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FINANCIAL REFORM AND ASIAN INTEGRATION: WHAT NOW?

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Financial Reform and Asian Integration: What Now?

Suman Bery, Director-General

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- **An independent economic research organisation; 53 years strong**
- **Current research areas include:**
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  - Infrastructure and Regulation

Overview

- Financial Reform and Regional Integration: Some Possible Channels.
- India: The Real Economy
- Indian Financial Reform: Goals, Achievements, Constraints.
- Post-Crisis Global and Regional Architecture

Financial Reform and Regional Integration: Some Possible Channels.

Analytic Framework

- Trade Integration, Monetary Integration, Financial Integration: What links? What sequencing? What policies?
- East Asia attracted by European model.
- Usual narrative: first trade; then monetary (at least for eurozone); now financial.

Analytic Framework

- Some caveats:
  - East Asia's internal trade integration, links with US subject to MFN disciplines, not Customs Union.
  - Financial Integration (based on London) started before EMU (eurodollar market), continues outside eurozone.

Analytic Framework

- As trade integration has progressed, Europe has struggled with “trilemma”. Euro most recent effort (cf. Sapir).
- Current crisis has demonstrated strains of monetary union without integrated labour markets, enforcement of fiscal rules, national banking regulation.
- Not a helpful model for East Asia, let alone integrating East and South Asia.

Analytic Framework

- Tentative conclusion: financial sector reform in developing Asia should primarily focus on “behind the border” agenda of productivity and growth.
- 1997 showed tight links between financial sector development and monetary/exchange rate regime.
- No easy answers; Latin America may provide some models. Cross-currency issues more tricky for Asia (RMB/USD/JPY)

Analytic Framework

- "Opening up finance" remains controversial (Bhagwati; Rodrik, etc). Trade in assets different from trade in goods. But seldom reversed.
- Harsh penalties for failure. Not just a developing country issue. But risk-aversion also has a price (Ranciere, Tornell and Westermann 2008)
- Several recent summaries: Obstfeld (2009); Prasad (2009; forthcoming).

Analytic Framework

- “There is evidence that domestic financial development spurs growth under the right conditions, and these conditions—plus domestic financial development itself—are likely to make capital inflows from abroad more productive” (Obstfeld 2009).
- Now turn to the debate within India on these “right conditions”, and how domestic and external financial integration have progressed, interacted.

India: The Real Economy.

Ten Largest Economies:
Gross National Income (PPP, Current $)

Country	1990 Total (Billion)	1990 Per Capita	2006 Total (Billion)	2006 Per Capita
United States	5726	22940	13196	44070
China	**909**	**800**	**6119**	**4660**
Japan	2325	18820	4196	32840
India	**729**	**860**	**2726**	**2460**
Germany	1446	18210	2692	32680
France	1025	18070	1975	32240
United Kingdom	940	16330	2037	33650
Italy	956	16860	1705	28970
Brazil	762	5100	1648	8700
Russian Federation	1352	9120	1815	12740

Source: World Bank, WDI

India Today: Historical Perspective

- India in 2007 approximately $2900 in 1990 prices (Maddison/OECD).
- Equals China 1997; Japan 1956; US 1880.
- Consider “developed” to be about $10,000 in same prices (Japan 1971; Italy 1972; U.S. 1942).
- Can India do this within one generation, like Japan, Korea? Will it want to? What can prevent it?

Growth in GDP and Population

Year	GDP	Population	Per Capita GDP
Avg. 50s	3.59	1.92	1.64
Avg. 60s	3.96	2.19	1.73
Avg. 70s	2.94	2.30	0.63
Avg. 80s	5.58	2.16	3.35
Avg. 90s	5.68	1.99	3.62
Avg. 2000-01/2006-07	6.91	1.64	5.18

Source: National Accounts Statistics, CSO

Why has growth accelerated?

