

Justice Konda Madhava Reddy Memorial Lecture

Global Financial Crisis And Asia

Memorial Lecture - Global Financial Crisis And Asia

"GLOBAL FINANCIAL CRISIS AND ASIA"

Twelfth Justice Konda Madha Reddy Memorial Lecture

By

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I am grateful to the organizers for giving me the honor of delivering Justice Konda Madhava Reddy Memorial Lecture. I had the privilege of knowing Justice Madhava Reddy garu at a personal level also, and had the good fortune of enjoying his hospitality at his home in Delhi on several occasions. A lecture in his memory is in a way expression of my gratitude to him as a person, and also a tribute to his contributions and achievements that are well known. He was a respected judge and a lawyer of distinction with universal reputation of being fair and pleasant. Above all, he carried his exalted positions of eminence and erudition very lightly on his shoulders. I am very happy that Justice Sri P. Venkatarami Reddy garu, for whom I have a high regard, is presiding over this event.

SIGNIFICANCE OF GLOBAL FINANCIAL CRISIS:

Global Financial crisis which is underway is of great significance for several reasons. It is being compared to Great Depression of 1930, and so it is natural to expect the consequences to be of similar importance. It changed the intellectual framework of managing the economies, with the onset of what is described as Keynesian-ism; basically indicating importance of public policy in avoiding such crisis or minimizing the impact of such events. The experience brought into existence multilateral institutions, especially World Bank and International Monetary Fund. Some attribute Second World War to be, in some ways, a consequence of Great Depression. Above all, Great Depression shifted the geo - political and economic balance from U.K and Europe to North America. Will there be a similar shift of balance from America to Asia now as a consequence of the current crisis? There are many explorations on this prospect, which should be of interest to us in India.

There are several reasons for examining such a prospect seriously. First, this crisis, unlike many others before, originated in the countries of global economic activity, especially in U.S.A and U.K and not the peripheries like Latin America, Asia or Eastern Europe. Second, the near collapse of markets happened in countries whose models of financial sector were considered as models for all others to emulate. Third, the policies and procedures of regulators of financial sector in these countries were considered to be the best and they set the standards for judging" other regulators. Fourth, the leading global financial institutions; and about 15 of them accounted for over 70% of cross border finance, based in the centre suddenly ceased to do business with each other. They were credited with having the best mathematical models for risk management, to be emulated by all others; and it is exactly they who were most affected. They were also too big to fail. Fifth, multilateral bodies, especially International Monetary Fund, pointed to existence of some broad economic imbalances, but were not able to anticipate let alone prevent or moderate the crisis that erupted. Above all, the global reserve currency happens to be U.S. Dollar but its economy has been consistently in recent years, depending on the flow of resources from the rest of the world for sustaining its economy. Finally, the pre-eminence of U.S. economy and the economic policies identified with U.S and U.K are thus challenged by the nature of their macro-economic imbalances and the causation of the current crisis.

Asia as a region has been dependent on U.S.A for exporting its goods and services and for investing their surpluses of financial resources, both through forex reserves of central banks and sovereign wealth funds setup by Asian governments. At the same time, Asia also receives significant inflows of capital on private account. Hence, when the financial crisis erupted in U.S.A, U.K. and Europe, Asia suffered due to trade-linkages and linkages through private capital flows. Such an impact is inevitable given the nature of global integration. But, Asia has suffered significantly less from the crisis than the rest of the global economy. Asia appears to be recovering sooner than the rest. Asia is maintaining high growth. Growth is very impressive in China and India. Asia has its own unique features of macro-economic management, and these are being favourably assessed. Asia's economies are dominated by banking systems, concentrating on traditional retail banking. It does not have dominant derivatives market that in a way caused the crisis. Asia built considerable forex reserves, as a self insurance against global shocks in real sector through commodity prices or financial sector through capital flows. Asia, had for most part, surpluses an current account, sort of exported more than it imported from the rest of the world, though a few like India had modest deficits. There is, in brief, churning of ideas, policies and practices that appear to be appropriate for global economy and in this process the question is: post-crisis, what will the return to normalcy of the global economy mean?

