



THEIR VIEW

MINT CURATOR

India must watch out for a taper tantrum in global capital markets

Our economy is vulnerable to a reversal of capital flows that might occur if the US Fed decides to tighten its monetary policy



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REUTERS

The macro comparison

India's economic metrics look worse than those of other emerging economies on four out of five counts.

All figures in %

International Monetary Fund data for 2020	GDP growth	Annual inflation	Fiscal balance/GDP	General government debt/GDP	Current account balance/GDP
Bangladesh	3.8	5.6	-5.5	38.9	-1.5
Brazil	-4.1	3.2	-13.4	98.9	-0.9
Indonesia	-2.1	2.0	5.9	36.6	-0.4
Russia	-3.0	3.4	-4.0	19.0	2.2
South Africa	-7.0	3.3	12.2	77.1	2.2
Thailand	-6.1	-0.8	-4.7	49.6	3.3
Turkey	1.8	12.3	-5.4	36.8	5.1
India	-8.0	6.2	-12.3	89.6	1.0
Average: EMDEs	-2.2	5.1	-7.7	63.4	0.6
Average: Asian EMDEs	-1.0	3.1	-8.9	66.6	1.7

Source: IMF WEO Database April 2021

SATISH KUMAR/MINT

With the economic recovery better and inflation higher than expected in the US, the Federal Reserve has signalled it might taper its bond purchases. The International Monetary Fund (IMF) in its *World Economic Outlook* of April 2021 has raised the possibility of capital outflows from emerging markets and developing economies (EMDEs) should the financial cycle turn, spelling instability ahead for them.

EMDEs have long been exposed to sudden surges and stops in capital flows that injure their macroeconomic stability and economic growth from time to time. The sources of such exposure are both internal and external. The external source has to do with spillovers from global financial cycles. The Fed's monetary policy is a major determinant of these cycles, since the US dollar is effectively the global reserve currency. Fed easing tends to whet risk appetite, sending a surge of capital to EMDEs in search of higher yield. Conversely, tightening raises bond yields, sucking capital back to the US. Internal policies of EMDEs can also lead to surges and sudden stops in specific countries, irrespective of the global financial cycle. Lax capital controls can lead to huge capital inflows, resulting in unsustainable external debt and/or appreciation of the exchange rate that worsens the current account. Worsening macroeconomic imbalances combined with triggers such as a rise in oil prices, default on external debt, turn in the financial cycle, etc. can lead to a sudden loss in international confidence (and capital inflows).

The orthodox policy advisory for EMDEs to avert the accumulation of macroeconomic imbalances is to choose between a combination of unrestrained capital flows and a flexible exchange rate on one hand, or a fixed exchange rate with capital controls on the other. The underlying trilemma for EMDEs is that they cannot simultaneously sustain an 'impossible trinity' of monetary policy independence, free capital flows and a fixed exchange rate. It must choose two out of the three.

While a policy option derived from the impossible trinity rule might work in normal times, as professor Helene Rey of London Business School has pointed out, this might be insufficient to deal with the fallout of shifts in the financial cycle when there is indiscriminate movement of capital in one direction. In such circumstances, EMDEs may have little option other than throwing sand in the wheels of such flows through some forms of capital control and macro-prudential policies. The IMF has long abandoned its policy advice for emerging markets to aim for fully-liberalized capital accounts.

Unlike the global financial crisis, EMDEs have not weathered the covid economic storm as well as advanced economies (AEs). Nevertheless, with higher growth, international reserves, lower exter-

nal debt, inflation and more robust current accounts, EMDEs in Asia are better equipped to weather a US interest rate pivot. Two-thirds of the increase in international reserves of EMDEs since 2001 has been in Asia. Asian EMDE external debt at 20% of gross domestic product (GDP) is way below the EMDE average of 31.5%, and its current account balance is projected at three times the EMDE average. In 2020, EMDEs in Asia shrank at half the rate of EMDEs in general, and their average inflation of 3% is 200 basis point lower than the EMDE average.

Some countries will nevertheless be more vulnerable than others, irrespective of geography. Past experience, especially during the taper tantrums of 2013, when it was widely expected that the Fed would taper its quantitative easing (QE), indicates that EMDEs with weaker macroeconomic fundamentals are hit harder. In 2013, India was among the worst affected countries because its current account and fiscal deficits and inflation were way above the EMDE average. India was among the 'Fragile 5', the other four being Brazil, South Africa, Turkey and Indonesia, with the Indian rupee falling about 25%.

How exposed is India today to a possible taper tantrum, compared to 2013? At 20% of GDP, India's external debt is eminently sustainable. Its burgeoning foreign currency reserves also provide an adequate cushion as measured by the Greenspan-Guidotti rule (reserves minus short-term external debt). But both these were also quite comfortable in 2013.

