India & The Global Economy

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1 Introduction

Just as the Depression, the Cold War Era, the Space Age, and the Roaring 20's are used to describe particular periods of history; globalization describes the political, economic, and cultural atmosphere of today.

2 What is globalization

People around the globe are more connected to each other than ever before? Information and money flow more quickly than ever. Goods and services produced in one part of the world are increasingly available in all parts of the world. International travel is more frequent. International communication is commonplace. This phenomenon has been titled "globalization."

The concept of globalization can be traced to the phenomenon of nation states. In the distant past, there were just human communities. For much of human history, most people remained confined to their communities, villages or local areas. With developments in communication and economic activity, it has progressively become easier to move from the local to the regional and then from the regional to the national level, and finally across nations.

In managing the process of economic integration that is driven by several forces, developing countries face challenges from a world order that is particularly burdensome on them. Yet, it is necessary for the public policy to manage the process with a view to maximizing the benefits to its citizens while minimizing the risks; but the path of optimal integration is highly country-specific and contextual. On balance, there appears to be a greater advantage in achieving a well-managed and appropriate integration into the global process, which would imply more effective - but not necessarily intrusive or extensive - interventions by governments.

3. Global economic integration-a trend to continue

Globalization, is seen to be the world's "mega-trend" over the next 15 years, causing the global economy to grow by about 80% compared with 2000, and raising average income per head worldwide by about 50% over the same period. The benefits will be unevenly distributed but there will be a much richer world.

Economists world over believe, that most of this growth will be in Asia, especially in China and India, driving Asia to displace the west over the next 15 years as the focus of global economic dynamism. The impact of that shift will be economic and political, pulling Washington's attention away from Europe and the Middle East and towards the emerging 21st century superpowers.
In this backdrop, it is important to carefully examine the issues underlying India and the global economy.

If we look at the Indian experience since independence, we find that export pessimism permeated the policy stance throughout the early decades of our planning. Import substitution was the principal instrument of trade policy and was regarded in the early years as not only the correct strategy but also inevitable in a continental economy like India. The gulf crisis and its impact on India provided several lessons for us, and one of them was that a relatively closed economy does not provide immunity from a foreign exchange crisis. Incidentally, India excelled in managing the crisis and emerged as one of the very few countries in the world, amongst both the developed and the developing, to have never defaulted on its external obligations. In the aftermath of the Gulf crisis, policy actions were initiated as part of the overall macroeconomic management well coordinated to simultaneously achieve stabilization and structural change. External sector policies designed to progressively open up the Indian economy formed an integral part of the strategy for structural reforms.

In this context, improvement in exports, both merchandise and invisibles were recommended. Suggestions were made regarding modulation of import demand on the basis of the availability of current receipts to ensure a level of current account deficit consistent with normal capital flows. Further, Indian policy makers took up measures to enhance non-debt creating flows to limit the debt service burden. A switch over to market-determined exchange rate; building up the foreign exchange reserves to avoid liquidity crises and elimination of the dependence on short-term debt were some of the most important changes that were suggested. It is evident that these changes in the external sector policies of the 1990s, paid rich dividends in terms of growth and resilience to a series of external and domestic shocks.

4. India's approach in the new millennium

In the 21st century, there has been a dramatic shift in India's approach to external sector management in tune with the changing circumstances. First, with the emergence of marginal current account surplus, the sustainability of India's current account deficit may not be a problem though the deficit on her trade account persists and has been increasing. Second, the main contributors to the positive outcome in India's current account are workers' remittances and export of software, both being a result of process of global integration. Third, the exchange rate regime as well as external debt management has served India well, especially the avoidance of sovereign debt through commercial borrowings. The new policy regime helped India withstand several global crises while maintaining a respectable growth. Fourth, the management of capital account has acquired the primary focus rather than the current account. Fifth, a judicious integration with the global trade regime has imparted some competitive efficiency and confidence to the domestic industry and perhaps, even to commercial agriculture though to a limited extent. Finally, it has become evident that the management of the external sector is closely linked to the domestic sector and the major thrust of Indian public policy is now on managing the integration.

In brief, India has moved from managing external sector to implementing an optimal integration of domestic and external sectors, and the global economy.

More recently, however, a debate in the rest of the world has been in evidence on the challenges likely to be faced by the global economy on account of progressively increasing global integration of the Indian economy. There is a need to have an ongoing appreciation of how the global economy is responding to the challenges of our integration while we move forward with our own agenda of securing an optimal integration.

5. The present day world

Currently, the major issue in the global economy appears to be the significant build up of current account imbalances. The current account deficit of U.S.A. has been rising and is around 5% of GDP, while current account surpluses are noticed in Asia and to some extent in Latin America and Russia. The external financing of the US deficit moved away from equity in the late nineties to debt in the recent years, possibly reflecting a perception of productivity growth in the former period and fiscal stress in the latter. The official reserves played a greater role than in the past in financing the US current account deficit in recent years.

