G 20 and India

Dr. D. Subbarao

FORUM
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"Free Enterprise was born with man and shall survive as long as man survives".

- A. D. Shroff
Founder-President
Forum of Free Enterprise

INTRODUCTION

In the current year three lectures were arranged in honour of A.D. Shroff. The first was by Dr. Kaushik Basu, Economic Advisor, Ministry of Finance on "Is India Ready for the Global Stage?". The second was by Mr. Arun Maira, Member, Planning Commission, on "Shaping India's Future-Democracy, Capitalism and Government" and the third one by Dr. D. Subbarao, Governor, Reserve Bank of India, on "G 20 and India".

All the three very learned speakers have underlined where India's ultimate destiny lies. According to all of them India has the pre-requisite to become a great economic power provided it gets its act together and all the stakeholders - the Government, the political class, business and civil society work in sync.

A resume of Dr. Subbarao's address is reproduced in this booklet. It is an excellent presentation which beautifully captures, from a vantage point, the increasingly important role India has been called upon to play at the big table, G 20, in the last three years. "G 20" has evolved out of the original Rich Man's Club of eight members to one having 19 members now, including many large Emerging Market Economies (EMEs) including India, representing 90% of the global GDP and 80% of global trade. It is a unique international initiative, an informal assembly of Finance Ministers and Central Bank Governors with nc mandate for global governance. Its decisions are not legally binding. Yet it has enormous relevance for fostering international policy formulation and is a paradigm shift away from the divisive style of global governance of the Bretton Woods system.

Global Rebalancing is one of the root causes for the global financial crisis. It is the build up of "consumption

binge" in the advanced economies and a 'saving glut' in EMEs. Reducing these imbalances is a necessary condition for restoring global financial stability. Global rebalancing will require deficit economies to save more and consume less.

Exchange Rate policies - were at the centre of the G 20 debates. China's effective real exchange rate has appreciated since 2005. Yet there is a constant demand from several countries, running large current account deficits (CAD), for China to appreciate its currency. In fact YUAN has appreciated between 20% to 35% against major international currencies since 2005. As far as the Indian Rupee is concerned, the object has been to ensure that the exchange rate is at a level which enhances the country's export competitiveness, India runs a large CAD in recent period relative to our historical record. Hence we need larger foreign equity flows, India is moving gradually towards opening its capital account along a roadmap, recalibrated to the evolving global situation.

The Speaker touched on capital flows. The quantitative easing by Central Banks in the advanced economies led to excess liquidity in the global system. In case of some EMEs it was in excess of their absorbing capacity leading to currency appreciation and decline in competitiveness. The lumpy and volatile nature of flows is a result of quantitative easing which compelled some of the EMEs to impose capital controls.

Dr. Subbarao expounded on the widely debated global reserve currency issue. Currently the US dollar is the world's reserve currency by virtue of the dominant size of the US economy and the preponderant use of the dollar in foreign trade and foreign exchange transactions. The US has met the obligation of an issuer of reserve currency by running fiscal and external deficits. However, it has not made the

necessary adjustment to bridge the deficit. The US could not have run the persistent deficit if the EMEs had not provided the impetus by accumulating reserve assets. Paradoxically as the US economy was in a downturn the dollar strengthened as a result of flight to safety.

He then touched on the possibility of alternative reserve currencies which could fulfill the basic pre-requisites viz. full convertibility, significant share in world trade, a large financial market, and adequate liquidity. Developing the SDR as a reserve currency which was earlier considered to be a feasible option, does not seem to fit the bill. With the increasing weightage of emerging markets some of the EMEs, especially China and Russia, have tried to see that their currencies play a greater role in international transactions. However the pace is slow. Consequently the US dollar will continue to be the global reserve currency at least for the next few years.

In the post-crisis world, the earlier view that globalization is unmixed blessing is being increasingly challenged. Recent international developments have brought about an ironic reversal. Previously the EMEs feared that integration into the world economy would lead to welfare loss at home. This has given rise to apprehensions in advanced economies that globalization means losing jobs to keep labour abroad. There is some concern that while protectionism is openly resisted, opaque protectionism has been on the rise, in the form of anti-dumping actions, preferential treatment of domestic firms and discriminatory product pricing.