The above table indicates that except for the current account deficit, all the parameters that made India vulnerable in 2013 are again significantly above the EMDE average. India is the only country

among eight major emerging markets that has four of the five selected macroeconomic parameters much worse than the average. Brazil, South Africa and Turkey have two of them misaligned, while Bangladesh and Thailand have one each. India's nominal current account deficit also doesn't inspire confidence, as both exports and imports have slid sharply. This could worsen if oil prices rise.

Moreover, five additional vulnerabilities exist that were not in evidence in 2013. First, there is the deadly ongoing second wave of covid, with the pandemic's epicentre appearing to have shifted to India, and uncertainties over the adequacy of its vaccination programme. Second, India's outsized decline in growth relative to EMDEs, with the economy contracting by 8% in real terms in 2020-21. The Indian economy is now back, in real terms, to where it was in 2017-18. This comes on top of serial year-on-year declines in growth from 2016-17. Third, there are strong headwinds in the path of an economic recovery on account of India's impaired banking system. Fourth, both exports and private investment show a long-term declining trend. Fifth, even as India's budget deficit is higher than the EMDE average, there are headwinds in the way of fiscal correction, as its tax-to-GDP ratio has been trending down, pointing to a broken tax system.

For all these reasons India is particularly vulnerable to the external shock of a rise in US interest rates and turn in the global financial cycle. The country's macroeconomic fundamentals do not look good in comparison with its EMDE peers. It is also far more exposed than the rest of Asia's EMDEs. India would do well to watch out.

Succession at Morgan Stanley: It missed the diversity memo

Such a high-profile firm should have a diverse pool of top talent



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CEO James Gorman's succession plan is being keenly watched

The largest US financial institutions are sending a clear message: The pandemic has shifted into their rear-view mirrors. After JPMorgan Chase & Co's management appointments earlier this week, it was Morgan Stanley's turn on Thursday to assign fresh roles to a line-up of potential successors to its chief executive officer (CEO).

Now that the covid storm is fading in the US, it's only natural that the question is coming up now about who should succeed James Gorman, who has been in the job for 11 years. But while Gorman's executive rejigging might be a textbook example of ensuring business continuity and a smooth hand-off to the next generation—still a rarity among European banking peers—there's one glaring deficiency in his largest shake-up in more than a decade: a lack of diversity that could significantly hurt in the future.

In a lineup that has been all too common in banking—and especially Wall Street—four [Caucasian] men are now in the lead to potentially succeed Gorman. As my *Bloomberg News* colleague Sridhar Natarajan reported, Morgan Stanley named Ted Pick, who helped revive Morgan Stanley's trading activities, and Andy Saperstein, who propelled the firm's wealth-management business, as co-presidents, the most likely to succeed Gorman. Dan Simkowitz, investment management chief, was promoted to co-head of strategy alongside Pick, and Chief Financial Officer Jon Pruzan will become chief operating officer.

To be sure, there is a nod at diversity, with a woman also receiving a promotion. Sharon Yeshaya, the head of investor relations, will become CFO, but it will be a while before she can prove herself sufficiently to have a chance at getting the top job because she has not run an operating unit so far.

To Gorman's credit, Morgan Stanley is a well-run company, regaining its stride under the Australia-born leader after the financial crisis-era wobbles. The executives he has promoted are well established in their positions, and it should be business as usual from here. Gorman spent the best part of a decade reining in risk while expanding wealth management. Last year, he pulled off not one but two large acquisitions—E*Trade and Eaton Vance—cementing the firm's diversification away from volatile trading toward fee-generating businesses.

In the meantime, Morgan Stanley has been regaining market share in investment banking. The firm is in the top three

in equities underwriting and a leader in mergers and acquisitions. Its shares have more than tripled from their post-pandemic trough to the highest in decades.

Still, the turnaround hasn't been all smooth sailing. The \$900 million hit Morgan Stanley took on the implosion of Archegos Capital Management in March made it the only large US firm to lose money on the blowup. The surprise disclosure only weeks after the losses were incurred also raised some concern about how Morgan Stanley has been managing the business and expanding in pockets of trading. Its earlier bets on some foreign-exchange derivatives had also backfired as the financial firm expanded aggressively in that space.

Only time will tell whether the Archegos episode remains an unfortunate but easily surmountable blunder. Compared with many peers, Morgan Stanley has managed to tread on fewer big landmines. So far, the firm has said it doesn't plan to retreat in prime brokerage, the unit that caters to hedge funds and where the losses stung.

But in an era in which executives are being judged not just for their ability to turn a profit, but also for their firm's role in society, a lack of diversity among senior managers in a position to lead the firm in the future does not look good. Contrast Morgan Stanley's top CEO candidates with JPMorgan's, where two women are competing head to head for the No. 1 job. While the potentially combative set-up isn't ideal, at least there has been a concerted effort to groom a CEO beyond the usual suspects. Improving diversity is an urgent task Gorman needs to tackle well before his successor takes over, if the data is anything to go by. As of 2018, the firm's most recent numbers, of about 1,700 executives, just 23 were African-American men and 14 were African-American women. Women held about 18% of those jobs. And the firm's operating committee is still dominated by Caucasian men, as is the next level of management, where 60% are Caucasian men.

