Imbalances, Local and Global, and Policy Challenges in the Post-Crisis World

Soumyen Sikdar

1 Introduction

The global financial meltdown of 2008–2009 following the housing market collapse in the USA is surely the most severe crisis in capitalism since the Great Depression of the 1930s. Christened the Great Recession, it has naturally caused a great deal of rethinking by economists and policy makers on a great variety of fundamental issues ranging from globalization, deregulation and financial management by central banks to the probity of highly paid company CEOs and the reliability of international credit rating agencies. Interesting, but not surprising, is the resurfacing of the ideas of Marx and Keynes. Symptomatic of the trend is the immense stir created by Thomas Piketty's book, Capital in the Twenty-First Century. Complacence and certitude have received rude jolts across the world and the need has emerged to think afresh on numerous policy fronts. India's integration with the rest of the world is still comparatively low. Yet, she could not escape unhurt. Prompt policy measures were successful in cushioning the shock, the worst could be averted but the economy is yet to recover fully and get back to the track of pre-crisis performance in terms of growth.

Though it has no obvious connection with the global catastrophe; at the national level too India has experienced a major political change. For the first time in many years, a party has been voted to power with overwhelming popular support. The government is no longer shackled by the stringent compulsions of coalitional politics. In the past coalition management (the perennialcurse of Indian democracy) and legislative logjam often led to policy paralysis with all its seriously adverse consequences. This constraint no longer obtains in India. So, the government has more freedom and flexibility to address the issues that have attained prominence in the post-crisis global scenario.

S. Sikdar (✉)
Indian Institute of Management Calcutta, Kolkata, India
e-mail: soumyen1956@gmail.com

© Springer India 2016

M. Roy and S. Sinha Roy (eds.), *International Trade and International Finance*,
DOI 10.1007/978-81-322-2797-7_21

In National People's Congress in March 2007, the Chinese Prime Minister Wen Jiabao expressed concern that China is increasingly becoming 'unbalanced, uncoordinated and unstable.' These alarming adjectives capture India's situation equally well. They merit close attention from those in charge of making policies.

Now we take a look at a number of imbalances that have emerged (and are growing) both at global and local levels. Long run stability of the world's economic order is seriously under threat as a consequence of these developments. The stiff challenge that the crisis has thrown in the face of central bankers, a very important and influential policy making group, is also taken up. It is argued that, instead of targeting inflation exclusively they should adopt a more balanced position while deciding policy. In other words, central bank objective functions should have a more balanced distribution of weights. Clearly, this particular 'imbalance' is not of the same kind as the other ones taken up in the discussion such as sectoral or distributional imbalances, but we consider it important enough (as source of critical policy failure) for inclusion in the context of the current global crisis.

The chapter is organized as follows. The next section looks at one major manifestation of global imbalance, namely, overdependence on the performance of a single country, the USA. This is followed by a look at macro imbalances on the home front. Attention is drawn to rising inequality in income and wealth, both in India and the world at large in Sect. 4. This is important because imbalance and iniquity in the sharing of the fruits of 'progress' calls into question the legitimacy of the entire programme of growth under free market capitalism. Section 5 discusses one vital failure in policy formulation, namely, the extremely lopsided view that the task of central banking begins and ends with inflation control. There is urgent need to restore balance in this sphere too. The final section concludes.

2 Global Imbalance

The global economy is too much dependent on a particular country, namely, the USA. It is American consumption that has become the motor of the world's prosperity. To give an idea of the motor's power, real consumption over the period 1993–2015 grew in the USA at an average rate of 4 %, which is no less than three times the consumption growth of Europe and Japan combined. American consumption-income ratio reached the value of 72 % in 2007, an all time record. In absolute terms, for the sake of comparison, the values of consumption expenditure in that year were $9.5 trillion for the USA, $1 trillion for China and $650 billion for India.

The notion of Global Decoupling was greatly in vogue for a number of years preceding the recent catastrophe. The putative decoupling was between the USA and a collection of Asian and Latin American countries including India, Thailand, Malaysia and Vietnam from Asia (but not China) and Brazil from South America. For these countries, the importance of the USA as a trade partner has been gradually decreasing and it was hoped that they would be able to function as a relatively autonomous group in the near future. But the hope turned out to be illusory as

consumption in the USA crashed after the crisis and one country after another was pulled down into the abyss. On more than one occasion, Chairman Ben Bernanke of the Federal Reserves had earlier pointed to the 'saving glut' of Asia as a prominent sign of structural imbalance in the world. Actually, it is the consumption frenzy of the Americans which should be blamed in this context, rather than the so called Asian saving glut.