International initiative spearheaded by the G 20 rest on few broad pillars - regulation, supervision and resolution. However, he cautioned that in the area of regulation the special needs of emerging economies deserve particular attention, to ensure that financial intermediaries are not put

to any added disadvantage. Hence the vital need that the regulatory response should be well coordinated globally.

Dr. Subbarao concluded by addressing the future challenges for the G 20. The most important being drawing a balance between short-term compulsions and medium-term sustainability. He pointed to the recent intense debate, specially in Europe, on austerity vls. growth

However, everyone agrees that long term fiscal consolidation is critical to macroeconomic sustainability. While all are aware of the pains of fiscal adjustment in the short term fiscal profligacy can lead to postponing the burden to future generations. Hence the imperative necessity for harmonizing these two objectives and to ensure that different countries move in agreed directions. But to hold them accessible for the commitments given is going to be a herculean task as there is no enforcement mechanism. This is especially difficult in vigorous democracies where the perception would be that national interests are being compromised for the sake of global stability.

While G 20 is certainly a bold initiative which is based on the realization that in a globalizing world our futures are all tied together and the only way we can prosper is through policy cooperation pursued through an honoured code.

The Speaker raised the 64-million dollar question - can G 20 survive ? He felt it can but only by showing exemplary leadership. Alas this is what is missing as there are hardly any farsighted statesmen visible on the global stage.

It is a superb treatise, lucid and well-researched. It is a 'must read for all interested in the evolving economic world landscape.

Minoo Shroff
President
Forum of Free Enterprise

G 20 and India

by

Dr. D. Subbarao*

A.D. Shroff

Even as he had no privileged background, A.D. Shroff rose to become one of the country's most eminent and respected professionals in the financial world of his time. From the Board of Tata Sons, where he was the financial adviser, he went on to become the chairman of New India Assurance and then of Bank of India prior to these institutions being nationalized. At a time when Nehruvian socialist ideology dominated economic thinking, the development paradigm was shaped by the Feldman-Mahalanobis model and the public sector was at the commanding heights of the economy, Shroff had the courage of conviction to argue for an increased role for the private sector in a market economy. It was these intellectual foundations that inspired the Bombay Plan of 1944 of which Shroff was one of the co-authors.

The Reserve Bank recognized Shroff's expertise and innovative thinking early on when, in 1953, it set up a committee under his chairmanship to examine how the flow

* The author is Governor, Reserve Bank of India. The text is based on the 46th A. D. Shroff Memorial Lecture delivered in Mumbai under the auspices of Forum of Free Enterprise on 20th November, 2012.

of finance to the private sector could be enlarged. The Shroff Committee recommendations played a key role in defining the basis for institution building in the financial sector - ICICI and at a later date IDBI, were set up as development financial institutions, a deposit insurance corporation in the shape of DICGC came in the early sixties and the Committee's suggestion of setting up unit trusts as vehicles to channelize small savings into investments provided the basis for the later day UTI.

The Shroff Committee recommendations were seminal and have been acknowledged. Perhaps less known is the fact that A.D. Shroff was the deputy governor that the Reserve Bank never had. Sir Osborne Smith, the first Governor of the Reserve Bank of India (RBI), asked for him as the deputy governor of RBI in 1936 but the proposal was vetoed by the British government which felt that Shroff was too close to the Congress Party. It is ironic that this perceived 'Congress Economist' went on to be regarded as one of the most virulent critics of the Congress Government's economic policies during the second and third plan periods.

Clearly a man ahead of his time, A.D. Shroff understood the importance of private investment in nation building in a liberalized, market driven environment. Like every great idea awaiting its time, the liberalization that he so fervently advocated had not fully arrived in the country till the early nineties - a quarter century after he passed away.

The economic liberalization that we started in the nineties has meant India integrating with the rest of the world, a process that is still work in progress. Over the last ten years, India's two way trade flows as a proportion of GDP have doubled; our two way current and capital flows as a proportion of GDP have more than doubled. The experience

of the global financial crisis and now the Eurozone crisis has taught us that even as we benefit from integration, because of that very integration, we become vulnerable to global shocks.

