

ST PETERSBURG SUMMIT

EM Emerging issues

G20 leaders would do well to hear out B20 leaders before monetary measures queer the pitch for global economic recovery

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There are likely to be two issues of vital interest from an emerging market perspective at the eighth G20 summit to be held in St Petersburg, Russia, on September 5-6, 2013. They need to somehow ensure that their interests are protected at a time faltering growth is undermining their voice within the G20.

The first issue relates to non-conventional monetary policies adopted by advanced economies, and the management of their public debt. It may be recalled that the initial reaction of EMEs, and particularly of the BRICS, to quantitative easing (QE) was, on the whole, negative. This was reflected in G20 summit declarations. China was critical because it devalued the dollar, and therefore the value of its large holding of US Treasuries and GSE (mortgage) holdings. As a commodity exporter, Brazil stood to gain from the rise in commodity prices. Its objection was to the appreciation of the Real on account of the sharp increase in capital flows. Guido Mantega, the finance minister of Brazil, famously coined the term 'currency wars' before imposing capital controls as a result. India was most affected by commodity price inflation. However, on account of the need to finance its large current account deficit (CAD), its views on capital inflows were muted.

The EMEs' reaction to QE3, especially following the Bank of Japan's decision to purchase \$75 billion treasury bonds each month (over and above the US Fed's monthly purchase of \$85 billion), is however subdued. Brazil, Turkey, Indonesia, South Africa and India experienced sharp depreciation as CAD increased and capital inflows declined. Brazil started rolling back capital controls, and India is in line to ease them, to attract more foreign capital. The recent rise in US treasury bond yields has sharply reduced capital flows

to EMEs and aggravated the problem. If just the talk of QE rollback has triggered tremors in EMEs, the situation could worsen to crisis proportions when it actually starts. It is, however, difficult for EMEs to take a position against this rollback in view of their earlier opposition to QE.

Monetary policy the world over responds to the domestic business cycle. The case of the US Fed is, however, singular in that its policies also shape cross-border capital flows by virtue of the dollar being the effective global reserve currency. This constrains the monetary stance of other countries in ways that may be inappropriate for their own business cycles. In 2007-08, when the Fed turned on the liquidity tap, EMEs, who recovered relatively quickly from the crisis, hesitated to tighten monetary policy for the fear of attracting more capital inflows. India's currency appreciated despite a widening CAD. Now when growth is weakening, EMEs hesitate to loosen monetary policy because of capital outflows. Reserve build up in EMEs is as much a defensive response to US monetary policy as the pursuit of export-led growth by some EMEs.

It is for this reason that EMEs argued for greater policy flexibility in dealing with cross-border capital flows in the run-up to the Cannes G20 summit. India has imposed some outbound capital controls, and also raised customs tariffs on a number of items as part of a slew of measures to lower the CAD. While these increases are within its WTO-bound limits, India should be prepared for some adverse attention at the summit in view of the 'trade standstill' agreed to earlier by the G20 countries. It could underscore the curbs' temporary nature, while leveraging them to make a case for an orderly tapering of QE that keeps in mind its international ramifications. While it is not clear how this conundrum can and should be addressed, in focus of the G20 Framework Working Group, of which India is a co-chair, needs to shift from global demand rebalancing, to this issue.

Closely related to QE is the issue of public debt management in advanced economies. Two separate themes seem to have got mixed up in recent G20 deliberations on debt management, namely the long-standing problem of



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external debt management in developing countries, and public debt management in advanced economies, which is an emerging post-crisis concern. Unsustainable external debt, irrespective of whether it is private or sovereign, in developing economies can lead to market revolt, collapse of the domestic currency, and a balance of payments crisis. High fiscal deficits, and the build-up of domestic public debt as a lagged consequence, on the other hand, can have inflationary outcomes, but market revolt and financing of fiscal deficits are never an issue because of the central bank backstop.

A few notable exceptions apart, such as Japan and Italy, excessive public debt was mostly seen as a developing country problem. While the position regarding external debt has not changed, in recent years the equation with respect to public debt has vastly changed. As advanced countries aged, and trend growth slowed, their public debt/GDP ratios started to rise, while the ratios in EMEs tended to decline as growth rates picked up. This fiscal divergence has been accelerated by the need for protracted fiscal stimulus, and falling revenues, in advanced economies as a result of negative and low growth over the

last half decade.

The problem with the G20 fiscal commitments agreed by the advanced economies at Toronto is that they were 'date' rather than 'condition' dependent. While there is no doubt that fiscal deficits and debt need to be brought within prudent limits, advanced economies will continue to grapple with the 'growth-austerity' dilemma as long as private demand remains weak. The Toronto fiscal commitments, therefore, need to be calibrated with the pace of recovery, i.e. cyclically adjusted, which may mean revisiting the agreed timelines for debt/GDP targets. The targets themselves may need to be revisited in due course as the ageing process and associated fiscal demands, and lower trend growth and attendant revenue declines can be expected to continue. Fiscal projections for the advanced countries, even by some reputed bodies like the Bank of International Settlements, look quite alarming.

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The second 'new' issue on which EMEs are required to take a stand relates to international tax matters. In the past India has enthusiastically backed the Global Forum-OECD initiative on automatic exchange of tax-related information because of domestic concerns about large amounts parked by Indian nationals in tax havens abroad. The issue of 'Base Erosion and Profit Shifting' (BEPS) is however altogether different, and one on which EMEs need to tread carefully, study the full implications and consult with other

BRICS leaders who will meet on the sidelines of the summit.

The need for higher taxes to reduce fiscal imbalances in OECD countries has gone hand in hand with loss of competitiveness and migration of production and, increasingly, services as they become more tradable, to EMEs. Attractive tax rates have also played a part. Much of this migration is through transnational corporations (TNCs) from OECD countries. This shift in economic activity has raised growth in EMEs, and along with economic activity and growth has come higher tax revenues. It is natural for OECD countries to eye a share in this revenue stream generated by their own corporates overseas.

A recent editorial in the US edition of *The Wall Street Journal* dated July 23, 2013, cited data indicating that there has not been any long-term decline in corporate tax revenue across OECD countries, as this has fluctuated between 2-3% of GDP depending on the business cycle. If this is indeed the case, the rationale for this OECD and G7 initiative, which is now sought to be endorsed by the G20, may well be to strengthen their fiscal position at the cost of EMEs.

Be that as it may, the timing of this initiative could be self-defeating in a broken global economy low on investment confidence. When growth and animal spirits are low, and governments want private investment to take over the load from public expenditure for a sustainable recovery, an international initiative to tighten or aggressively target tax avoidance, especially when corporate tax receipts have not dipped out of proportion to the fall in growth, can only make the recovery more difficult. Of the two 're-balancings' identified by the G20 itself for a sustainable recovery, global demand rebalancing is clearly in evidence, but a question mark still hangs over the second, namely from public to private. Perhaps the G20 leaders need to listen more attentively to what the B20 (Business 20) leaders tell them in St Petersburg in this regard before they contemplate new measures that may queer the pitch for the global recovery.

(Concluded)

The author is a civil servant.
Views are personal