The message is clear. The degree of dependence of the rest of the world on any single country must not be allowed to rise beyond a limit.

3 Local Imbalances

The Indian economy could escape the Great Recession with relatively minor damage precisely because its linkage with the American economy is not very strong. After the worst year of 2008–2009 recovery has been fairly quick. However, its own performance over the past quarter century reveals an extremely undesirable trait. Growth has been very unbalanced between the three major sectors- agriculture (primary), industry (secondary) and services (tertiary). Agriculture has suffered from secular stagnation, manufacturing barely manages to limp along, while services have grown at a very high rate. In the course of the last two decades, agriculture's share has been declining continuously. It h now stands at 16 %, while manufacturing has managed to maintain its share at an average of 20–24 % over 1980–1981 to 2009–2010. This is dwarfed by Thailand (36 %), South Korea (32 %), China (45 %) and Taiwan (30 %). India's share of global manufacturing is a tiny 2.2 %, compared with China's 18.9 %. Another glaring imbalance in the Indian economy is the fact that although agriculture contributes only 22 % of GDP, it engages close to 50 % of the total workforce. Over the period 1980–2000, agriculture's share (in percentage) in total employment declined from 68 to 59 in India. Over the same period, China managed to bring it down from 70 to 48.

The services component of India's national income has swelled and swelled and at present commands a share of nearly 60 %. Actually, our strong economic performance in recent (pre-crisis) years has been powered mostly by the growth in the export of services.

India's share in total global service exports is now almost 4 %. There was a marked slowdown in 2009–2010 following the severe global crisis, but the damage was smaller than in merchandise exports. Recovery also was very quick and service exports are back at their pre-crisis levels. Given that it will be very difficult to compete with China in the field of manufacturing exports, our growing success as service exporter indeed augurs well for the future of the economy.

Two questions have arisen in this context. First, is India following an 'abnormal' trajectory deviating from the Kuznetsian sequence of primary-secondary-tertiary growth? The simple answer is that there is no fixed and predetermined development path that every country is destined to follow. The Indian experience of service-led growth may well become a unique model for the emerging market economies.

The second question is much more important. Is the current pattern of sectorally unbalanced growth sustainable over time? If it is not, then the economic impetus will soon peter out and we may slip back into the old days of stagnation or very sluggish growth.

Is it likely that external demand for our services may dry up in the near future? This is not a serious threat because the trend of outsourcing by corporates in the high wage advanced countries is not likely to be reversed soon. Services account for more than 60 % of global GDP at present and have high income elasticity. With global income recovering after the severe slump, demand for services, both as production input and as final consumption, is likely to resume its steady growth.

Slackening of external demand may, however, arrive in the form of demand switch away from India. This will happen if there is a drop in our global competitiveness. Alarming signs are already noticeable. One factor contributing to decline in competitiveness may be relative wage inflation. That is, wages in our service sector rising faster than those of our competitors. And a major factor behind the rise in the remuneration of skilled workers in India (in real terms) may be the widening gap between demand and supply in the labour market. There are many studies that draw attention to the various problems of skill development in India, highlighting in the process the mismatch between industry needs and the output of educational institutions (Murugaia et al. 2014). The literature also reveals that China, Vietnam, Indonesia and the Philippines are racing ahead of us in some crucial areas of skill formation. (For a comparison with China, see Asuyama 2009.) Our market share in business services may begin to shrink if we fail to maintain a steady rise in the supply of adequately trained workers. In that event growth of our GDP will take a nasty hit.

There is, therefore, an urgent need to bring our exports out of the very narrow spectrum within which they are confined at present. There is considerable scope for diversifying exports away from services in general and business services in particular into other types of activities. For that to happen, our manufacturing cum export oriented infrastructure has to be expanded and improved. The incentive regime still favours the domestic market by and large and protection of inefficient industries still persists, though at a lower level compared to the pre-reform days (Alfaro and Chari 2013). Concerted attempt must be made to design and implement better policies and reverse the serious disparity in growth between the three major segments of the economy.