India's embrace of globalization and the remarkable transition the economy went through after the economic reforms of the 1990s are an eloquent testimony to eminent thinkers with foresight and conviction like A.D. Shroff, I can think of no better way of honouring the memory of a visionary like him than talking about India's enlarged stake and growing role in global economic policy making. In particular, I will focus on the G 20 and India's interests in this very vital international forum.

G 20

The G 20, as all of you know, has been in the forefront of battling the financial crises - the global financial crisis of 2008109 and the Eurozone crisis since 2010 -that have taken a devastating toll on global growth and welfare. Indeed when the history of this crisis is written, the London G 20 Summit in April 2009 will be acknowledged as the clear turning point when world leaders showed extraordinary determination and unity. Sure, there were differences, but they were debated and discussed, and compromises were made so as to reach the final goal - of ending the crisis. This resulted in an agreed package of measures having both domestic and international components but all of them to be implemented in coordination, and indeed in synchronization where necessary. The entire range of crisis response measures - accommodative monetary stance, fiscal stimulus, debt and deposit guarantees, capital injection, asset purchases, currency swaps, keeping markets open - all derived in varying degrees from the G 20 package.

Five years on the crisis is still with us; only its epicenter and the main actors have changed. During these five years, the world has also become privy to the differences on some vital issues within the G 20 membership. Understandably therefore, there are concerns and apprehensions that the vaunted unity and sense of purpose that the G 20 showed earlier on are dissipating.

My own view is that these differences should not be exaggerated. After all, in a world comprising nation states, there is no natural constituency for the global economy. There are bound to be differences when the agenda is so broad and country level compulsions are seen to be clashing with global interests. What is important is that we are able to resolve these differences with the realization that in a globalizing world, no country can be an 'island'. What happens anywhere affects economies everywhere. Global financial stability is a global public good, and there can be no more an effective forum than the G 20 to steer the world towards globally optimal solutions.

Having set that context, I will now address the following questions:

(i) What is the G 20 and how does it function?
(ii) Why is the G 20 important?
(iii) What have been/are the main issues on the G 20 agenda and India's concerns regarding them?
(iv) What are the future challenges for the G 20?

What is the G 20?

The G 20 is an informal club with 19 member countries and the European Union which together represent 90 per cent of global GDP, 80 per cent of global trade and two-thirds of the global population.

Contrary to popular belief, the G 20 is not a new international grouping triggered by the global financial crisis. It was, in fact, triggered by an earlier crisis, the Asian crisis of 1997. Although, it has been meeting regularly since 1997, it acquired a higher profile and credibility in the aftermath of the global financial crisis during which time it was elevated from a Finance Ministers' forum to a Leaders' forum.

The chair of the G 20 rotates every year from country to country. The chair country takes the lead in formulating and driving the agenda. The G 20 leaders meet at the summit level once a year.[1] Besides, the Finance Ministers and central bank governors of G 20 meet twice a year. All the meetings are typically held in, and hosted by, the chair country. The President of the World Bank and the Managing Director of the IMF attend the G 20 meetings, thereby ensuring that the activities of the G 20 are integrated into the agenda of the Bretton Woods Institutions where necessary. There are also other invitees to the G 20 meetings such as the OECD, UNDP and the regional development banks.

Why is the G 20 important?

The G 20 can be seen as a watermark in international economic diplomacy in at least two ways.

First, it is a major step forward from the old divisive style of global governance of the Bretton Woods system characterized by little communication and much acrimony between major developed (G 8) who were largely seen as donors, and developing (G 77) countries that were seen as

1. During the crisis, the Leaders met twice a year. Now, the frequency has reverted to the standard pattern of once a year. Post-crisis, seven Leaders' Summits have been held: Washington (November 2008), London (March 2009), Pittsburgh (October 2009), Toronto (June 2010), Seoul (November 2010), Cannes (November 2011) and Los Cabos (June 2012).

the recipients of bilateral and multilateral aid. Differences in perception remain, but there is now a paradigm shift in the donor-recipient equation, a better appreciation of each others' viewpoint, and an emerging consensus on what increasingly appears to be an incipient new international order through G 20 reports and declarations to'which both sets of countries are committed.