The normalcy after the crisis cannot obviously be the old world order and hence post-crisis, the return to normalcy would be what may be called return to new normalcy. The new normalcy would be a rebalanced world order, and in this what will Asia's position be? That in brief is the focus of my presentation today. The presentation is on very broad contours; general rather than technical; pragmatic rather than ideological and above, all exploratory and conjectural rather than conclusive or predictive. The lecture has a public policy orientation keeping in view the

CAUSES OF THE CRISIS: SYNCHRONISED EXTENSIVE EXCESSES:

There are multiple causes for the crisis and these operated in a way that they reinforced each other in bringing about the crisis. There are, no doubt, differences in opinion on the relative importance of the causes but there is little difference on the relevance of each of these causes. I will characterize the common factor in all these explanations in one word "excesses", excessive on several fronts up an extensive manner and in a synchronized fashion. These excesses were observed in liquidity, macro-economic imbalances, focus on inflation, inequalities, financialisation, leverage, risk taking, deregulation, Innovation, networking, greed, globalization and concentration. Let me briefly and illustratively explain them in an over simplified manner.

(a) Excess liquidity: Many central banks especially in U.S.A and U.K. permitted abundance of supply of money at relatively low interest rates. They adopted this policy due to a primacy in their policy to price-stability to the neglect of asset bubbles (i.e. high prices in real-estate, housing, equity markets etc.) and financial stability. In times of excess of liquidity, when money is available in plenty and low interest rates, people may use it to speculate in assets or even commodities; and more risks are taken in an environment of cheap-money. Even when asset bubbles were noticed, central bankers felt, either due to ideology or convenience, that markets will correct by themselves, efficiently if not smoothly. Thus, bubbles were built and excess volatility injected into several markets.

(b) Excessive macro-economic imbalances: Some countries, notably U.S.A. had large current account deficits: that is deficit in earnings from the rest of the world - say by exports - relative to payments to be made to the rest of the world - say for imports. This deficit has to be bridged by capital inflows. Some countries, notably China and Japan had large current account surpluses. Thus, one set of countries were consuming too much and saving less while another set was saving too much and consuming too little; too much or too little depending on what the global economic system can bear. For example, current account imbalances between states in India do not matter, since each state is an open economy within the country, but among countries beyond a point they do matter. That these excessive imbalances existed was known, and concern was expressed by many, but policy actions to correct them did not happen - both at national levels and at global level through multilateral babies.

(c) Excessive focus on inflation: The governments and central bankers were focussed on maintaining price stability, but in some cases a narrowly defined price stability in terms of core-inflation, thus excluding price increases in food and fuel. In many cases there was a policy of inflation targeting, and this did not include asset prices. The growth in prices of financial assets was unrealistically higher than growth in nominal Gross Domestic Product, thus building more of a paper asset economy than a real asset economy.

(d) Excessive inequalities: In many economies, especially U.S.A, the Inequalities increased and labour's share in growth was less compared to capital. In a more equal society, aggregate demand for goods and services tends to be more stable, and in a less equal society, less stable.

(e) Excessive Financialisation: Financial sector has grown far more rapidly than real economy, though finance is mainly a means to the end, namely goods and most other services. This growth happened on the assumption that finance could lead growth, and will improve growth with more efficient distribution or allocation of resources, rewards and risks. In reality the efficiencies that were assumed did not fully materialize; and financial sector took most of the gains to itself and managed to transfer all the risks to other people or governments. Further, many of the participants in financial sector have a tendency to multiply transactions, since their incomes increase with number and size of transactions.

(f) Excessive leverage and risk taking: High leverage basically means that an institution (individual) is doing business with a disproportionately high proportion of others or borrowed money than one's own. In some cases, such as banks, regulators did not insist on adequate capitalization appropriate to risks (that is insist on a reasonable minimum proportion of owned money to borrowed money). In some cases, the non-banks, especially hedge funds or private equity, remained unregulated resulting in high leverage, especially if the incentives of managers are biased in favor of excessive risk-taking and shorter term gains. For example, standard practice for fund-managers was to get two percent of fund as management fee and twenty percent of profit as bonus, while losses are not shared by the fund managers.

(g) Excessive deregulation: There was a belief that costs of regulation of financial markets are often high relative to benefits and, mechanisms such as self-regulation and principle based regulation are often more efficient. This process of deregulation which commenced with Thatcher and Reagan era as a reaction to financial repression in previous decades, was taken too far. Several legislative and policy initiatives were taken to deregulate the financial systems, consistent with these beliefs.

(h) Excessive innovation: There was a spate of financial innovations, namely new products. Derivatives, in particular, were expected to help dispersal of risks though the underlying risks of real transactions do not disappear. However, whether they disperse or concentrate risks depend on the intent of innovation, nature of products and the magnitudes involved and where the risks ultimately reside. The size of derivatives markets became a huge multiple of underlying transactions with growing disconnect between the two. There is view that complexity was deliberately injected into these products and the trading was multiplied by the traders; while regulators allowed this process either out of ideology or lack of skill or will. In the end, the risks were apparently but not really dispersed from the mainstream financial institutions.

