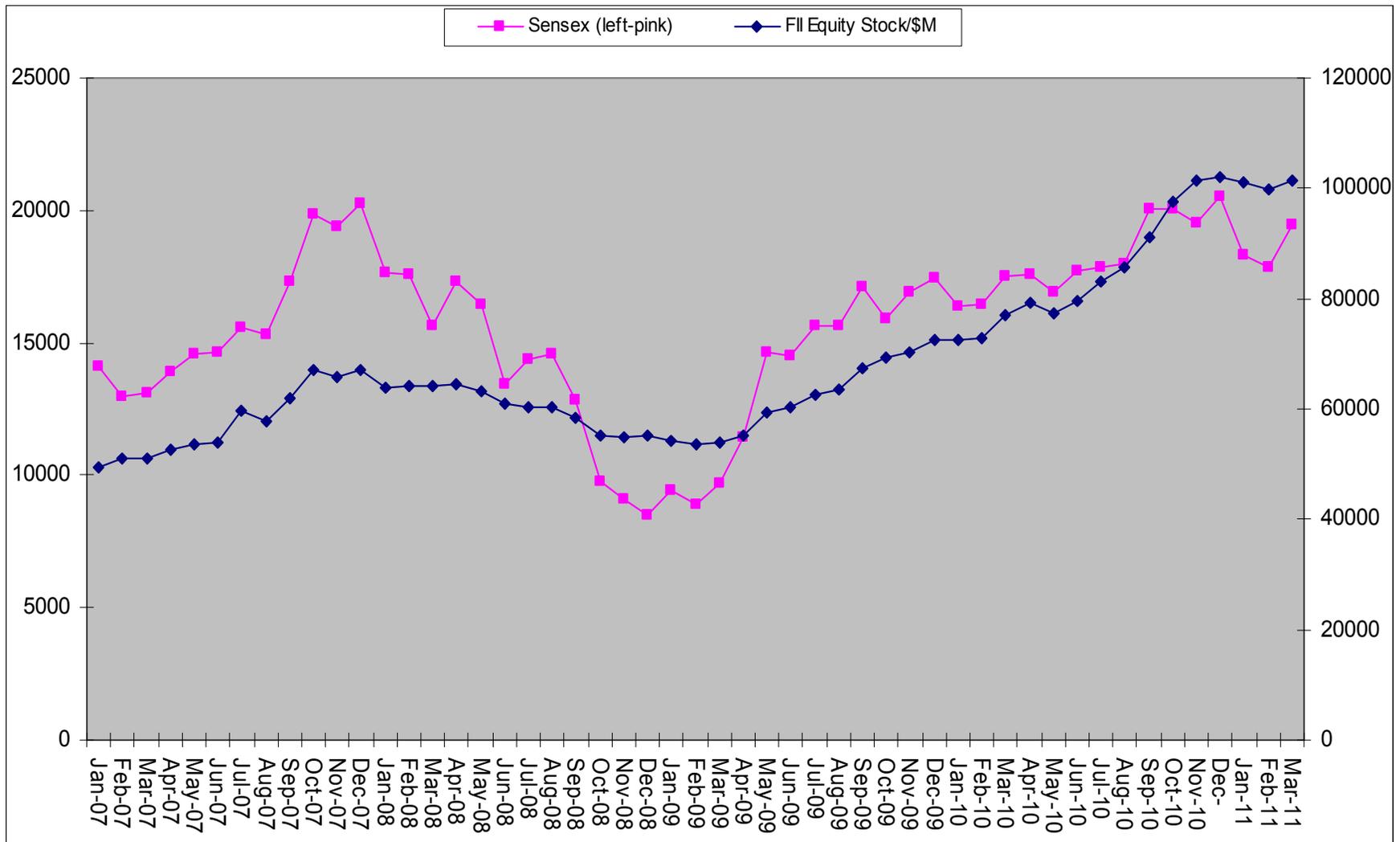
- Volatile flows have revived talk of ‘Tobin Tax’: requires high level of global consensus
- Central Bank intervention in currency markets
- IMF’s evolving views on capital flows: from recommending capital account convertibility to regulating inflows, including using capital controls as last resort
- G 20 grappling with the issue: Financial Safety Nets and IMS work streams, but no practical ‘innovative’ solution in sight yet. Focus on sudden stop rather than on surge.

Figure 1: Net capital flows to Asia have returned quickly and are hitting record highs



Source: CEIC; Nomura Global Economics.

Asset Bubbles? India: FII Stocks and Sensex



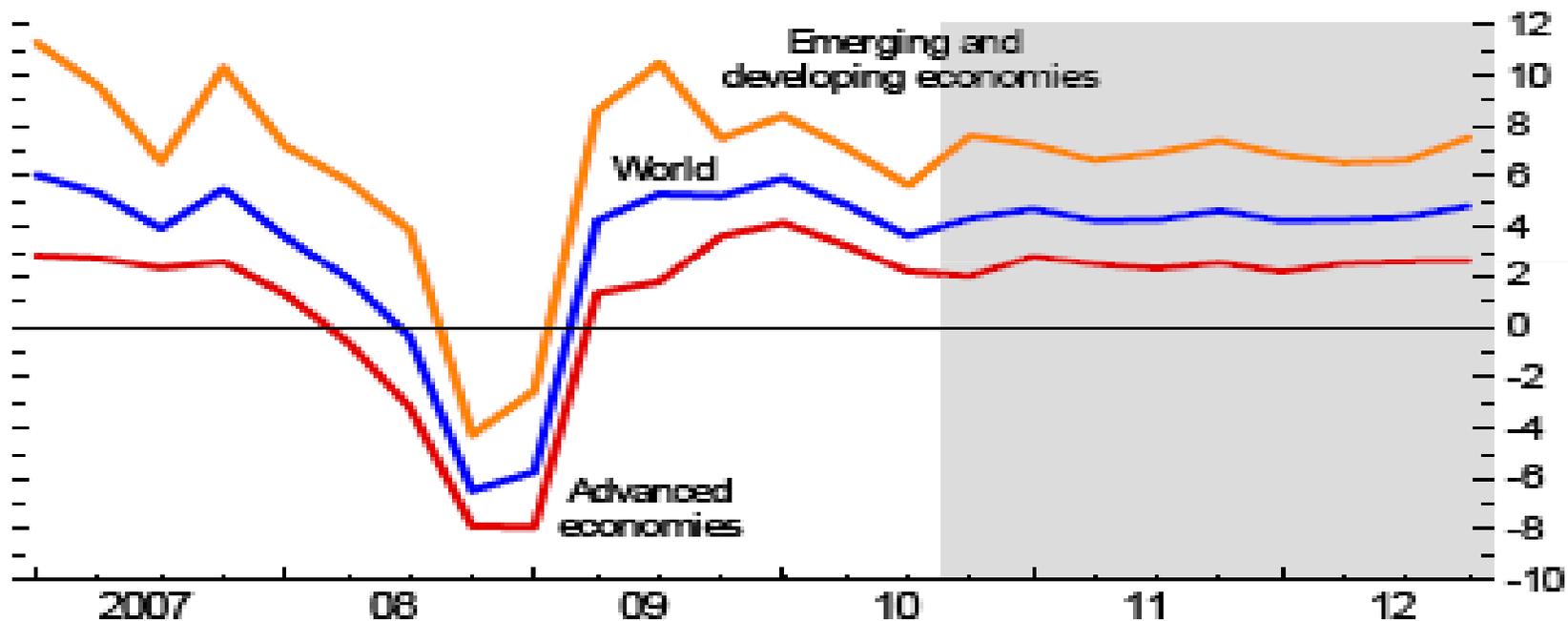
WHERE DOES THE GLOBAL ECONOMY STAND TODAY?

Global Economy: Recent Trends

- Highly differentiated recovery : literally two worlds
- Adverse fall-out of policy response to crisis:
 - Volatile capital flows in emerging markets (*monetary Response*)
 - Sovereign debt crisis in developed countries (*Fiscal Response*)
- Risks in financial markets still remain in developed countries
- Rising food and commodity prices
- Unemployment just beginning to recede from crisis highs
- Downside risks elevated: just as animal spirits were returning new concerns due to revolution, war, natural disasters, rising food prices and debt crises
- Risk of disruption in global cooperation high: growing unilateralism – protectionism and currency markets
- No policy space for ‘second dip’: trade policy?

Recovery Stronger than Projected in 2010 H1, but differentiated and slowing

Figure 1. Global GDP Growth
(Percent; quarter over quarter, annualized)



Source: IMF staff estimates.

Source: IMF, World Economic Outlook, January 2011 Update.

Alok Sheel MOF India

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Markit ABX.HE Closing Prices

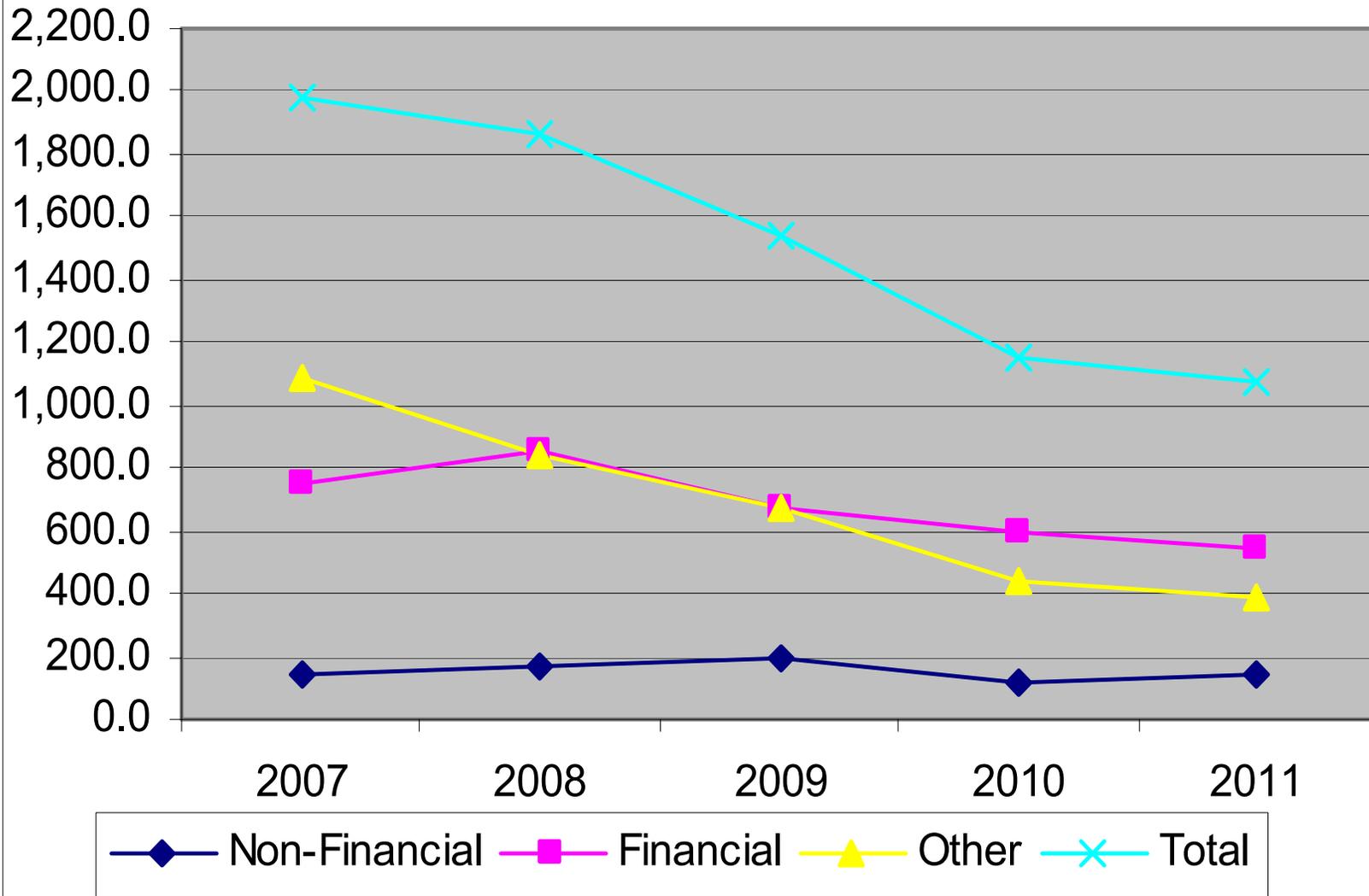
Register your interest in the Markit ABX.HE