This new style of international governance had been in the making for some time. The bigger EMEs, particularly the BRICS[2], were growing at a much faster pace than ECD countries for a long time, and were becoming increasingly systemically important. It became clear that for any multilateral economic consultative process managing globalization to be effective, their inclusion in the process was imperative. Even prior to the global crisis, the G 8 found it expedient to invite the big emerging economies - the G **5** (Brazil, India, China, Mexico and South Africa) - to their Summits as special invitees, but only to select sessions in what was termed the Heligandamm process. The global financial crisis has simply underscored the need to associate major emerging economies in global economic governance. From being the sources of constant instability in the global economy, some of the larger emerging economies are now increasingly seen as nodes of stability and growth.

The second factor that makes the G 20 unique is its attempt to coordinate the macroeconomic policies of systemically important economies to make them more effective in a world where national macroeconomic policy instruments are being blunted via rapid global integration through trade and financial markets. Following its concerted ahd coordinated policy response to the crisis, the G 20 set about the task of addressing reform of the global economic

2. Brazil, Russia, India, China and South Africa comprise the BRICS.

and financial architecture, and to remove long-standing structural impediments to strong, sustainable and balanced global growth going forward by launching its signature 'mutual assessment process' which is increasingly seen as the heart and soul of the G 20. The success of this process is important for global financial stability, as I will explain later.

Main Issues on the G 20 Agenda

In that context of the origins and importance of G 20, let me now turn to some of the main issues on the G 20 agenda after the world surfaced from the depth of the 2008109 global financial crisis. I will also give the Indian perspective where appropriate.

Global Rebalancing

The first issue I want to address is global imbalances. Almost everyone is agreed that one of the root causes of the global financial crisis is the buildup of global imbalances. In as much as global imbalances - no matter whether they were caused by a 'consumption binge' in advanced economies or a 'savings glut' in EMEs - were the root cause of the crisis, reducing imbalances is a necessary condition for restoring global financial stability.

The post-crisis debate on global imbalances has three interrelated facets. The first is the role of exchange rates in global rebalancing. The second relates to capital flows into EMEs raising the familiar challenge of managing the impossible trinity. And the third facet is the framework for the adjustment process. Let me turn to these one by one.

First, on the role of exchange rates - a prime lever for redressal of external imbalances. Global rebalancing will require deficit economies to save more and consume less. They need to depend for growth more on external demand

which calls for a real depreciation of their currencies. The surplus economies will need to mirror these efforts - save less and spend more, and shift from external to domestic demand. They need to let their currencies appreciate. The problem though is that while the adjustment by deficit and surplus economies has to be symmetric, the incentives they face are asymmetric. Managing currency tensions will require a shared understanding on keeping exchange rates aligned to economic fundamentals, and an agreement that currency interventions should be resorted to not as an instrument of trade policy but only to manage disruptions to macroeconomic stability.

That takes me to the second facet of global imbalances - capital flows. The problem of capital flows came centre stage in the aftermath of the quantitative easing by advanced economy central banks when the excess liquidity in the global system found its way into faster growing EMEs. The most high profile problems thrown up by capital flows, in excess of a country's absorptive capacity, are erosion of monetary policy effectiveness, currency appreciation and loss of competitiveness. Speculative capital flows could also lead to asset and commodity bubbles potentially threatening both financial and economic stability.

In the G 20 debate on capital flows, popularly but mistakenly referred to as 'currency wars', EMEs agitated mainly two points. First, that in as much as lumpy and volatile capital flows are a spillover from the quantitative easing of advanced economies, the burden of adjustment has to be shared. Second, that capital controls should be understood as legitimate and acceptable defence against speculative capital flows.