- Recent spurt exceptional, but builds on almost thirty years of strong performance, policy continuity.
- Reform, liberalisation, structural change have produced a much more resilient economy.
- Demand impulses primarily domestic: consumption; more recently private corporate investment

Structure of Demand (% of GDP)

	Pvt. Cons.	Govt. Cons.	GCF	Goods & Services Exports	Goods & Services Imports	GDS
China						
1990	45.9	14.2	36.4	19.2	15.7	39.9
2006	33.2	14.3	44.6	40.1	32.2	52.5
India						
1990	65.6	11.7	24.2	7.1	8.5	22.7
2006	57.6	11.3	33.9	23.0	25.8	31.1

Source: World Bank, WDI

Structure of Output

	India			China		
Sector/Periods*	**1981**	**1991**	**2005**	**1981**	**1991**	**2005**
Agriculture	34.4	29.6	18.3	31.8	24.5	12.5
Industry	25.6	25.8	27.6	46.4	42.1	47.5
(Manufacturing)	16.8	15.7	16.0	38.5	32.7	33.5
Services	40.1	44.6	54.1	21.8	33.4	39.9

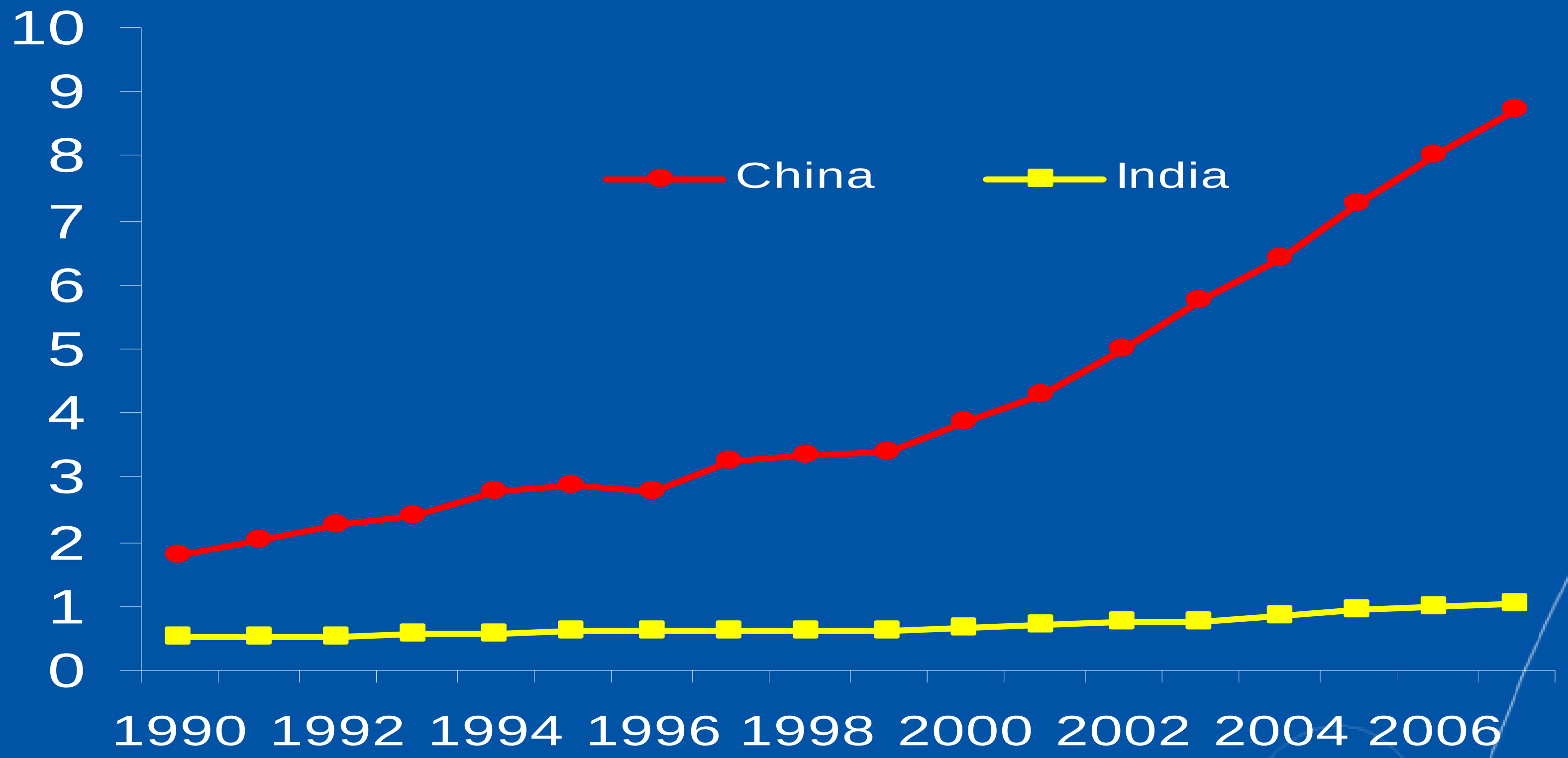
* Percentages of GDP; Triennium Ending in indicated year
Source: World Bank (2008), WDI, CD ROM