Factors Effective: 2011-03-25

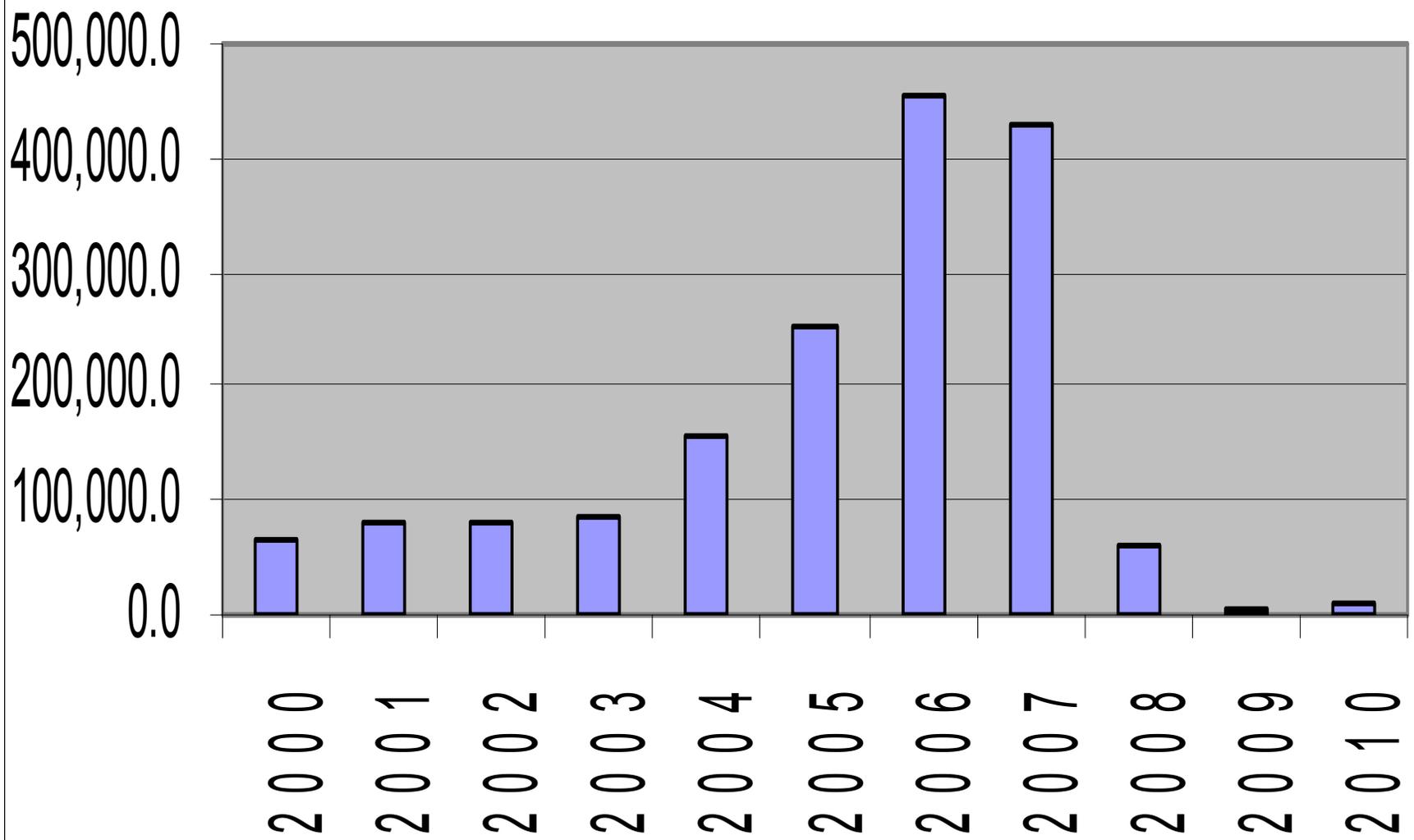
07-Apr-11 Overview

Index	Series	Version	Coupon	ISIN ID	Price	High	Low	Factor
ABX.HE.ITENAAA.07-2	7	2	75	CA05AWAD01	47.29	70.00	24.58	0.950547559
ABX.HE.AAA.07-2	7	2	75	CA05AHAD04	41.88	69.33	23.10	0.934020159
ABX.HE.AA.07-2	7	2	100	CA05AGAD08	6.92	97.00	2.75	0.810851502
ABX.HE.A.07-2	7	2	200	CA05AFAD05	6.18	91.94	2.67	0.15
ABX.HE.BBB.07-2	7	2	500	CA05AJAD02	4.70	58.81	2.59	0.1
ABX.HE.BBB-.07-2	7	2	500	CA05ADAD09	4.93	50.33	2.55	0.072029431
ABX.HE.ITENAAA.07-1	7	1	5	CA05AWAD03	55.21	90.27	25.38	0.923528525
ABX.HE.AAA.07-1	7	1	5	CA05AHAD08	43.50	100.09	23.25	0.970487735
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ABX.HE.AAA.05-2	5	2	11	CA05AHAD05	55.14	100.12	25.72	0.988592343
ABX.HE.AA.05-2	5	2	17	CA05AGAD00	15.42	100.12	6.64	0.538680525
ABX.HE.A.05-2	5	2	44	CA05AFAD02	7.20	100.12	2.42	0.211240127
ABX.HE.BBB.05-2	5	2	122	CA05AJAD05	7.84	100.59	2.29	0.1
ABX.HE.BBB-.05-2	5	2	242	CA05ADAD03	7.48	100.94	2.34	0.1
ABX.HE.ITENAAA.05-1	5	1	15	CA05AWAD07	54.50	95.50	52.15	0.119058255
ABX.HE.AAA.05-1	5	1	15	CA05AHAD01	51.39	100.35	50.75	0.72559194
ABX.HE.AA.05-1	5	1	22	CA05AGAD09	54.58	100.73	15.90	0.95
ABX.HE.A.05-1	5	1	24	CA05AFAD07	23.64	100.51	7.50	0.733226054
ABX.HE.BBB.05-1	5	1	134	CA05AJAD04	7.12	101.20	3.95	0.275343483
ABX.HE.BBB-.05-1	5	1	287	CA05ADAD02	7.24	102.19	3.90	0.18457158

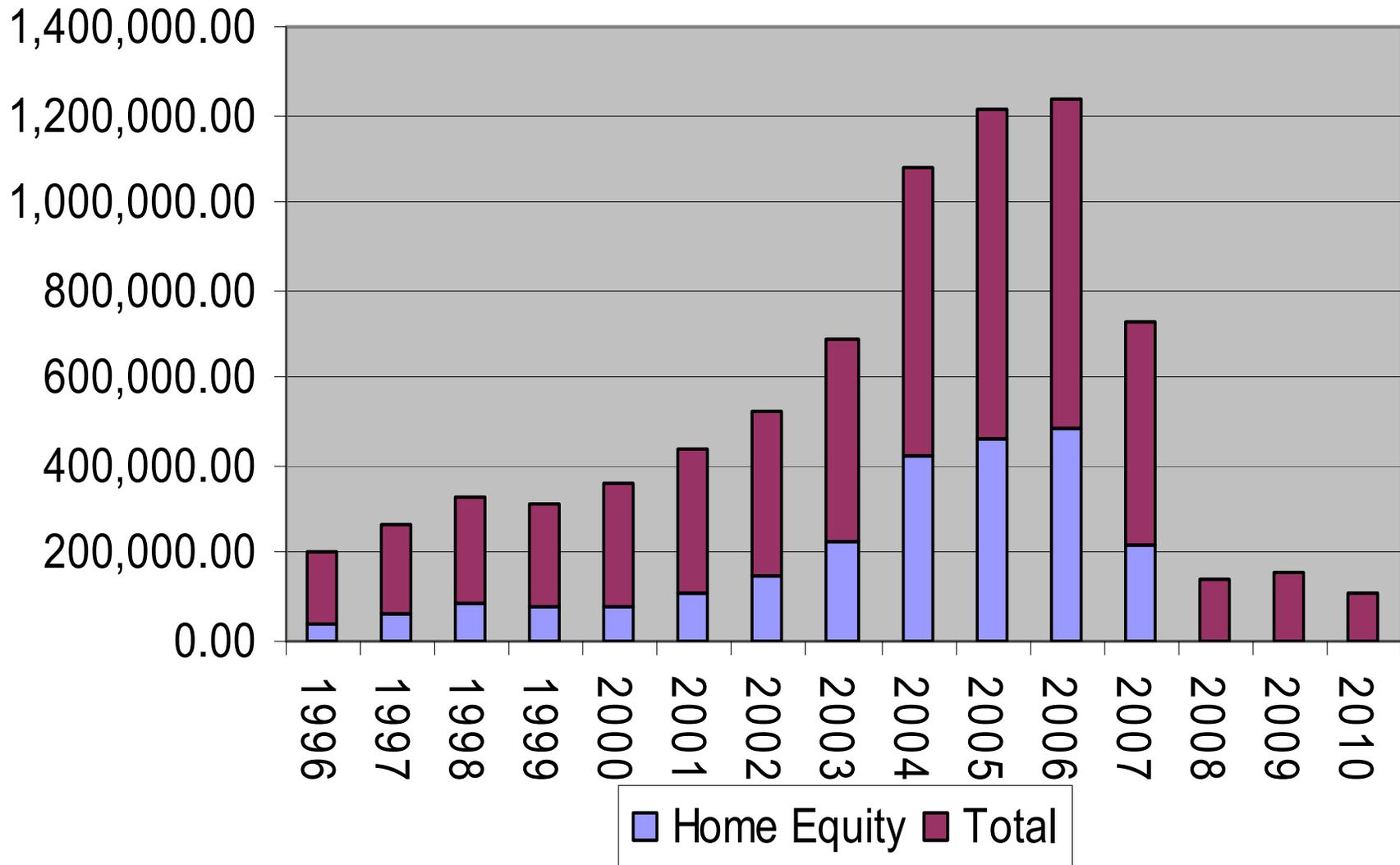
US Commercial Paper Outstanding \$ Billion (SIFMA)