Global imbalances and their correction were the main concern in the G 20 Framework and Mutual Assessment

Process (MAP) exercise. The MAP exercise is aimed at making countries commit to external sector policies that lead to strong, sustained and balanced growth at the global level. The understanding is that global imbalances, especially imbalances built on the strength of undervalued exchange rates accompanied by a build-up of reserves, threaten the stability of the global economy due to the possibility of disorderly unwinding.

China's exchange rate policies were at the centre of the debate in the G 20. As on date, China's current account surplus (in relation to its GDP) has declined from the pre-crisis peak, and China's real effective exchange rate has also appreciated since 2005, even though it is widely believed that it needs to appreciate further. In the meanwhile, however, the cumulative surpluses of oil producing countries (mostly OPEC, Russia and Norway) have increased and now account for the lion's share of global current account surpluses. While global imbalances have declined in the post-crisis period, their nature and composition continue to evolve. It is important that the MAP exercise in the G 20 keeps a watch on changes in the composition, nature and distribution of global imbalances and their implications, and to steer the work towards their underlying causes.

Now let me comment briefly on the India perspective on the global imbalance problem, India did not contribute to the generation or transmission of global imbalances. As much as we want to enhance our export competitiveness, we believe that it should come from improved productivity rather than an artificially calibrated exchange rate. Our exchange rate is largely market driven, and we intervene in the forex market only to manage volatility in the rate and to prevent macroeconomic disruptions. As a developing economy, we run a large current account deficit (CAD) that has in recent period expanded

relative to our historical record. We need capital flows to finance the CAD. We have an express preference for equity flows over debt flows, for direct investment over portfoiio investment and for long term over short term flows and. We are moving gradually towards opening our capital account along a roadmap, the roadmap itself being recalibrated to the evolving global situation. Our policy, in short, is festina lente which is Latin for 'make haste slowly'.

India co-chairs, along with Canada, the G 20 Framework 'MAP' Working Group (FWG). This provides India an opportunity not only to get an early preview of the macro and micro consequences of global initiatives, but also to actively contribute to such initiatives. India's suggestions on the role infrastructure investment can play in the global recovery and rebalancing is a case in point. As a co-chair, it may be important to ensure that the work of the FWG is not seen as merely a technical exercise but as an effort towards a genuine dialogue on macroeconomic policies of the 20 most significant economies and for engaging in a cooperative game that results in greater policy coordination which is a public good.

Global Reserve Currency

The global crisis has revived the familiar concerns about the robustness of the international monetary system, and in particular about the global reserve currency and the provision of liquidity in times of stress. The system we now have is that the US dollar is the world's reserve currency by virtue of the dominant size of the US economy, its share in global trade and the preponderant use of dollar in foreign trade and foreign exchange transactions. And as Barry Eichengreen told us in his book on the story of the dollar[3] , the reserve currency

3 "Exorbitant Privilege: The Rise and Fall of the Dollar and the Future of the International Monetary System" by Barry Eichengreen.

status depends also on a host of intangible factors such as strategic and military relationships, laws, institutions and incumbency which he referred to as 'network externalities'.

In line with the Triffin paradox, the US has met the obligation of an issuer of reserve currency by running fiscal and external deficits while enjoying the 'exorbitant privilege' of not having to make the necessary adjustment to bridge the deficits. With no pressure to reduce the deficit, a dominant economy can potentially create imbalances at the global level as indeed happened in the build up to the crisis. An argument can be made that even in the context of a single reserve currency, global imbalances are not inevitable. The US could not have run persistent deficits had not the EMEs provided the demand side impetus by accumulating reserve assets either for trade advantage or as a measure of self-insurance against external shocks.

The problem with the world having only a single reserve currency came to the fore during the crisis as many countries faced dollar liquidity problems as a consequence of swift deleveraging by foreign creditors and foreign investors. Paradoxically, even as the US economy was in a downturn, and its central bank resorted to extraordinary quantitative easing, the dollar strengthened as a result of flight to safety.