It's not the image the highest-paid bank CEO in the US would want to be remembered for, surely. Before Gorman heads into the sunset—he told the board he plans to stay at least three more years—there's plenty of unfinished business he needs to take care of.

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MY VIEW | GENERAL DISEQUILIBRIUM

Covid has exploited the comorbidities of our federalism

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Coronavirus is a true-blue change agent. Look at Russia, the bastion of Putin-style socialism, which is now opening its doors to vaccine tourism: Come to Moscow, get vaccinated and, as a bonus, enjoy the sights. Even as an *agent provocateur*, the Sars-CoV-2 virus has upset the fragile economic balance of the past 40 years or so, disturbed the tenuous political order, and injected chaos into social networks and kinships. General Disequilibrium, anybody?

Among other disruptions, the second wave has exposed gaping crevices in governance capacity and public health infrastructure, apart from exposing the questionable practices of some constitutional authorities. As the Centre has floundered in managing rising infections and deaths, a new breach has emerged in the country's federal framework. The signals are clear: There's an urgent need to upgrade state finances and discuss whether the Constitution's Seventh Schedule—which delineates the Centre's and states' responsibilities—needs a hard

relook. Will the Centre oblige?

While the new gaps in the federalism framework are a direct consequence of governance lapses, they have also surfaced from the government's pursuit of political goals by leveraging the pandemic and lockdowns. This is not to say that the federal structure was infallible earlier (see: [bit.ly/3yq2cWY](#) and [bit.ly/3hKUCtV](#)); the covid virus has only manipulated existing gaps in the structure, much like it exploits comorbidities, and exposed the hollowness of the slogan "cooperative federalism".

This is true for all forms of federalist structures. The Goods and Services Tax (GST) Council has not met for seven months despite rules mandating quarterly meetings, thereby depriving states of resources for combating covid. This is important because the Centre's absence from the frontlines in tackling the second wave has shifted the burden of healthcare expenditure to states. In politics, the West Bengal governor saw it fit to bypass a popularly elected chief minister and approve the Centre's vilification of recently-elected Trinamool Congress state legislators, though their earlier partners in the same alleged violations have been spared because they shifted allegiance. Here is another example of a federal imbalance: The

Election Commission's insistence on 8-phase elections for West Bengal, in the midst of a raging pandemic, could be viewed as a constitutional body's not-so-subtle partisan signals to voters.

The federalism question reared its head once the Centre's mismanagement of the forced states to float global tenders for buying vaccines. A flurry of articles appeared thereafter, debating the state of India's federalism. States are also, for good measure, not looking up to the Centre for guidance and have instead implemented their individual lockdown protocols, all distinct from each other's. These individual state responses have collided with the unstable and unequal form of Indian federalism and, consequently, something has to give. It is this column's hope that a framework currently biased towards a stronger Centre will yield to a kinder, gentler and more even-handed federal structure, one that does not perpetuate or worsen the patron-client relationship

between the Centre and states. The starting point for that should be state finances.

As stated above, the second wave has squeezed state finances and, in the absence of additional central funds, this has constrained states' pandemic efforts. After much prodding, the GST Council is finally meeting and is expected to discuss the GST revenue shortfall during the current financial year and how to compensate states. When GST was introduced in 2017, states were assured a 14% increase in their annual revenues till 2022, with the proviso that revenue shortfalls would be compensated through a cess levied on luxury goods (such as alcohol, cigarettes or automobiles, among other things).

The Centre's earlier estimate that states would need ₹156,164 crore compensation during 2021-22 now needs revision because the second wave has impacted economic activity. There was a similar shortfall in 2020-21, and the Centre had agreed, after much coercion, to borrow and pass on a por-

tion of that outstanding to states, repayable from future compensation cess accruals. In the absence of economic activity and commensurate tax revenue inflows, the Centre will now have to find new ways of transferring additional revenue to states, even if that means expanding debt.

The fraying federalist structure also mandates a relook at the Seventh Schedule; this has become especially pressing with the Centre increasingly encroaching upon state territory. And now states are competing with each other in the global market for securing vaccines, something that should have been centralized at the Centre.

What next? Can states draw up their own foreign policies? For example, West Bengal—which shares borders with Nepal, Bhutan and Bangladesh—is currently hostage to the Centre's shifting foreign-policy quirks, lacking agency and unable to intervene for its own benefits. Perhaps foreign policy may be too extreme a step, but that shouldn't stop a reassessment of the Seventh Schedule, especially the misaligned balance of powers in health-care, education agriculture or labour issues.

The pandemic's lessons are loud and clear, but it is moot whether this government's overt centralist tendencies will continue to drown them out.