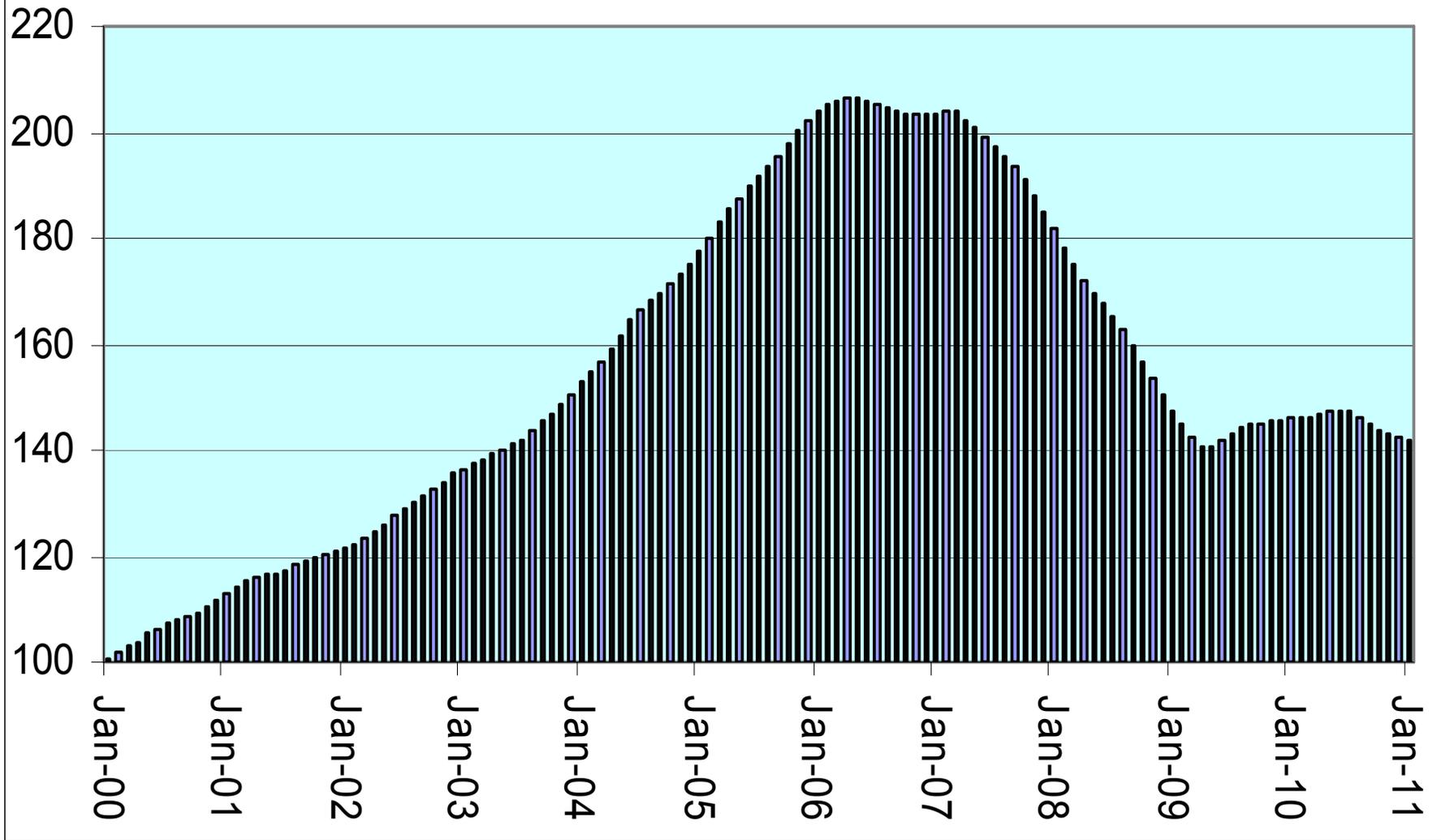
Tota CDO Issuance \$ Million



US Asset Backed Securities Issuance \$ Million



Standard & Poors-Case Shiller Composite 20 US House Price Index



Financial Crises and Recessions

Financial crises take a particularly severe toll on growth because of the need to repair household and financial institution balance sheets. Analyses of past recessions indicates that synchronized recessions with origins in the financial sector, and especially those associated with housing busts, are amongst the deepest and most protracted. IMF, *World Economic Outlook*, April 2009.

Stijn Claessens, M. Ayhan Kose, and Marco E. Terrones, “*What Happens During Recessions, Crunches and Busts?*”, IMF, WP/08/274. December 2008.

Carmen M. Reinhart and Kenneth Rogoff, “*The Aftermath of Financial Crises*”. NBER Working Paper Series # 14656, January 2009.

Recovery from Balance-sheet Recession Fundamentally Different

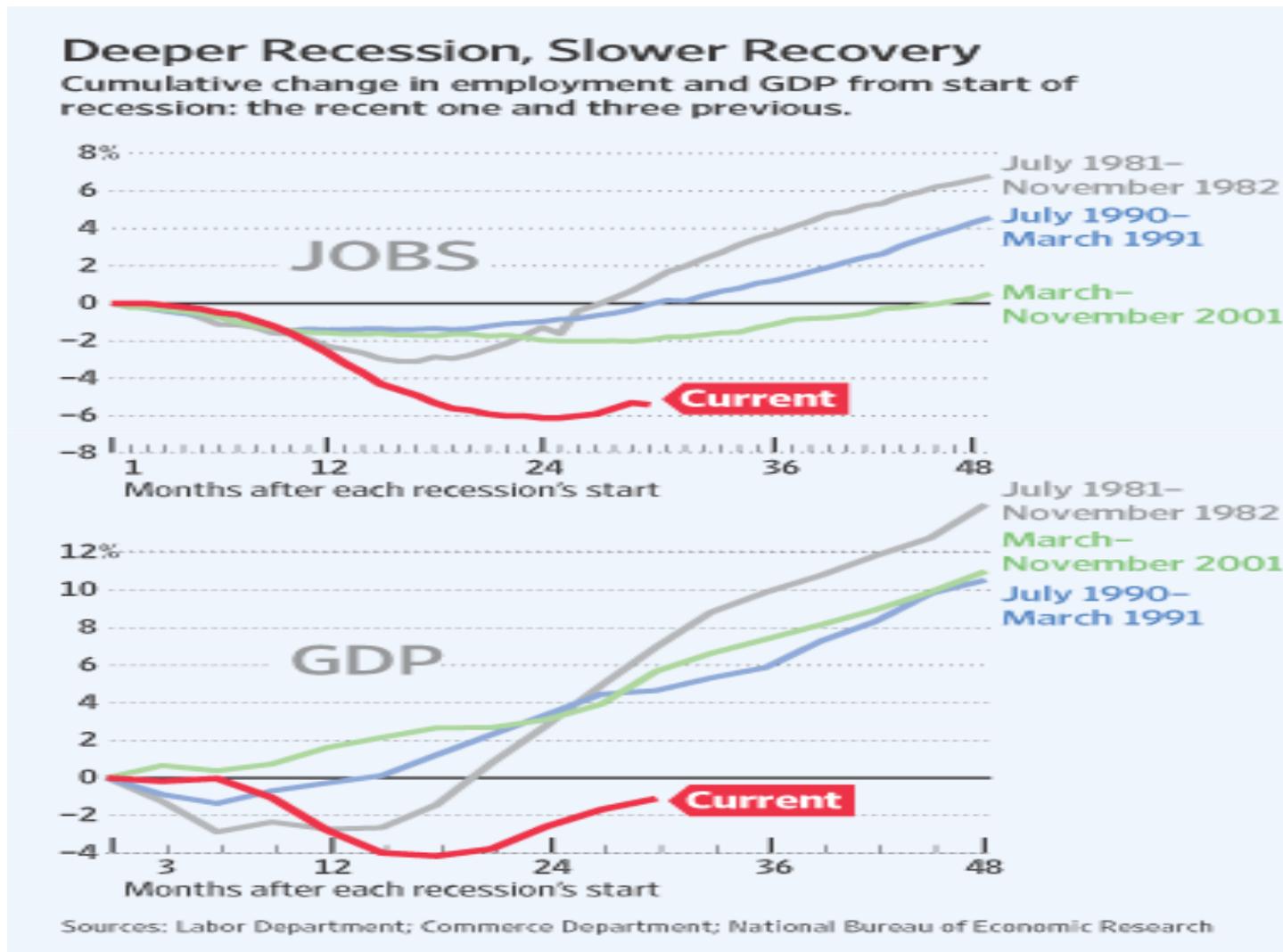
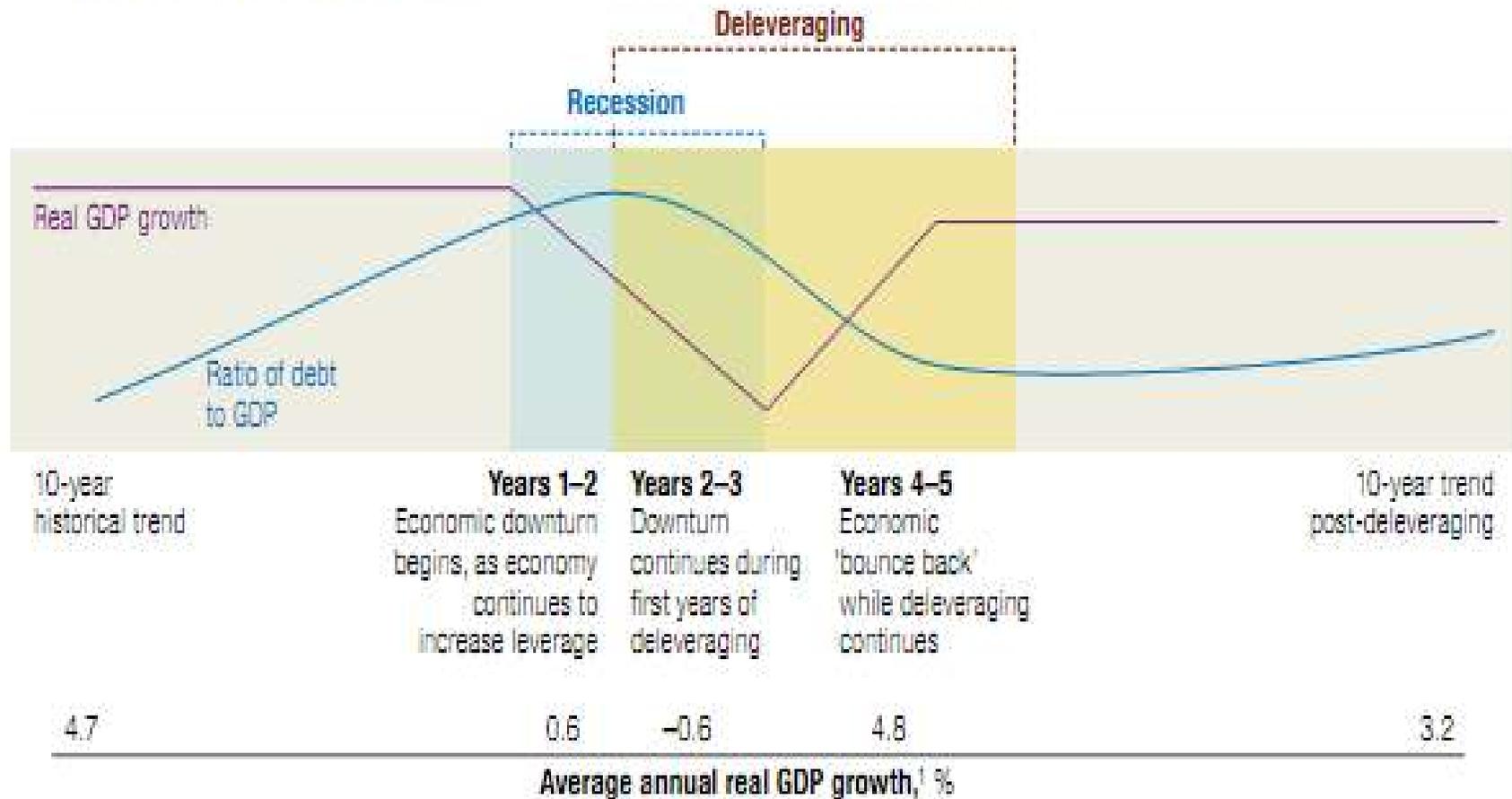