Based on the experience of the crisis, several reform proposals have been put forward to address the problems arising from a single 'reserve currency. One is to have a menu of alternative reserve currencies. But this cannot happen by fiat. To be a serious contender as an alternative, a currency has to fulfill some exacting criteria. It has to be fully convertible and its exchange rate should be determined by market fundamentals; it should acquire a significant share in world trade; the currency issuing country should have liquid, open and large financial markets and also the policy credibility

to inspire the confidence of potential investors. In short, the 'exorbitant privilege' of a reserve currency comes with an 'exorbitant responsibility'.

A second solution to the single reserve currency issue is to develop the SDR as a reserve currency. This does not seem to be a feasible option. For the SDR to be an effective reserve currency, it has to fulfil several conditions: the SDR has to be accepted as a liability of the IMF, it has to be automatically acceptable as a medium of payment in cross-border transactions; it should be freely tradeable and its price has to be determined by forces of demand and supply.

Another option, a third possible solution, is to expand the SDR basket by including the currencies of countries that are increasingly important economically and politically. With the increasing economic weight of emerging markets, it seems inconceivable that emerging markets will not want to see their currencies play a greater role in international transactions. Recent initiatives by some EMEs, especially China and Russia, aim at facilitating international use of their currencies. The exclusion of emerging markets currencies makes emerging markets bystanders of the system rather than stakeholders. Integration of emerging markets into the international monetary system could increase their incentives to gear their policy conduct towards contributing to the stability of the system. However, the pros and cons of this alternative have yet to be fully studied. In particular, we have to reckon with the question of whether emerging market currencies, not being fully convertible, can meet the demanding criteria required for inclusion in the SDR.

The fourth option is not actually an alternative, but is in part a solution. It aims at reducing the need for self-insurance and thereby the dependence on a reserve currency by supporting a multilateral option of a prearranged line of credit that can be

easily and quickly accessed. The IMF has designed some line of credit specifically with this objective in view.

None of the above solutions fully addresses the problems arising from a single global reserve currency. What this underscores is that at the global level we need to explore these and other options for protecting ourselves from the vulnerabilities that we confront as a consequence of a single reserve currency.

India's own position on the global reserve currency is that the world will be better served by increasing the number of reserve currencies, but this has to happen in an organic way, not by fiat. Meanwhile countries need safety-nets to protect themselves against the vulnerabilities of the global currency system. Also, the US has the responsibility of ensuring that every country has access to dollar liquidity, especially in times of stress.

According to this view, countries cannot be asked to desist from building up reserves and depend entirely on external safety-nets. Foreign exchange reserves should invariably form the first line of defence. On top of that, they need currency swap arrangements. In fact, the US obligation, by virtue of its status as the issuer of the global reserve currency, to provide dollar swap facilities to all large economies, including India, is one of the issues that we discussed in the Ministerial Level Indo-US Dialogue last month.

Protectionism

In the post-crisis world, there may not actually be 'deglobalization' but the earlier orthodoxy that globalization is an unmixed blessing is being increasingly challenged. The rationale behind globalization was, and hopefully is, that even as advanced countries may see some low end jobs being outsourced, they will still benefit from globalization because

for every low end job gone, another high end job - that is more skill intensive, more productive - will be created. If this does not happen rapidly enough or visibly enough, protectionist pressures will arise, and rapidly become vociferous and politically compelling.

Recent international developments mark an 'ironic reversal' in the fears about globalization. Previously, it was the EMEs which feared that integration into the world economy would lead to welfare loss at home. Those fears have now given way to apprehensions in advanced economies that globalization means losing jobs to cheap labour abroad.

Following the global financial crisis, the G 20 leaders were determined not to repeat the mistakes of the 1930s when the brunt of protectionism exacerbated the Great Depression. However, there is concern in some quarters that even as open protectionism has been resisted relatively well during the current crisis, opaque protectionism has been on the rise. Opaque protectionism takes the form of resorting to measures such as anti-dumping actions, safeguards, preferential treatment of domestic firms in bailout packages and discriminatory procurement practices. To strengthen multilateral trade discipline, the need for a quick conclusion of the Doha Round can hardly be overemphasized. In a world with growing worries about the debt creating stimulus packages, a Doha Round agreement should be welcomed as a non-debt creating stimulus to the global economy.