Tariff Barriers
(Import weighted)

		All Products	Primary	Manu-factures
China	1992	32.1	14.1	35.6
	2006	4.3	3.5	4.5
India	1992	56.1	34.1	70.8
	2005	14.5	16.5	12.7

Source: World Bank, WDI

Merchandise Exports
(% Share in World)



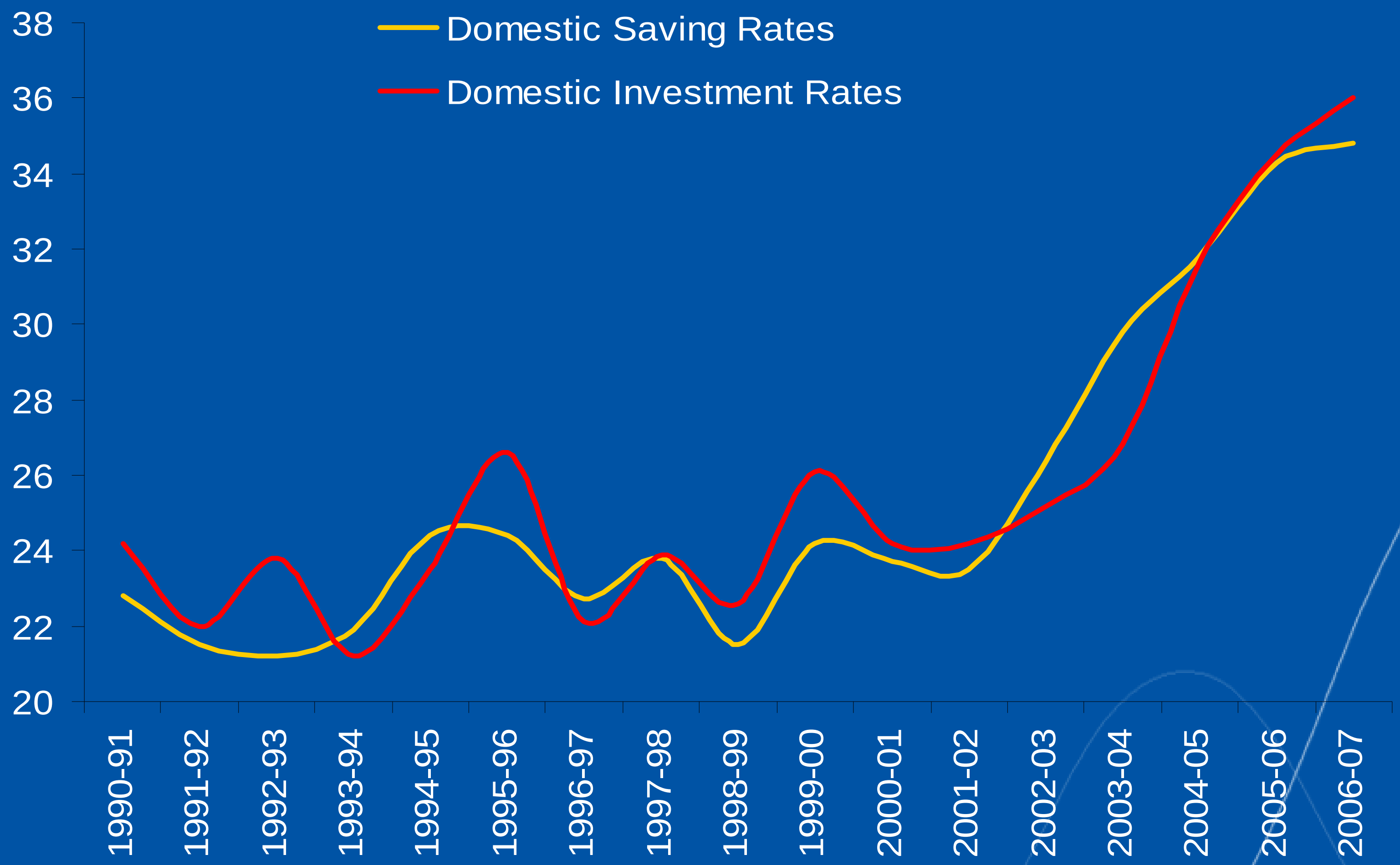
$ Billion	China	India
1990	62.09	17.98
2007	1217.80	145.33