Illustration of impact of deleveraging on GDP growth



¹For "belt tightening" scenario (historically, the most common path). This scenario involves a prolonged period of austerity when most countries experience some growth in credit, but at a pace far below pre-crisis rates of growth and slower than nominal GDP growth.

Source: International Monetary Fund (IMF); McKinsey Global Institute analysis

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"I'LL FEEL BETTER ABOUT HIS RECOVERY CHANCES AFTER HE'S ABLE TO BE TAKEN OFF OF LIFE SUPPORT."

1: This time is different?

- **Virtually every major financial crisis after World War II was preceded by rising leverage and followed by a prolonged period in which the ratio of total debt to GDP declined significantly. Japan in the 1990s is an exception.**

2: This time is different?

- **Aging populations in much of the developed world is lowering labor force participation rates, making it more difficult to jump-start and sustain high rates of GDP growth.**

3: This time is different?

- **2008 Financial crisis was/is global in scale, affecting world's biggest economies—not just one or a few, as in most previous crises. It is very difficult for all affected countries to boost net exports simultaneously, as many did in the past to support GDP expansion when credit growth was slowing and households were saving more.**

4: This time is different?

- **Affected economies are not competitive enough to export their way to higher growth without politically difficult structural reforms: OECD's 'Going for Growth' framework is not working in Europe.**

5: This time is different?

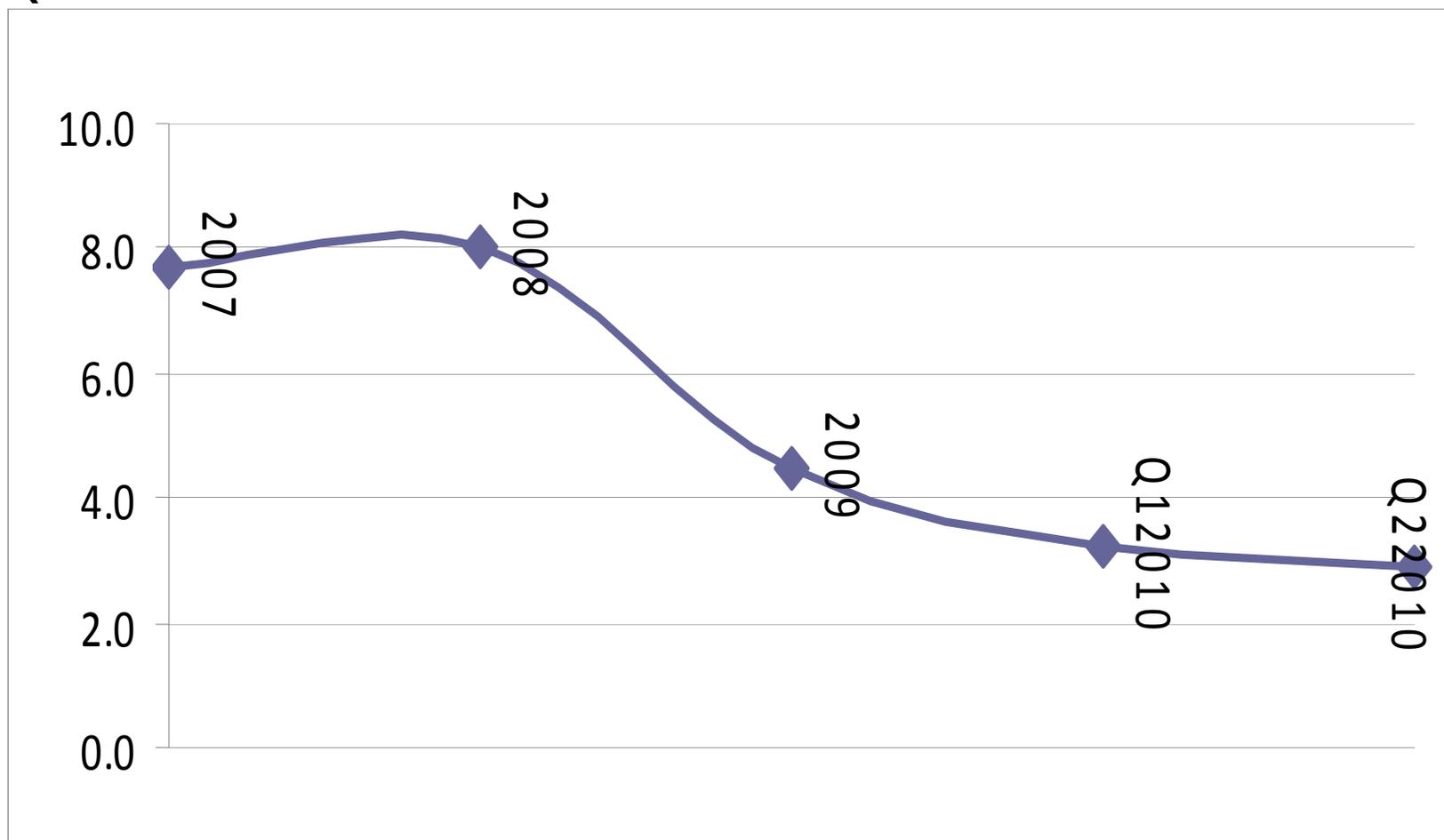
- **Sharply increasing government debt relative to GDP in major economies is offsetting deleveraging by the private sector, making it likely that debt-to-GDP ratios will decline more slowly than the historical average, creating severe headwinds to economic growth: cautionary tale from Japan, where bursting asset bubbles in the early 1990s touched off a financial crisis followed by many years when rising government debt offset deleveraging by the private sector leading to a “lost decade” – and beyond? -- of sluggish GDP growth.**