India opposes protectionism in all its forms. However, at the same time, we have to respect the WTO-consistent policy space available to the developing countries to pursue their legitimate objectives of growth, development and stability. We are encouraged by the analysis of the recent trade monitoring report jointly released by WTO, OECD and UNCTAD on G 20 economies which shows that majority of the trade measures

taken by India in the review period were either trade facilitative or roll back measures.

IMF Quota and Governance

The global economic and financial crisis of 2008 exposed critical weaknesses in the structure of the International Financial Architecture as well as in its governance. The G 20 has been trying to address these governance and structural weaknesses while at the same time endeavouring to stabilize the global economy through a process of mutual consultations and policy co-operation. An important motivation for these reforms is that the global economy has undergone fundamental changes in the past decade and a half and these changes have not been reflected appropriately in the International Financial Architecture.

While agreement has been reached in the G 20 for effecting major reforms, implementation has so far has been disappointing. The agreement for IMF quota and governance reforms in 2010 has not yet been implemented. India's major concern is that we should adhere to the timeline for completing the IMF Quota reforms by January 2013, so that it serves as the basis for the 15th General Review of Quotas to be completed no later than January 2014.

There has been some criticism that IMF quota and governance issues should be settled within the IMF management and not at the G 20. The dominant view though has been that the G 20 should continue to be the main forum for overall guidance not only on the direction that the comprehensive review of the formula should take but on continued reform of the International Financial Architecture, as it may be difficult to reform this from the inside in view of its flawed and outmoded shareholding structure. The G 20 has played a crucial role in steering discussions on the quota

formula in the past and it will be unfortunate if this aspect is diluted going forward.

Global institutions can only be legitimate and credible if their vote share and governance structure reflect members' share in the world economy. It is in this context that India and other emerging countries believe that GDP should have predominant weight in the quota formula as it is the most robust measure of relative economic weights in the global economy.

Financial Sector Reforms

Received wisdom today is that financial deregulation shares the honours with global imbalances as being one of the twin villains of the crisis. Not surprisingly therefore, reforms to the financial sector regulation have been on top of the G 20 agenda.

The broad contours of the international initiatives spearheaded by the G 20 on financial sector reform rest on four broad pillars: regulation, supervision, resolution, especially in respect of global systemically important financial institutions (or SIFIs), and assessment of the implementation of new standards. So far, one pillar that has received substantial public attention is regulatory reform, where there have already been some notable achievements, including agreement on the new Basel III capital and liquidity standards.

However, the process of regulatory reforms that is proceeding across various jurisdictions has come to pose new challenges especially as the global economy continues to be marked by new risks. The uncertain and uneven recovery has led to calls in some quarters to dilute or slow the financial reform initiatives. While there may be a case for some back loading of difficult adjustments to strengthen the recovery of the financial sector, any weakness in our resolve or commitment to reform will sow the seeds for a fresh crisis

down the line. The key task is therefore to fully implement what has been agreed in a cooperative manner.

All G 20 members have committed to the implementation of the Basel III package. However, major jurisdictions have come out with their own regulatory standards. It is important that there is no disharmony that could be confusing. We need to guard against the possibility of regulatory arbitrage. If comparable standards are not implemented in all jurisdictions simultaneously, financial activity will likely migrate to less regulated jurisdictions as well as into shadow banking with disruptive consequences for the entire global financial system.

As we move forward in the area of regulation, the investment needs of the emerging market and developing economies also deserve special attention. There are two important points in this regard. First, it is important to ensure that financial intermediaries in emerging and developing economies are not disadvantaged in the new regulatory framework, especially since the opportunities and challenges in their systems are quite different.

Second, the more demanding regulatory standards should not lead to deleveraging by global financial institutions out of emerging markets. It should be noted in this regard that the financial regulatory reform has so far focused on reducing systemic risks, and rightly so, but not much attention has been devoted to redirecting savings from investment in volatile financial assets to financing investment in the real economy, where the impact on growth and jobs is more tangible and direct. We need to recognize that it is income from the real sector that must ultimately pay for the profits of the financial sector. Standards setting bodies should design incentives in a manner that helps redirect global savings into investment in the real economy, particularly in infrastructure, supports demand and enhances long-term potential growth

thereby fulfilling the original role of intermediating for growth and development of the real economy.