Further, the simultaneous emergence of China and India with significant competitive strengths in trade in goods as well as services will have to be accommodated by the global economy. Thus, the issue for the immediate future is that both, correcting current global imbalances and integrating the two Asian giants, may have to take place simultaneously in the global economy.

It is evident that China and India will have to give a high priority to generating employment. Both these emerging economies are poised for substantial increases in productivity. Consequently, the global economy will have to consider the implications of these developments on prices, exchange rates, wages and structures of employment in industrialised countries. Over the medium term, it is felt that outsourcing will grow in geometric progression, particularly to India, and may also cover high-end research and development. One sector where the industrialised economies continue to show considerable strength and dominance is the financial sector, partly attributable to the confidence factor in financial markets that favours the industrialised economies and traditional international financial centres. It is essential for India to carefully monitor the developments in both real and financial sectors, and to modulate her policies in accordance with the global developments so that global integration continues to be a positive sum game for all the countries. Global economic integration is technology induced and policy-managed. While the economic integration of India with the global economy will continue to take place, a successful integration, with due regard to the interests of a vast majority particularly, the poor would be possible only through sound public policies - evolved and redesigned from time to time. The BRIC report reflects considerable confidence in the future of the Indian economy, though it is necessary to see the fine print to realise that while India would be a super power in 2050, "if development proceeds successfully", the per capita income would still not be at a high end. What is important to recognise is that the report leans on the demographic strength that India derives from its huge workforce. In order to harness the demographic advantages, the quality of labour force, (in terms of relevant skills which need to be sustained, reoriented and upgraded in a globally competitive era) and the physical health of the workforce become crucial. Education and health, therefore, provide the link between supply and demand for labour through increases in productivity.

6. An appraisal of the public policies in India

RBI's Governor Y V Reddy in his speech emphasized on the prorties for public policy to ensure successful economic integration of India with global economy.

He mentioned in his speech that practical policies in the external sector, particularly in the management of capital account and exchange rate, contributed to growth, provided resilience to shocks and an overall stability. Thus, India must continue with pragmatic, cautious and, gradual approach in this regard, subject to improvements in fiscal arena and the progress in strengthening the domestic financial sector.

Second, the management of financial sector has been oriented towards gradual rebalancing between efficiency and stability and the changing shares of public and private ownership. Enhanced competition among diverse players, including from branches of foreign banks, has been encouraged. Considerable improvements have taken place in prudential governance as also in moving away from administrative measures to market-orientation. Hence, it will be advisable to follow the same path in the coming years.

Third, on the fiscal front, he expressed concern about the high ratio of public-debt to GDP, but the structure of public-debt displays characteristics that make India less vulnerable than other countries with similar debt magnitudes. Therefore, there is advantage in continuing the progress in public debt management keeping structural aspects in view. An effective and qualitative fiscal adjustment would enhance the scope for a more successful integration with the global economy.

Fourth, significant liberalisation of external trade has taken place smoothly, which has imparted competitive efficiency to the domestic sector almost upto the global best standards in many of the sectors. There has also been demand for credit and creation of employment due to this. However, there exists several trade restrictions within India even as there has been progress in liberalising external trade. Eliminating trade restrictions can have adverse impact on vulnerable sections, but a straight forward subsidy to the poor might well serve as solution. There is another well recognised distortion, vestiges of which still continue, in the form of reservation for small scale industries. With liberalisation of external trade, it is anomalous to persist with such distortions, even if on a reduced scale. Thus, there is still an unfinished agenda on trade reforms especially in regard to domestic trade and a policy commitment to remove such distortions in a defined short time frame would be ideal.

Fifth, it is interesting to note that the two sectors where India is globally most competitive, namely, software and pharmaceuticals, are not power intensive and do not require bulky transportation. The competitiveness of the manufacturing industry is admittedly a function of the availability of reliable power supply at reasonable cost. The budget of 2004-05 has rightly emphasised the importance of power, airports and seaports (apart from tourism, which has significant employment potential) but there is need for implementation at a pace significantly faster than we have ever witnessed in any sector so far.

Sixth, there is universal recognition of the need to improve both productivity and output in the agriculture and related activities to meet the objectives of growth and employment. Yet, despite the best of efforts and excellent results achieved in that direction, there will have to be a massive shift of the workforce from agriculture to non-agricultural avocations. The quality of urban infrastructure even in the metropolitan cities is not conducive to globally competitive economic activity. The inevitable large scale redeployment of the migrating workforce would, therefore, need institutional arrangements, be they in public or private sector, for skill-imparting and skill up gradation. Seventh, improvements in institutional infrastructure in matters relating to administrative, judicial and other systems of governance are admittedly important.

Eighth, the quantity and quality of water, education and health care infrastructure are far from adequate, and are not even at the minimum level consistent with a modern society. These fall under the ambit of delivery of public services and the Prime Minister has already accorded a high priority to this issue. Any tangible reform in this area would require action on several fronts, i.e., legislative executive and judicial and at several levels, Centre, State and local. Ninth, there are regional inequalities in growth. One should hope that the demonstration effect of a few high-performing States will spur the other States, in the medium term, to compete for better governance and economic performance.