Rebalancing Imperative

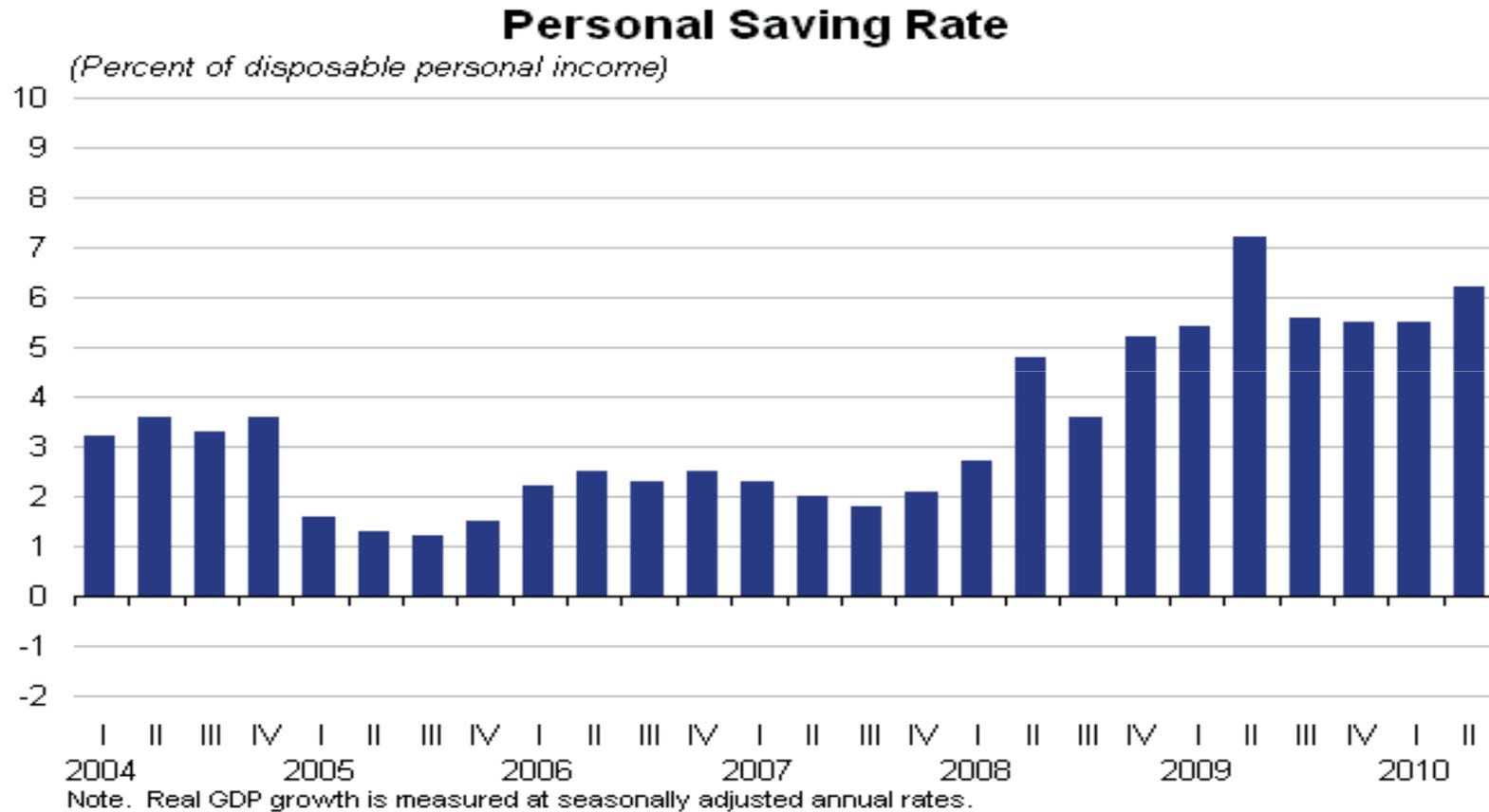
- **Can high growth in developing countries be sustained without robust growth in OECD countries?**
- **Rising American consumption enabled East Asian economies, especially China, follow an export led model of growth.**
- **With the global consumer of last resort retrenching, surplus Asian economies need to rely more on domestic demand to return to record pre-crisis levels of global growth.**
- **The debt crisis in Southern Europe and consequential need to repair Sovereign and household balance-sheets has queered the prospects of growth in Europe**
- **Because of a common currency, Southern Europe cannot use exchange rate policies to export and grow out of the crisis.**
- **G 20 battleground: Stand-off between the US and China but do interests converge?**
- **The Imbalances debate and development economic theory: are all surpluses/deficits bad? Both US deficits and Chinese surpluses anomalous according to received wisdom in developmental economics. The Triffin dilemma.**

Even as Current Account Imbalances have Shrunk.....

(Standard Deviation of G 20 Current Account Balances)

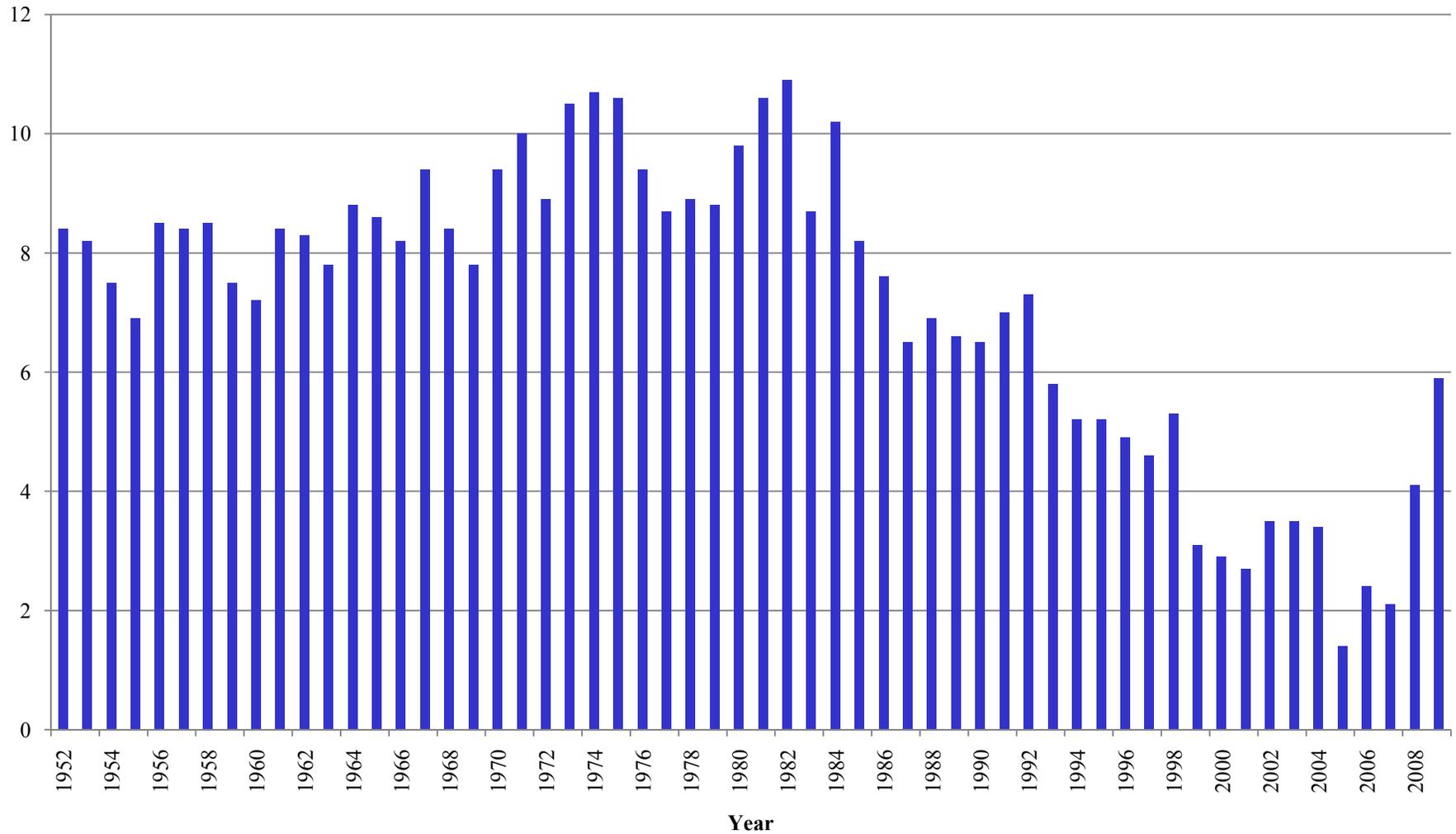


And US Personal Savings Have Risen...