Collaboration between financial authorities on these issues is an important, albeit a difficult and painstaking task. Collaboration becomes difficult especially when it entails profound structural changes in the face of volatile financial markets and anemic growth. Yet, it is precisely these challenges that make it so vital that the regulatory response in the G 20 should be well coordinated internationally to ensure that the new regulatory framework is effective and globally implemented and the follies of the past that led to the financial crisis are not repeated.

Future Challenges for the G 20

I have so far discussed some of the major items on the agenda of the G 20. Let me now look ahead to the challenges that confront the G 20 on the way forward.

The first challenge is drawing a balance between short term compulsions and medium term sustainability. A case in point is the intense debate in the advanced economies on fiscal austerity vs growth. Everyone is agreed that long term fiscal consolidation is critical to macroeconomic sustainability. At the same time, everyone is also aware of the pains of fiscal adjustment in the short-term. If fiscal profligacy is seen as consumption of future income and shifting the burden to a future generation, fiscal austerity should be seen as the price for the necessary correction so that burden sharing across generations is fair and optimal. If the compulsions of short-term and long-term policies point in different directions, how can these be harmonized, especially since the long-term is a stringing together of the short-terms? How can G 20 commitments and the 'Mutual Assessment Process' (MAP) commitments and assessments accommodate such dynamic policy shifts?

The second challenge for the G 20 is to nudge countries' policies in mutually agreed directions and hold sovereigns accountable for commitments given, especially since these are not legally binding and there is no enforcement mechanism. This is particularly difficult in vigorous democracies where the popular perception could be that national interests are being compromised for the sake of global stability. How can national leaders build and nurture, within their national boundaries, a constituency for the global optimal?

Seeking firm, forward looking commitments, or pointed criticism of policy frameworks of other countries, on the lines of the European Union, or even the OECD, style of functioning, may be difficult and divisive at this stage. A more ambitious style of global governance would understandably take some time to take shape. At this stage the issue really is monitoring and assessing whether the general direction of G 20 member country policies is heading in a mutually consistent and agreed fashion over the medium to long-term, and how the G 20 processes can help countries navigate their domestic legislative, regulatory and judicial processes such that commonly agreed policies are adopted.

The third challenge for the G 20 is that the success of domestic policy actions in an increasingly globalizing world with growing policy and market spillovers is linked to global outcomes. If rebalancing is uncoordinated, the outcomes could be even worse. Policy co-operation is therefore potentially win-win, since economic integration has moved far ahead of political integration. While this is most clearly manifest in the case of the euro zone, to a great extent, the challenges ahead before the G 20 may be similar. In this sense, the G 20 can be seen as a brave new experiment to push the boundaries of globalization to harvest this cooperation dividend.

Summary and conclusion

Let me now conclude. I began with explaining the importance of G 20 and how it acquitted itself quite credibly in managing the global financial crisis. I have also dealt with some criticism of the G 20 for its seeming failure to address post crisis issues with the same alacrity and unity of purpose. I then went on to address some of the major items on the G 20 agenda, and where appropriate, indicated the Indian position on these issues. Finally, I listed the three big challenges on the way forward for the G 20 experiment.

The G 20 is by all accounts a bold initiative. It is unique from earlier international initiatives in the sense that it is not formed by a charter, has no mandate for global governance and its decisions are not legally binding and enforceable. In short it is based on the realization that in a globalizing world, our futures are all tied together and the only way we can all prosper is through policy cooperation and on the belief that the only way global governance can be pursued is through an honour code.

Can the G 20 survive? What would the late Shri Shroff have said? Pragmatist that he was, he would have said that the only way the G 20 can survive is by showing exemplary leadership in resolving our most pressing challenges at the global level.

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"People must come to accept private enterprise not as a necessary evil, but as an affirmative good".

- Eugene Black
Former' President,
World Bank

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