Imbalance is also growing among the states of India. Both FDI and BPO activities by MNCs show a marked regional bias, with some states (Gujarat, Karnataka, Maharashtra and Tamil Nadu) gaining disproportionately more than the others. In the context of regional divergence, Maiti and Marjit (2010) examined whether over the period 1980–2004 greater openness has had an equalizing impact or not. Their major conclusion is that more open states grew faster by 1–1.5 % per annum. States that were able to change their production structure towards export production showed greater increment in growth. And this ability was strongly correlated with the quality of institutions and the prevailing investment climate.

4 Inequality in Income and Wealth

Another very serious manifestation of imbalance is that in the distribution of income and wealth, both within and across countries. Piketty's fundamental research (Piketty 2014) into the evolution of inequality in capitalist countries and the contributory factors has induced a great upsurge of interest in this problem. Within the developing world, the gap between the rich and poor is growing steadily both in India and China, though possibly at a faster rate in the latter. Our recent export success has been mostly confined to the IT sector which is intensive in the use of skilled labour and which does not have strong linkages with the rest of the economy. Its concentration in particular areas of the country has contributed to a widening of regional disparity. If the benefits of globalization continue to be enjoyed so unequally, the whole growth process runs the risk of being disrupted by social disharmony and upheaval.

Improvement in labour's share in national income in India has been held back by the stagnant (or declining) share of labour intensive products in manufacturing and exports. Das et al. (2009) identified thirty-one four digit industries, such as food and beverages, readymade garments and apparels, textiles products and furniture manufacturing as labour intensive. Gross value added (GVA) in these industries between 1990–1991 and 2003–2004 averaged only 13.8 % of the total organized sector manufacturing GVA. There are reasons to believe that since then the overall production structure of the economy has shifted further towards higher capital intensity. Some of the fastest growing sectors over the last couple of decades have been two, three and four wheeler vehicles, auto parts, software, telecommunications equipment, petroleum refining, pharmaceuticals and finance. None of these offers much scope for employment to low-skilled workers.

Our export composition also has increasingly tilted towards capital and skilled-labour intensive components. In manufacturing engineering goods and petroleum products continue to show the largest expansion, while the share of readymade garments, the most low-skilled labour absorbing product, fell from 12 to just 6 % over 1990–1991 to 2007–2008 (Panagariya 2011). Unless these tendencies are reversed or moderated, distribution of factor earnings will continue to be characterized by rising inequality.

5 Wake up Call for Central Bankers

The latest crisis originated in the financial sector of the USA. It is now clear that flawed supervision and failure of regulation by the Federal Reserve Board (Fed) played a major role behind the catastrophe. That the Indian economy could escape relatively unhurt is in no small measure due to the prudential stance of the RBI consistently maintained over the years.

How could the Fed (and other central banks of the advanced countries to a lesser extent) be remiss on such a big scale for so long? Apart from the possibility of

outright insensitivity (or nefarious nexus with Wall Street, which cannot be ruled out), what is at fault is a fundamentally flawed view of the duty of the monetary authorities. It is the view that inflation control is the one and only relevant policy objective of the central bank. This is an exemplar of serious lopsidedness or lack of balance in policy formulation and setting of priorities.

Inflation Targeting acquired prestige in the USA after the spectacular (and much publicized) victory of Fed Chairman Paul Volcker over the double digit inflation raging in the 1970s in the country. Subsequently, it became enshrined as the official policy of the Fed. Since 1988, it has been explicitly adopted by several countries. New Zealand was the first to do so in 1989, followed by Canada and Israel (1991), the UK (1992), Sweden, Finland and Australia (1993) and Spain (1994). While the earlier policy of monetary targeting had been drawn up after intensive academic debate and discussion, inflation targeting was adopted ad hoc from the American model. 'Stability-oriented monetary policy' became virtually identified with keeping inflation under tight control. In the words of Ben Bernanke, another Fed Chairman, 'Low, stable inflation is monetary policy's primary long run goal.' As it happened, it quickly became the primary short run goal also. In the singleminded concentration on price stability the vital supervisory role of central bankers was completely ignored. In particular, the evil of unemployment ceased to be a matter of concern altogether. To quote Bernanke and his co-authors of *Inflation Targeting*, 'Contrary to what was believed 30 years ago, it appears that the benefits of expansionary policies (such as lower unemployment) are largely transitory, whereas the costs of expansionary policies (primarily the inefficiencies associated with higher inflation) tend to be permanent'. (Bernanke et al. 2001) This is the legacy of a strong belief in the idea of the natural rate of output (and employment) towards which an unregulated economy tends automatically to gravitate. (For a cogent critique of 'the natural rate hypothesis' of New Classical Economics see Akerlof 2002.)