U.S. Bureau of Economic Analysis

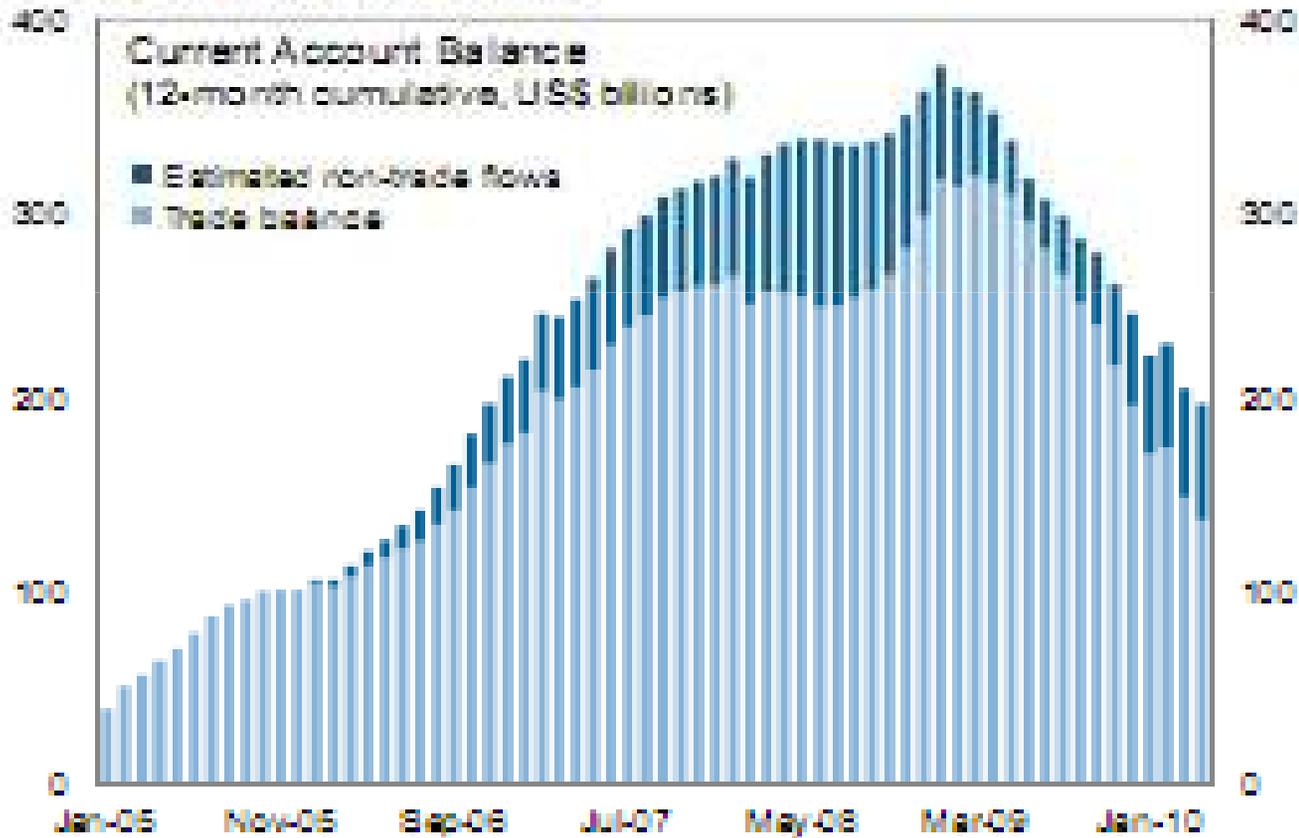
US Personal Savings: Long-term Trends



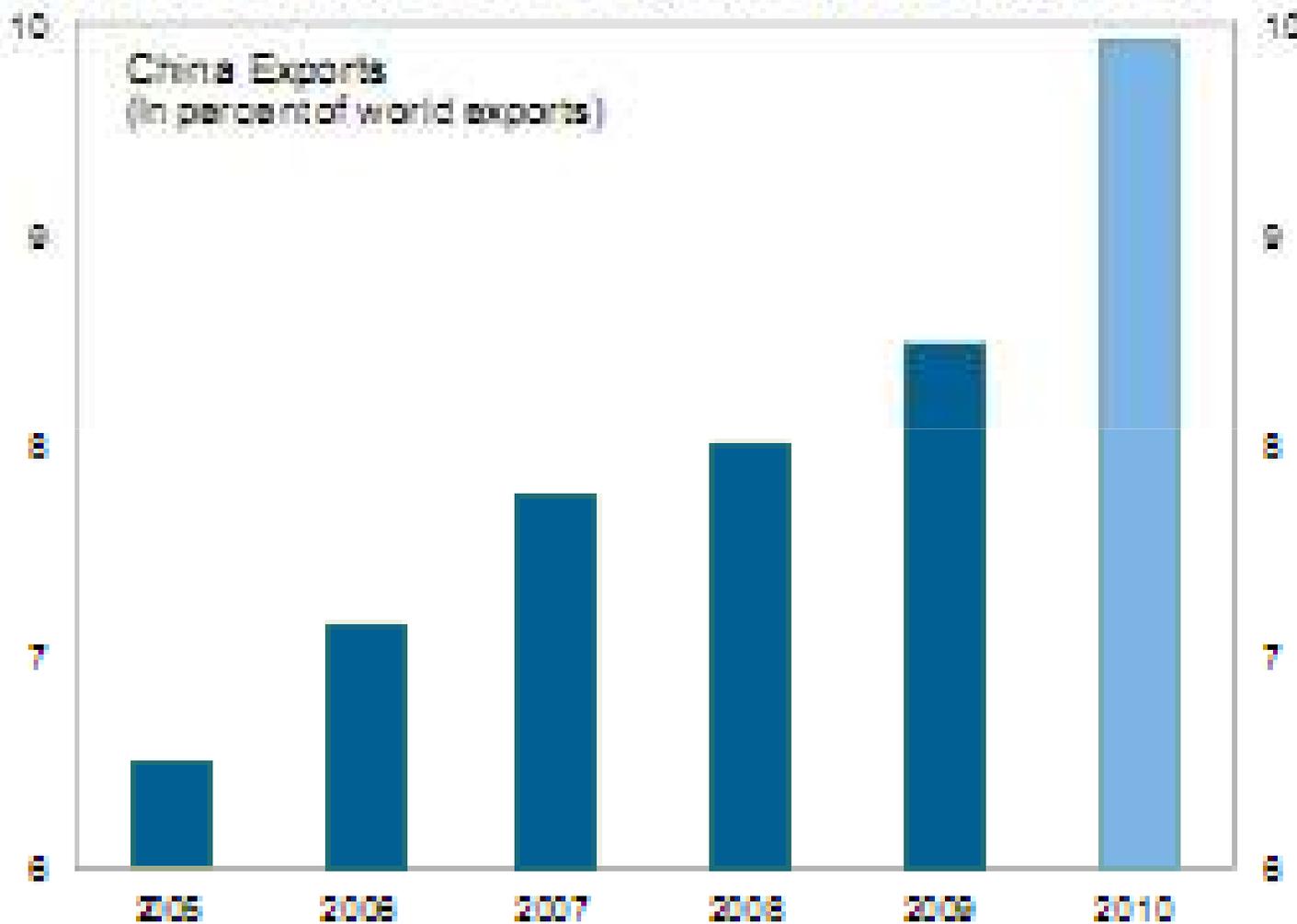
And Chinese Savings Have Declined

(IMF, Staff Report Article IV China, July 2010)

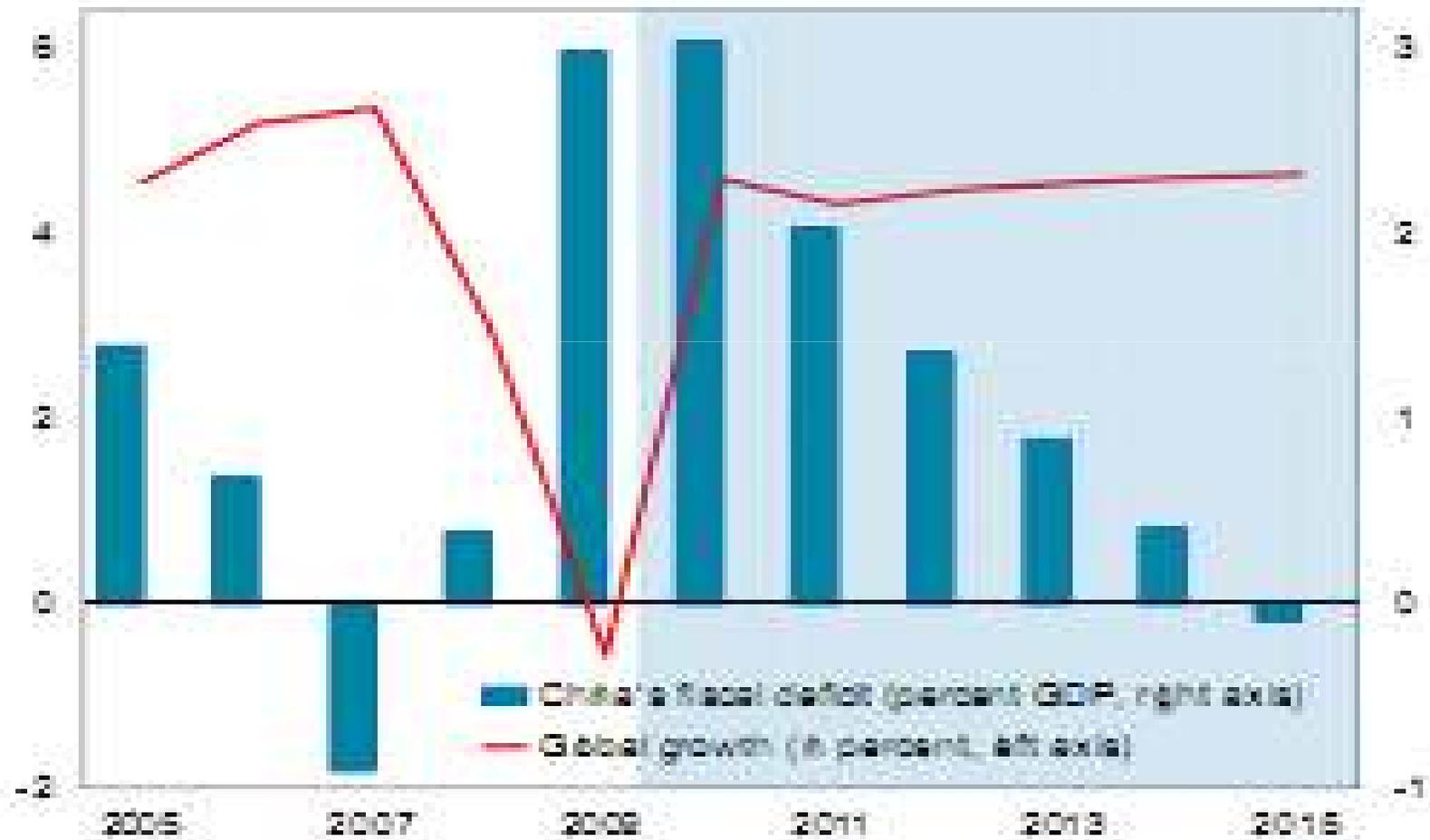
The current account surplus has been almost cut in half over the past two years....



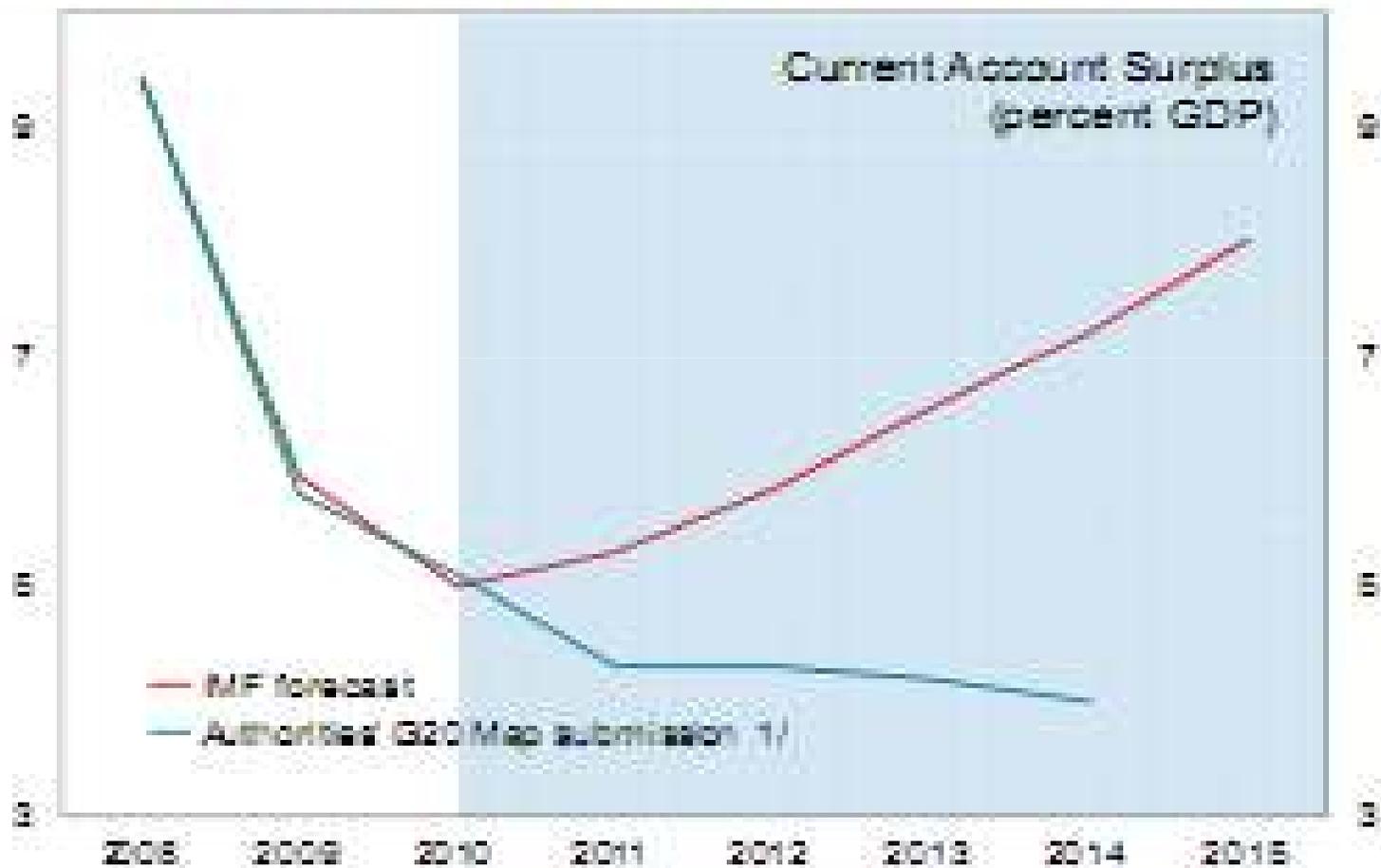
Nevertheless, even during this global downturn, China was able to continue building export market share.