Source: WTO, International Trade Statistics, various years

Why did growth accelerate?

- GDP growth of last four years unprecedented in magnitude, continuity
  - 2004-05 7.5%
  - 2005-06 9.4%
  - 2006-07 9.6%
  - 2007-08 8.7% (Advance Estimates)
- Reflects strong services, manufacturing; recovery in agriculture

Saving and Investment Rates



Source: Economic Survey 2007-08

Base Year: 1999-00

How bad is the slowdown

- 2008-09 a very challenging year, particularly for manufacturing.
- Global financial crisis began to bite in second half of fiscal year.
- Main channels: trade; finance; uncertainty
- Financial system fortunately robust
- Differences, similarities from 1991

Indian Financial Reform: Goals, Achievements, Constraints.

Financial Sector Elements

- Bank-dominated system; long-standing equities culture. Large public debt. Sluggish traded domestic corporate bond market.
- Progressive nationalisation of domestic banks from 1955 (SBI) to 1980.
- “Closed phase” from 1969 till 1992; steady, cautious deregulation in banking entry, equities, insurance since then.

Financial Sector Agenda

- Traditional concerns: widening access ("financial inclusion"); loan quality; financing government; monetary policy transmission mechanism.
- Regulation and supervision have improved, corporate governance getting better.
- Periodic "scams" may have helped reform.

Financial Sector Agenda

- Main new challenge is safe/productive integration with global finance.
- Several official committees (Tarapore 1, 2; Mistry; Rajan) have explored/addressed linkages between domestic policy and global integration.
- Fiscal/Debt/Exchange Rate more pressing constraints than health of banks.

Financial Sector Agenda

- Recent foreign capital boom-bust cycle more extreme than in past.
- Managed without too much harm to the financial system.
- Partial sterilisation raised interest rate, stimulated arbitrage flows.

Financial Sector Agenda

- Challenge is to direct into productive uses without excessive appreciation of the real exchange rate.Requires greater flexibility in non-tradables supply.
- Broad conclusion similar to Obstfeld. Main challenge is to ensure productive resource allocation through micro, fiscal reform.
- Domestic finance can help; foreign finance is at best an additional discipline.

Post-Crisis Global and Regional Architecture

Financial Sector Architecture

- Role of global financial/monetary system in intermediating large cross-border savings flows with safety and efficiency remains, will probably increase.
- Developing Asia, India and China in particular, have a vital interest in shaping this process, at a time when Anglo-Saxon finance is subdued.

Financial Sector Architecture

- Current G-20 agenda not particularly responsive to these interests; so far more likely to lead to de-globalisation of finance.
- Issue: Can the ASEAN+6 (East Asian Summit) process be equipped to develop with rules for an Asian financial architecture ? Or do trans-Pacific trading, security links make this infeasible, unlikely?

Thank You