It is now widely recognized that the market-friendly low interest policy stance of the Fed maintained quarter after quarter under the stewardship of Alan Greenspan was responsible in a big way for fueling and sustaining the asset bubble in the USA. Following the warnings of Robert Shiller who has intensively studied the behaviour of stock markets over long periods, Greenspan talked of 'irrational exuberance' in asset markets in a speech of December 1996. The anticipation that the Fed would initiate a tight money policy led stock markets around the world to fall sharply. In reaction, Greenspan immediately backed off believing that increase in interest rates will do significant damage to the economy. But he had other tools at his disposal. He could have increased capital requirements for financial institutions, limiting their capacity to borrow, take steps to check widespread fraud in the issuance of mortgages and insisted on greater transparency in the collateralized debt obligations (CDOs) and other novel products of innovative financial engineering. Believing in the power of the Invisible Hand of the free market to achieve efficiency unaided, he took none of these measures. However, after the catastrophic bursting of the bubble he admitted that there was indeed a serious policy mistake. But it was too late to undo the damage already done.

Under the Fed's sustained easy money policy there was hardly any attempt to control the unnatural and clearly unsustainable developments in the financial market and restore orderly conditions there. The crisis has once again highlighted the wisdom that without going for heavy-handed intervention, central banks should constantly monitor developments in the asset markets and use the information as an essential input in monetary policy formulation. Everything's fine because inflation is close to 2 %, this patently absurd view should be given up once and for all. This is possibly the most important lesson for monetary authorities to come out of the colossal policy failure. Actually, in 2013 some members of the Fed including Janet Yellen, who would succeed Bernanke in 2014, began to call for more attention to the poor employment situation. One can only hope that this concern will continue to share equal weight with inflation control in future policy formulations of the Fed.

Over the recent past, RBI's policy too has been showing a tendency to drift towards inflation targeting. Encouraging signs of change in favour of a more balanced approach have begun to appear.

6 Conclusion

The most severe economic crisis since the Great Depression has spawned an immense number of questions about the viable functioning of the global economy driven by the forces of unregulated capitalism. The path to the collapse originated in an ideological turn in the 1970s that blindly sought to eliminate the government rather than reform it. The influence of this biased ideology, on the thinking of policy makers, the world over is profoundly responsible for what has happened in the USA and the rest of the world. The rude shock seems to have induced a change in the mindset of policymakers including central bankers. It is now clear that there can be no substitute for intelligent governance freed of ideology. Financial markets, in particular, must be carefully supervised and regulated. Laissez faire in this sector is a recipe for disaster.

Over the past quarter century or more many glaring imbalances, sectoral, regional, distributional have been steadily on the rise across the globe. Unless effective measures are taken to check or reverse them quickly, growth will inevitably become unsustainable and with high probability the entire superstructure will come crashing down once more.

References

Akerlof G (2002) Behavioral macroeconomics and macroeconomic behavior. Am Econ Rev 92:411–433

Alfaro L, Chari A (2013) Reforms and the competitive environment. In: Bhagwati J, Panagariya A (eds) Reforms and economic transformation in India. Oxford University Press, New Delhi

Asuyama Y (2009) Skill formation systems of China and India. In: Moriki O, Kimura K (eds) Comparative study on industrial development process in China and India. Interim Report, Institute of Developing Economies, Tokyo

Bernanke B, Laubach T, Mishkin F, Posen A (2001) Inflation targeting: lessons from the international experience. Princeton University Press, New Jersey

Das DK, Wadhwa D, Kalita G (2009) The employment potential of labour intensive industries in India's organized manufacturing. ICRIER Working Paper 236, June

Maiti D, Marjit S (2010) Regional openness, income growth and disparity among major Indian states during 1980–2004. Institute of Economic Growth Working Paper 304

Murugaia S, Kubendran V, Vimala A (2014) Skills mismatch between industry needs and institutions output-challenges for higher education in India. Indian J Appl Res 4, 9, September

Panagariya A (2011) Avoiding lopsided spatial transformation. In: Ghani E (ed) Reshaping tomorrow. Oxford University Press, New Delhi

Piketty T (2014) Capital in the twenty-first century. Harvard University Press, Boston