As the world economy recovers and China's fiscal stimulus is unwound...



...staff see a potential for the current account surplus to reassert itself. The authorities, however, are confident the decline is a structural break that will be sustained.



The Imbalance Conundrum

- **Keynes: Market penalizes deficit countries, but not surplus countries**
- **Puzzle: Why has the market not penalized the dollar? Answer: international reserve currency status.**
- **Because, unlike Japan, US is a net dissaver it needs external finance to plug deficits (both fiscal and current account)**
- **The key political problem for the US is not China's surplus that finances its deficits but its own elevated unemployment rate that has hovered around the peak crisis rate of 9% +/- .**
- **The US needs to expand exports to reduce unemployment, and finds that China's aggressive exchange rate policy is in its way.**
- **But for net US exports to increase it needs to boost its savings.**
- **While US private savings have risen following the crisis, this has been mostly offset by rise in government dissavings, as a result the US CAD has not shrunk very much, and the US remains a big net importer.**
- **An appreciated yuan may therefore simply mean that the US ends up importing the same goods at higher prices from China or elsewhere!**
- **Indian Prime Minister suggested at the fifth G 20 Summit at Seoul that recycling global savings through multilateral development banks for investing in infrastructure would address both the global demand imbalance as well as the global developmental imbalance.**

Towards Bretton Woods III?

- If financial regulatory reform reins in the financial sector, and there is no return to leveraged consumption, there would be permanent demand retrenchment in advanced economies.
- Rebalancing of the global economy would then be necessary to return to former levels of growth: Bretton Woods III
- Rebalancing would hasten global per capita income convergence with attendant trust and peace dividends.

Rebalancing Prospects

- The Japanese experience closely tracks the Chinese: Failure of the Plaza accord: Japanese growth plummeted while external surpluses have not abated.
- Japanese experience makes it difficult to use exchange rate policy for rebalancing: other tools are monetary and fiscal policies.
- Rebalancing could be deferred by fiscal expansion in advanced countries, as is currently happening: Alternative Bretton Woods III scenario?
- Policy can directly target only the nominal exchange rate and not the REER. Could inflationary outcomes in developing countries lead to rebalancing on its own?
- If oil prices are sustained at high levels (IMF's WEO April 2011), the direction of imbalances could shift from China to oil rich economies, in which case we could be back to square one.

Growth in Advanced Countries without Rebalancing?

- Aggressive and coordinated macroeconomic policies?
 - Monetary transmission affected by uncertainty in financial regulation and private demand (retrenchment of US consumer and fiscal consolidation)
 - Fiscal policy transmission hampered by Ricardian equivalence on high debt concerns
 - Massive liquidity injection and public debt could impair long-term growth prospects
- Structural reforms (OECD's 'Going for Growth Framework')?
 - Would not address demand side problem
 - Political challenges (spate of strikes in Europe)
 - Demographic constraints on growth in advanced countries.
- Labour mobility?
 - Acceptance by civil society: Nation State concept still strong
 - War on terror and security concerns

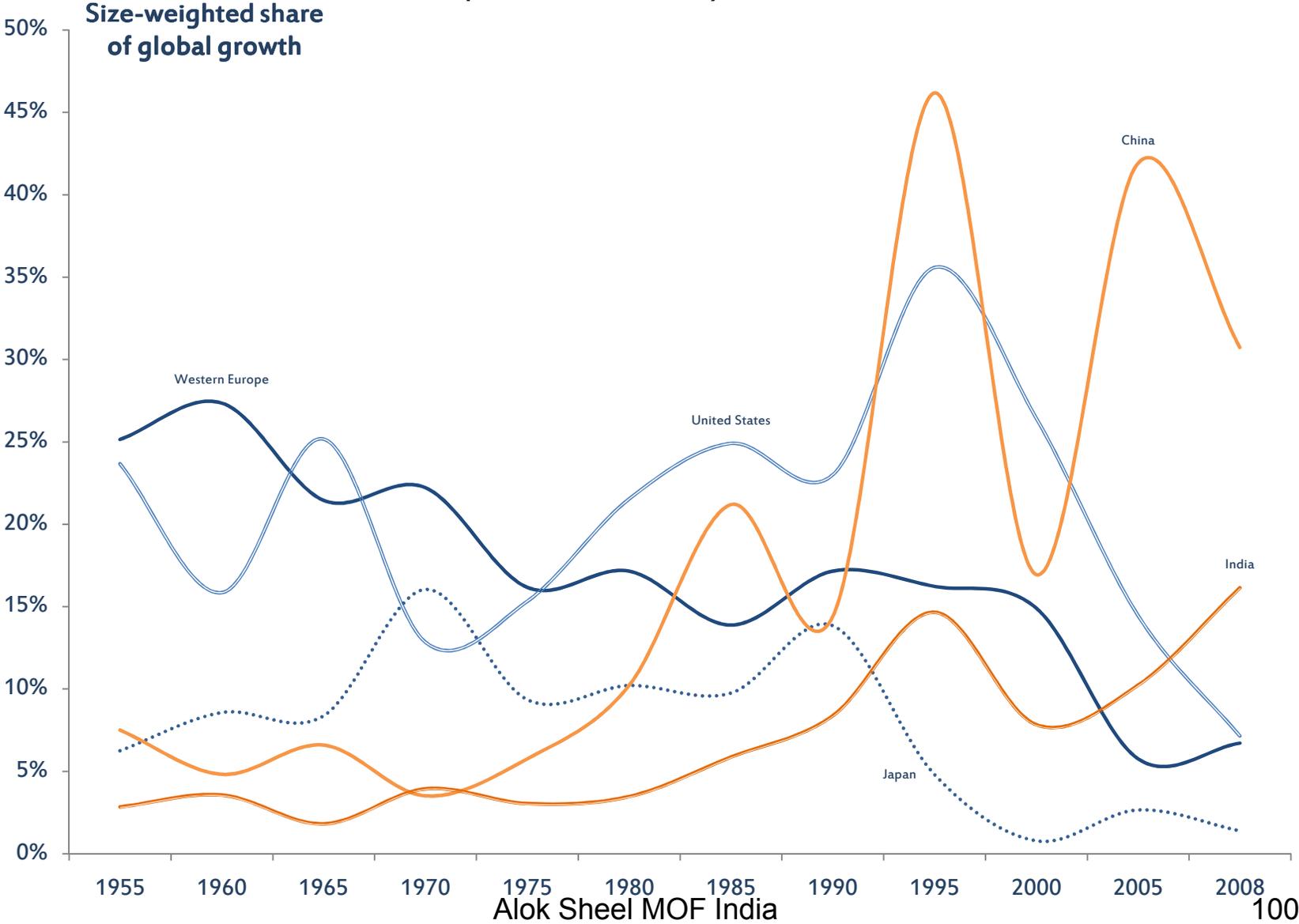
G 20 Framework on Strong Sustainable and Balanced Growth

- Signature effort of the G 20 at the Pittsburgh and Toronto Summits: India co-chair
- Emphasis on strong sustainable and balanced growth
- G 20 countries divided into groups: advanced deficit, advanced surplus, emerging surplus, emerging deficit.
- Basket of policy tools for each country group so that the upside scenario for the global economy is realised.
- Moving towards country specific action plans. Too divisive to succeed?

STRUCTURAL CHANGES IN THE GLOBAL ECONOMY?

Shift in Economic Gravity: Global Growth shares Post WW II

(World Bank)



Globalization and Development

- During the colonial period globalization associated with 'underdevelopment' and divergent income growth in advanced and developing countries: free trade as the engine of underdevelopment
- In the spurt of globalization since the 1970s, globalization has led to faster growth in erstwhile colonies and greater income convergence: free trade as the engine of growth
- The global crisis has accelerated this process
- Over long-term are we reverting to the pre-industrial pattern of global income distribution?
- Even after 'crossover' huge disparities in per capita incomes likely to remain: the challenge for the big developing countries is to grow rich before they get old.

Angus Maddison and Goldman Sachs I: Long-term Global GDP Trends

	GDP							
1990 \$ B	1000*	1500*	1700*	1820*	1900*	1980*	2003*	2050**
USA	0.5	0.8	0.5	12.5	312	4231	8431	35165
W.Europe	8.4	38.4	71.0	142.4	626	4849	6733	N.A
China	26.6	61.8	96.0	228.6	218	1040	5939	44453
India	33.8	60.5	74.3	111.4	170	637	2267	27803
Brazil		0.4	0.6	2.9	12	639	1013	6074
World	120	248	371	695	1974	20042	40664	
	Per Capita GDP							
1990 \$								
USA	400	400	527	1257	4091	18577	29037	83710
W.Europe	425	798	1032	1243	3076	14056	20596	50142
China	450	600	600	600	545	1060	4609	31357
India	450	550	550	533	599	938	2160	17366
Brazil		400	400	459	678	5198	5563	26592
World	450	566	615	667	1262	4521	6477	

*Angus Maddison, **The Contours of the World Economy 1-2003 AD.** (Oxford University Press, 2007)

Goldman Sachs, **Dreaming with BRICS: The Path to 2050 *Global Economics Paper 99, Oct 1, 2003,*

Angus Maddison and Goldman Sachs II: Average annual growth rates

	1000-1700	1700-1820	1820-1900	1900-1980	1980-2003	2005-2050
USA	0.2%	1.2%	1.5%	2.3%	2.0%	1.7%
W.Europe	0.7%	0.2%	1.1%	2.0%	1.7%	1.6%
China	0.2%	0.0%	-0.1%	1.0%	6.7%	7.3%
India	0.1%	0.0%	0.2%	0.7%	3.7%	7.9%

Angus Maddison, **The Contours of the World Economy 1-2003 AD.** (Oxford University Press, 2007)
 Goldman Sachs, **Dreaming with BRICS: The Path to 2050** *Global Economics Paper 99, Oct 1, 2003.*

Measuring Asia's Rise



The Economist, February 27th-March 5th, 2010. P.71.