(i) Excessive network: The financial markets enabled by the technological developments, went into a state of complex networks encompassing countries, institutions and complex products. But, unlike the telecom or energy networks, no circuit breakers or sands under the wheel were considered, either by the self regulatory bodies or regulators.

(j) Excessive greed: There is a view that, for some reason, the conduct of many participants in financial sector was characterized by excessive greed. It is not clear whether such a conduct was characteristic of financial sector or of Anglo-Saxon values, or it was universal. In any case the cult of the financial markets led to the neglect of focus on economic fundamental and institutional incentives.

(k) Excessive globalization of finance: The financial sector is regulated by national authorities, while financial markets and the operation of financial institutions with strong cross-border presence became increasingly global. Thus, relative to the regulatory framework which remained national, finance was globalized and deregulated prematurely or excessively. Further, even in the absence of appropriate and effective global financial architecture and their continued out dated governance structures, the financial markets were globalised with support from the multilateral institutions. Further, tax regimes vary as between countries, with some jurisdictions being tax-heavens. So, the cross border movement of financial activity is influenced by differences in regulatory regimes and tax regimes also through what is called arbitrage.

WHY DID THESE EXCESS EXCESSES HAPPEN?

It is necessary to explore the reasons for these extensive excesses, since such synchronised extensive excesses for a prolonged period may not be a mere accident. There are several explanations, and each of them as usual, is partially true. First, the financial sector took full advantage of technological developments to innovate complex financial products, and utilised them to redistribute wealth in its favour. Second, the ideological preference for unfettered markets was particularly unsuitable for financial sector in view of its huge externalities; that is what happens in financial sector affects other sectors significantly and disproportionately. Further, such an ideological approach to finance, especially globalised finance, was inappropriate in view of varying levels of institutional developments among countries, though globalisation of trade in goods was on the whole beneficial. Thirdly, there was convergence between political leadership which looks for short-term gains and financial markets which also have a short time horizon. For example, this resulted in emergence of Washington - Wall Street linkage in U.S.A with similar linkages in other countries.

Fourthly, there was a "race to the bottom" in financial regulation, particularly among those, such as U.S.A and U.K. who want to be international financial centers. In view of the nature of financial sector which is often described as foot-loose, it gravitates with ease to centers which have less rigor in their regulation.

However, when problems arise due to soft regulation in such international centres in one country, the globalized finance and trade transmit the problems to others and many countries become innocent victims of such a contagion.

Fifthly, competitive advantage in sectors like agriculture, manufacturing and services has shifted to developing world, while the developed world continues to have competitive advantage in financial sector. Consequently, there was a pressure from financial markets in the developed economies to globalise finance without due regard to overall financial stability. Sixth, the global watchdogs like I.M.F were influenced by the ideology and voting power of developed world, with the result they could not guide or assist the global economy towards stability. Finally, most people saw themselves as consumers and investors, focussing on the price and quality of goods that they can buy and the returns that they can get on their investments, ignoring their identity as citizens or members of a community and long term stake holders in a corporate. The democratic pressures were thus in favour of short term gains than overall stability. All these

factors added to the strength of short-term horizon that financial markets signified.

It must be recognised that the problem was not with financial sector or markets or liquidity per se but it was in a result of excesses on several fronts.

CRISIS MANAGEMENT, REBALANCING AND TOWARDS NEW NORMALCY:

There is a general agreement that there have been excesses in many areas of economic and financial management in many countries. However, the more immediate issue was to manage the crisis in a way that it does not led to a collapse. sometimes, the measures to manage the crisis may have the effect of rebalancing in future more complex. The longer time issue is to decide on what, the new normalcy after re balancing could mean, since the normalcy as represented by the pre-crisis order was clearly inappropriate. There are very difficult choices to be made in regard to (a) measures for crisis-management, (b) withdrawal of such extraordinary measures and (c) defining the parameters of new normalcy through a process of re balancing.

Response of public policy to the crisis was prompt, displayed cooperation among leading economies of the world, and was characterised by extraordinary as well as unconventional measures by central banks and governments. It is noteworthy that the crisis has been global and all policy interventions for crisis-management had to .be at the national level. The public policies took centre-stage and the goal of avoiding global recession and deflation has been achieved, to the extent of available evidence so far. The financial markets are functioning normally. The declining trends in real output and employments have been arrested, though economic distress already brought about remains. In brief, there is no panic or despair, but uncertainties remain.