Finally, enhanced investment activity, particularly in the infrastructure area, would necessitate higher domestic savings, especially in the public sector coupled with efficient financial intermediation. In addition, foreign savings need to be attracted and absorbed with a strong preference to Foreign Direct Investment in all sectors though in some sectors like banking, a calibrated approach may be warranted. At the same time, our enterprises should be enabled to attain a strong global presence in all sectors.

7. Financial integration- the third side of global integration

Unlike in the case of trade integration where benefits to all countries are demonstrable, in case of financial integration, a "threshold" is important for a country to get full benefits. Fortunately, India, has been adhering to a cautious and calibrated approach in our reforms so far and there is merit in adopting a 'road map approach' building on the strengths that we have already developed.

One of the major concerns for developing countries in proceeding with financial integration appears to be the financial stability. Hence, the role of cross-border linkages in this regard should not be ignored.

It is noteworthy that financial integration complicates the conduct of monetary management. The growing cross-border integration of financial markets enables massive movements of capital, which quickly arbitrage interest rate differentials across national boundaries. This is reinforced by the ever-widening impact of the information technology revolution. Real long-term interest rates in industrialised countries have been converging since the late 1980s. Financial integration has also brought with it shocks common to several countries since the "confidence channel" transmits financial crises across countries swiftly. In a world of generalised uncertainty, monetary policy in several countries is faced with a progressive loss of discretion. For developing countries, in particular, considerations relating to maximising output and employment weigh equally upon monetary authorities as maintaining the price stability.

It is also useful to recognise a close link between the extent of capital account liberalization and the presence of foreign financial enterprises in a country. One of the important considerations for encouraging the presence of foreign financial enterprises is to ensure adequate and healthy competition. The compulsion to expand foreign enterprises would thus depend on quality of competition that already exists in a country. In any case, the consensus appears to be that process of liberalization in financial sector has to be carefully calibrated and sequenced.

8. There are some pros and cons associated with licensing foreign banks in the emerging economies:

The pros relate to (a) increasing and diversifying available funds; (b) enhancing banking competition and efficiency; (c) developing financial markets and market infrastructure; (d) helping with recapitalization and wider diversification of banks; and (e) reducing sensitivity of the host country banking system to local business cycles and changing financial market conditions. The arguments against foreign banks' entry encompass (i) weakening infant domestic banks; (ii) servicing only the 'best' customers and neglect of Small and Medium Enterprises; (iii) likelihood of bringing instability; (iv) concerns that majority of banking assets will become foreign owned; and above all (v) challenges to financial supervisors in the emerging markets.

India's approach to financial sector reforms, in general, and to the management of the external sector, in particular, has served the country well, in terms of aiding growth, avoiding crises, enhancing efficiency and imparting resilience to the system. The development of financial markets has been, by and large, healthy. The basic features of the Indian approach are gradualism; co-ordination with other economic policies; pragmatism rather than ideology; relevance to the context; consultative processes; dynamism and good sequencing so as to be able to meet the emerging domestic and international trends. The intention to move over to capital account convertibility was announced in 1997 and its achievement is still an ongoing process - which differentiates the roles of individuals, corporates and financial intermediaries.

In the banking system, diversified ownership of public sector banks has been promoted over the years and the performance of their listed stocks in the face of intense competition indicates improvements in the system. Foreign banks have been operating in India for decades with a few of them having operations in India for over a century. The number of foreign bank branches in India has increased significantly in recent years since RBI issued a number of licenses - well beyond the commitments made to the World Trade Organisation. The presence of foreign banks in India has benefited the financial system by enhancing competition, resulting in higher efficiency. There has also been transfer of technology and specialised skills which has had some "demonstration effect" as Indian banks too have upgraded their skills, improved their scale of operations and diversified into other activities. At a time when access to foreign currency funds was a constraint for the Indian companies, the presence of foreign banks in India enabled large Indian companies to access foreign currency resources from the overseas branches of these banks. Also with the presence of foreign banks, as borrowers in the money market and their operation in the foreign exchange market has resulted in the creation and deepening of the inter-bank money market. Now, it is the challenge for the supervisors to maximize the advantages and minimize the disadvantages of the foreign banks' local presence.

The liberalisation measures would need to take into account several imperatives, such as, consolidation of domestic banking sector; restructuring of Development Finance Institutions; and appropriate timing for the significant entry of foreign banks so as to be co-terminus with the transition to greater capital account convertibility while being consistent with our continuing obligation under the WTO commitments. The Reserve Bank of India intends to formulate the guidelines, through an ongoing process of consultation, as in the past. The proposed guidelines in this regard are expected to carry forward the process of financial integration of India in a carefully calibrated and transparent manner.

Thus, in this background India's global integration has to be a two way process, encompassing movement of people with some caveats, trade in a free and equitable manner and financial integration on a specially sequenced basis.