Alok Sheel MOF India

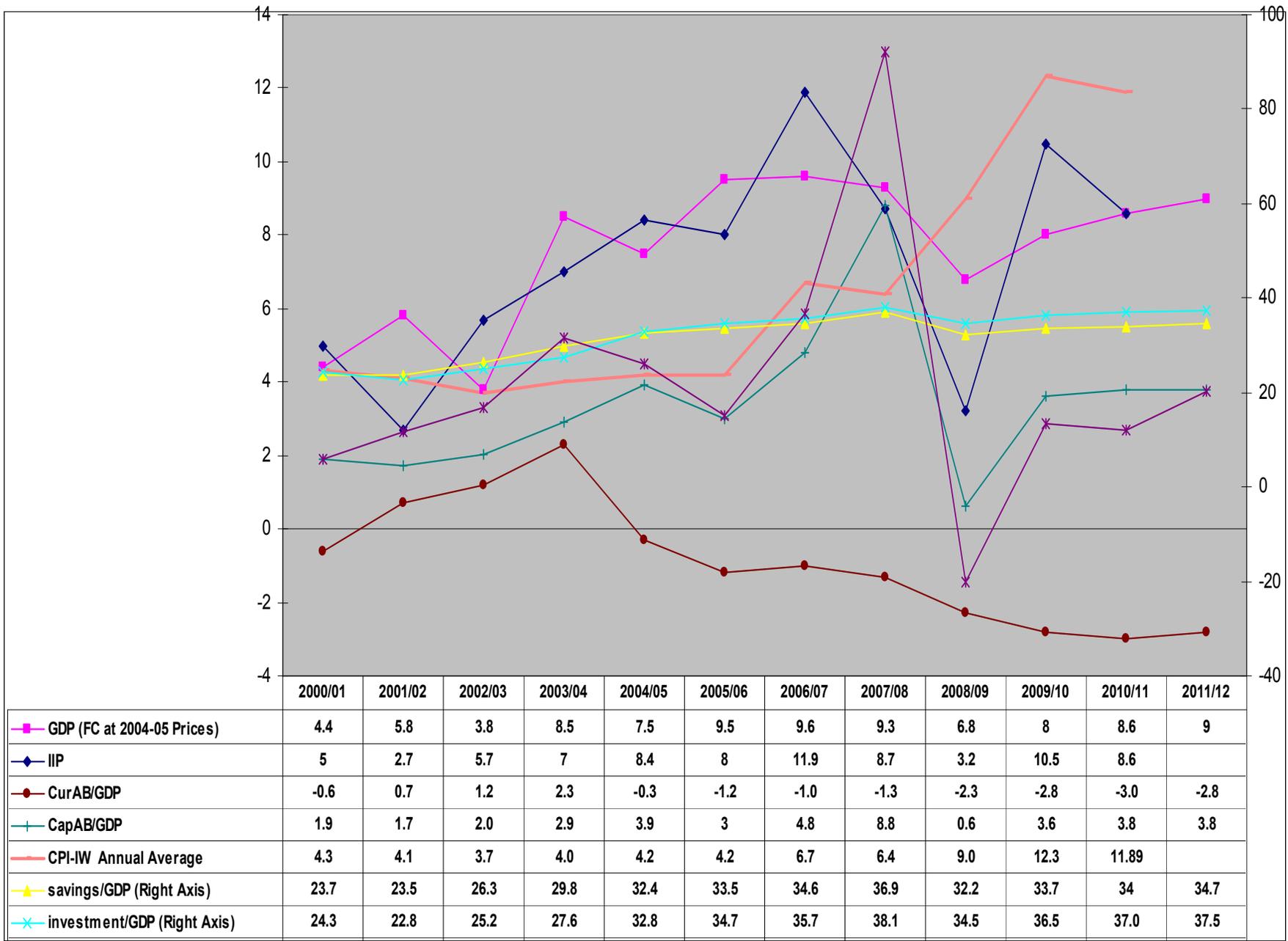
Goldman Sachs: Updated BRIC MER Crossover Projections

	Fra.	Ger.	Italy	Japan	UK	US
Brazil 03	2031	2036	2025	--	2036	--
Brazil 08	2027	2029	2020	2034	2038	--
China 03	2004	2007	2000	2016	2005	2041
China 08	2006	2008	2004	2010	2006	2027
India 03	2019	2023	2016	2032	2022	--
India 08	2021	2024	2017	2027	2023	--
Russia 03	2024	2028	2018	--	2027	--
Russia 08	2024	2029	2017	2037	2027	--

Goldman Sachs, Global Economics Paper No.192, December 4, 2009:
The Long-Term Outlook for the BRICs and N-11 Post Crisis

Role of India?

- With a population of 1.2 billion, **over the next few decades India could contribute the lion's share of global**
 - incremental growth (**Demand side**)
 - **The Economist*** October 2nd-8th 2010 : India could overtake Chinese growth rates within 3-5 years
 - William Buiter: By 2050 India can overtake China as the world's biggest economy
 - Incremental addition to the work force (**Supply side**)
 - **The Economist*** October 2nd-8th 2010 : India will add 136 million new workers by 2020 compared to 23 million in China
 - Incremental growth in the **sunrise Knowledge Economy**
 - People living in **open societies**
- * September 4th-10th 1999 issue had described India as “the world's biggest underachiever” considering its size.



THE RISE OF THE G 20?

G 20 in a nutshell

- **An informal body that operates through consensus (as opposed to majority) whose decisions are not legally binding like WTO, UNFCCC.**
- **Set up as Finance Ministers Forum in the wake of the 1997 East Asian crisis.**
- **First G 20 Leaders' Summit convened by President Bush in Washington DC in the wake of the Global financial and economic crisis.**
- **Five Summits held so far: Washington DC (2008), London and Pittsburgh (2009), Toronto and Seoul (2010).**
- **Annual summits hereafter: France in November 2011 and Mexico in 2012.**
- **At the third Summit at Pittsburgh the G 20 designated itself as the premier international forum for international cooperation, effectively replacing the G7/G8.**
- **No permanent Secretariat so far, the agenda being set and driven forward by the Chair.**
- **Chair elected by the G 20 for one year through a 'bucket system': five buckets comprising developed and developing countries. The Understanding is that the Chair would rotate between developed and developing countries.**
- **Half the membership comprises developing countries.**
- **Two separate channels: Finance Ministers and Leaders/Sherpas issue separate Communiqués following meetings.**
- **Detailed work done through Working/Expert groups.**

Who is in the G 20 and who is not?

	Country	GDP (current US\$)	GNI, Atlas method (current US\$)	GNI, PPP(current international \$)	Rank of G20 countries according to GNI,PPP	Share in world GNI (current US \$) in per cent	Share in world GNI, PPP (current international \$) in per cent
		2009 (in Billions)			2009		
1	European Union**	16415	17114	15579	1	28.9	21.6
2	United States	14256	14503	14345	2	24.5	19.9
3	Japan	5068	4830	4246	4	8.2	5.9
4	China	4985	4778	9019	3	8.1	12.5
5	Germany	3347	3485	3027	6	5.9	4.2
6	France	2649	2755	2193	9	4.7	3.0
7	United Kingdom	2175	2567	2310	8	4.3	3.2
8	Italy	2113	2112	1887	11	3.6	2.6
9	Brazil	1572	1557	1988	10	2.6	2.8
	Spain*	1460	1465	1454		2.5	2.0
10	Canada	1336	1423	1268	14	2.4	1.8
11	India	1310	1369	3768	5	2.3	5.2
12	Russia	1231	1330	2609	7	2.2	3.6
13	Australia	925	958	836	17	1.6	1.2
14	Mexico	875	959	1515	12	1.6	2.1
15	Korea	833	967	1331	13	1.6	1.8
	Netherlands*	792	816	670		1.4	0.9
16	Turkey	617	653	1027	15	1.1	1.4
17	Indonesia	540	513	933	16	0.9	1.3
	Switzerland#	500	431	320		0.7	0.4
	Belgium*	469	489	394		0.8	0.5
	Poland*	430	468	704		0.8	1.0
	Sweden	406	455	359		0.8	0.5
	Norway	382	417	271		0.7	0.4
18	Saudi Arabia#	369	439	595	18	0.7	0.8
	Greece	330	323	321		0.5	0.4
	Denmark	310	326	209		0.6	0.3
19	Argentina	309	305	569	19	0.5	0.8
20	South Africa	286	284	496	20	0.5	0.7
	Ireland	227	197	148		0.3	0.2
	BRIC	9098	9034	17384		15.3	24.1
	World	58228	59219	72039		100.0	100.0

The Expanding G 20 Agenda

Short Term Policy Response to the Financial Crisis

- **Coordinated and aggressive fiscal and monetary response**
- **Liquidity for developing country bystanders: London Summit**
- **Resolve against protectionism**

Long Term Agenda

- **Financial Regulatory reform**
- **Structural reforms:**
 - **Policy: rebalancing, development, financial safety nets, link between commodity and financial markets (France)**
 - **Institutional: FSB, Bretton Woods, IMS (France)**
- **Other**
 - **Climate Change Finance**
 - **Doha**
 - **Anti-Corruption**
 - **Fossil Fuel subsidies**

The G 20 in Perspective

- Globalization needs effective institutions of global governance
- First attempt: Congress of Vienna following the Napoleonic Wars failed to accommodate a rising Germany: WW I
- Second attempt: League of Nations following WW I also failed to resolve the German problem: WW II
- Third attempt: United Nations system following WW II degenerating into indecisive and ineffective talk shop.
- Fourth attempt: Informal grouping of G7/G8 comprising major economies that also called the shots in multilateral economic organizations like the Fund-Bank, FSF, WTO, etc.
- MEF: Need to accommodate the rising BRIC in global governance
- Fifth attempt: Informal grouping of G 20 economies that collectively account for about 85% of global GDP, trade, capital flows, emissions. G 7/8 could not have effectively steered an effective response to the crisis.
- Style of functioning changing?

Future of the G 20

- Effective in crisis situations when you are staring into the barrel of a gun. Will it be able to address long-term structural issues in non-crisis situations?
- How will it deal with its non-inclusive nature?
- How will it deal with membership anomalies?: Argentina in and Spain out!
- How will it deal with the elephant (G-2) in the room?
- **Bottomline:** Will it be able to put in place policy tools and Institutional reforms that address the macro-economic anomalies and structural and institutional imbalances in the global economy apparent even before the crisis so as to lead to sustainable growth?

India and the G 20

- **Need to take greater global leadership role and responsibility for global outcomes: co-chaired the Working Group on Financial Regulatory reform (Rakesh Mohan) and currently (Kaushik Basu) co-chairing with Canada the Framework Working Group to address global imbalances.**
- **Capacity building and infrastructure necessary to assume this expanded global role: G 20 Secretariat being set up in DEA.**
- **Domestic policy making needs greater outward orientation to take stock of emerging global consensus, e.g on fossil fuel subsidies, corruption, financial sector, macro-economic policies etc.**
- **When should India make a pitch to chair and host the G 20?**
- **What agenda(s) can and should India place before the G 20?: would need to resonate with both developed and developing countries.**
- **Having joined the global high table what happens to India's leadership of the third world who see the G 20 as the new G7?: apparent in the G 20 handling of IFI reforms where only the big G 20 developing countries benefitted.**



Thank You For Your Patience!