The current stage of global economy is functioning with a stimulus in most countries and such a stimulus cannot but be temporary. The test of successful management of the crisis is in the successful exit from stimulus. Mobilising consensus and coordination for exit policies among countries and policy-wings within each country will be complex and critical and certainly not as easy as that of fire fighting to stem the impact of crisis. It is possible that political leadership and financial markets would avoid the risk of premature withdrawal and in the process embrace the risk of delayed response. The withdrawal of stimulus has to be specific to the problems of each country; and bigger the original stimulus, more complex the exit. The quality of original stimulus is also important.

More important, there may be difficulties and disagreements in the destination of exit: namely the new normalcy that should avoid serious pitfalls. It is possible at this stage. to indicate the extent of rebalancing would depend on the extent and nature of excess that were described extensively; these excesses varied as between countries and hence rebalancing will have a country focus.

At the same, the contagion was a cross border issue and' the rebalancing of excesses relevant to contagion will have both national and multilateral dimension.

Broadly stated, the main areas that require to be rebalanced to transit to new normalcy are:

First, the balance between state or government and markets needs to be considered. It is clear that the crisis is not simply a failure of markets but also the apparatus of state especially in the areas of money and finance. Hence rebalancing should address issue of governance in both state and market.

Second, the links between real and financial sector and regulation of financial sector need to be revisited. Finance has a critical role in efficient allocation of resources among users, nations and over time; but how to ensure that the means do not become an end? The process of de-leveraging and recapitalizing financial institutions may be necessary, but an agreement on the appropriate levels is difficult to obtain. New balances may have to be struck between regulation, self regulation and free-markets in financial sector. In particular, the scope for and limits to separating traditional banking activities and treating them as public utilities will have to be revisited. The optimal framework for bank regulation may be more complex than mere return to status quo ante.

Third, the overall approach to re-balancing in the global context has take account of not only excesses and experience of some leading economies such as U.S.A and U.K. which were hard-hit but also the experience of those economies which could avoid serious problems in their jurisdictions. In this regard, experience of Asia is particularly instructive.

Fourth, the crisis-management has shown the importance of actions at national level and also coordinating mechanisms at global level. The mechanisms like G-20 are more representative but still are informal ones. The deficits, both in governance and ideology of current global financial architecture are coming to the fore while global imbalances are yet to be resolved. The major issues in his regard are: How to re balance the consideration of national sovereignty and strengthening of global cooperation? Will it involve resetting limits to global finance - say through national management of cross border capital flows? Will it result in strengthened global surveillance and institutions? What will be the role of regional arrangements and bilateral treaties? Finally, in the emerging re balance, how would different countries or continents be affected? Specially, what is the evolving position of Asia in the crisis and in a future rebalanced world?

THE CRISIS AND RE-EMERGING ASIA:

In a land-mark publication in 2001, Angus Maddison estimated that in A.D.1700 India accounted for 24.4 percent of world's gross domestic product, China for a similar share and Japan a fifth of India's share. Thus, Asia accounted for a major part of world's economic activity three centuries ago. After the crisis, and noticing trends in growth and resilience of Asian economies, there is a view that Asia will re-emerge to dominate the world economy soon. Already by 2007, Asia (including Japan) accounted for 67% of world's official forex reserves; 55% of world population; and 25% of world GDP. Angus Maddison has projected in a publication in 2007 that by 2018, China would overtake U.S.A as the largest economy, with India as number three and estimated that Asia would account for 53 percent of world GDP. In other words, by 2018 Asia will restore its position in global economy to its level of three hundred years ago.

Growth in Asia has been impressive in recent decades. Despite the Asian crisis that hit many countries in 1997, the region has resumed high growth. It has proven its resilience, relative to others, in the ongoing crisis. It is noteworthy that Asia continues to be performing well, with China and India leading the growth during the crisis, though it has moderated relative to the pre-crisis period, due to contagion. It is also noteworthy that the exit from huge stimulus to manage the crisis has already commenced in parts of Asia.

During the crisis, financial markets in most of Asia faced' some temporary turbulences but financial institutions, banks included, did not generally warrant bailout by government or central banks. Growing importance of Asia was recognised in the ongoing dialogue on reform of global financial architecture. At the same time, Asia has taken several initiatives for strengthening cooperation within the region.

OUTLOOK FOR ASIA IN NEW NORMALCY: RANDOM THOUGHTS:

There is a broad agreement that the crisis has reaffirmed the prospect of Asia re-emerging as a dominant region in near future. It is critical for Asia to assess its problems, prospects, and its role in the process of rebalancing and designing the. new normalcy in global economic management. My view is that there are opportunities and prospects but, significant challenges especially for public policy, remain to be addressed at national levels and to some extent regional level, for Asia to aspire to exceed or equal the dominance of Anglo-Saxon or Europe-American regions. I will mention a few random thoughts in this regard.

(1)Economic Activity: There will be definitive and massive aggregate economic activity in Asia. The addition to workforce each year will be huge and standards of living will keep improving. The culture of savings in Asian will provide capital to match growth in supply of labour; and together huge demand will be generated by what may be termed as growing new middle class of Asia. Urbanisation and concomitant infrastructural demands will be large, spurring massive economic activity. Indonesia and Vietnam are emerging on ways similar to China and India. The region has great diversity in demographic cycles, with Japan at one end and India or Indonesia at the other; China being at the intermediate state. This characteristic could lend considerable stability of demand for and supply of labour, and goods and services. Asian multinationals could take centre stage in the world. Intraregional trade should grow very rapidly, which may warrant re-emergence of Silk Road and Spice Route. The most defining factor for the re-emergence of Asia as a force to reckon in global economy may be the magnitudes balance and quality of trade between China and India.

(2)Economic challenges: With an annual addition of about 40 million to workforce which would include rural-urban migration, education and skill up gradation will continue to be a major challenge for Asia. Demands on public health .and medical care will be huge. Water could prove to be a complex issue, while climate change will be a daunting challenge. Above all the social consequences of growing inequalities and inadequate social security could be serious. Most of these challenges are in the domain of public policy but private sector can not prosper if these issues are not resolved satisfactorily.

(3) Financial activity: Asia has potential for becoming a hub for global financial activity with the pool of capital that is being supplied and perhaps demanded; and human skills in managing finance. Till now domestic or regional financial markets have tended to follow rather than lead global finance, though recent initiatives in this regard, particularly by China, are noteworthy. Major issue, however, relates to infrastructural services for economic activity, such as credit rating services, business news agencies; standard contracts and dispute resolution mechanisms. The dominant global financial conglomerates are still based out of U.S.A and Europe but their ownership could, over the years, change hands in favour of Asia reflecting changing balances in economic activity between Asia and the rest of the world.

(4) Intellectual activity: The leadership in global economy has significant link with the leadership in thought and in innovation, as history shows. Asia as a region is yet to invest adequately and demonstrate its strengths in thought and in innovations. Japan has demonstrated significant capabilities in technological advances but for the region as whole considerable distances have to be covered in achieving excellence in research and technological innovation on par with the west. Public policy has a critical role in this regard.

(5) Standards of Governance: The size of economic and financial activities in a region or a country do indicate the importance for global economy, but, commanding the confidence and credibility of global markets over long period, and standards of governance in governments do matter. In particular, assured existence of property rights and enforcement of contracts is essential while social and political system stability also play a role.

(6) Intra regional Cooperation: Intra regional cooperation is already taking place on several fronts and in various fora. The most notable in the recent past are multilateral fund under Chang Mai-Initiative and agreement to have surveillance at regional level. This initiative does not, as yet, include India. The regional arrangements and initiatives in Asia could supplement the efforts of the Asia to assert and advance its emerging role in global economy and global multilevel institutions. However, Asian regional cooperation, to be effective in the global context may have to rest on four pillars, namely, Japan, China, India and ASEAN.

(7) Managing Transition: History indicates that major shifts in economic balances or power in the world take place over a period of decades and may not necessarily be smooth. The transition from U.K. and Europe to North Atlantic was relatively smooth because of underlying common cultural features after the renaissance and dominance of Anglo-Saxon leadership. The transition of balance between U.S.A, U.K. and Europe to Asia may not have the same advantage but the technological developments and globalisation that has already taken place may help the process. In other words, the transition will involve considerable policy-initiatives among the major countries within the region to reinforce each other and between Asia and rest of the world to make the smooth transition. Further, shift in regional balances in favor of Asia will be smoother than other wise, when there is a degree of acceptance of such a shift by other regions, especially Latin America and Africa.

CONCLUDING REMARKS

Let me conclude this lecture with a reference to India on this subject. I would endorse what, Dr. C. Rangarajan, my guru, said in his sixth Justice Konda Madhava Reddy Memorial Lecture on Globalisation and Challenges before India" on 20th December 2003.

"As an eminent critic put it, the world cannot marginalize India. But India, if it chooses, can marginalize itself. We must guard ourselves against this danger. More than many other developing countries, India is in a position to wrest significant gains from globalization. However, we must voice our concerns and in cooperation with other developing countries modify the international trading arrangements to take care of the special needs of such countries. At the same time, we must identify and strengthen our comparative advantages. It is this two-fold approach which will enable us to meet the challenges of globalization which may be defining characteristic of the new millennium".

I thank the organizers for inviting me and I am grateful to the distinguished audience for their presence and attention.
