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Regional Keynesianism: An Urgent Need of the Hour and Its Relevance for India Today

Introduction

In *RIS Policy Brief #31* published in May 2007[1], we argued for creation of a regional Special Purpose Vehicle (SPV) in Asia to address the triple challenge of low rates of return on foreign exchange reserves of the region, the infrastructure deficits at both national and regional levels and the risks to the region from a possible disorderly correction of "global imbalances". Since May 2007, the challenges mentioned have become more acute and there is now an urgent need for regional action to address these challenges. In this Policy Brief we update our earlier proposals for a regional mechanism for a stimulus package which can turn the current economic crisis into an opportunity for sustained growth in the region. The case of India is presented as an illustration of what is needed and possible for the region.

Disorderly Unwinding of "Global Imbalances"

The current financial crisis in the US is basically due to disorderly correction of the "global imbalances" which have bedeviled the world economy since the beginning of this century. A clear understanding of the causes behind these imbalances is essential for identifying the root cause of the crisis and its possible solution. In our assessment, these global imbalances were largely due to excess consumption of one country, namely, the US and that was permitted largely because of one factor: reserve currency status of the US$.

As noted in Table 1, US current account deficits increased steadily from $241.8 billion in 1998 to $811.5 billion in 2006 before declining to $664.1 billion in 2008. Exchange rate policy of China is often mentioned as a key factor in China's rising current account surplus. It is also often suggested that it was the saving glut in Asia that led to excess global liquidity and decline in the interest rates in the US which contributed to excessive expenditures in the US. However, the time sequence of movements in US current account deficit and interest rates on the one hand and exchange rate and current account surpluses in Asia do not support this thesis. As noted in Table 1, during the years 1998-2004, when China had a fixed exchange rate with respect to the US$, the current account surplus of China was modest (only about 8 per cent of the total US current account deficit during 1998-2004). Since 2005, China has been appreciating its exchange rate with respect to US$ but China's current acount surplus and US details have been rising faster than before.

Throughout this period it is Euro that has faced an appreciation of its currency in real effective term (much more than the US$) but that did not lead to any significant current account deficit in the Euro zone.(Table 1) Similarly, the US Federal Fund rate which was declining until 2004 rose precisely when the current account surpluses of Asia were in fact rising rapidly. In other words, neither the exchange rate policy of China nor the so-called "savings glut" in Asia can explain the interest rate and current account movements in the US. It is the rising US consumption at both household and government level that lay behind the rising US deficits. They reflected the US decisions about monetary and fiscal policies rather than any external influence. The only question is: how could the US follow such an imprudent policy for so long? In a normal economy, the need for external finance will provide the discipline for correcting current account deficits. But since the world has been on a US dollar reserve system, that regulatory mechanism was not available and the

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This Policy Brief has been prepared by Dr. Ramgopal Agarwala, Distinguished Fellow, RIS.

Table 1: Macroeconomic Indicators of Select Economies and Regions

Country/Region	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008*	2009 (p)
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)	(12)	(13)
(A) Current Account Balance (US $ Billion)												
United States	-214.8	-301.7	-417.3	-384.6	-459.4	-522.1	-640.1	-754.8	-811.5	-731.2	-664.1	-485.9
United Kingdom	-5.3	-35.2	-37.4	-31.4	-24.6	-24.5	-35.2	-55.0	-77.5	-105.2	-101.5	-92.8
Japan	118.7	114.6	119.7	87.8	112.4	136.2	172.1	165.8	170.5	211.0	194.3	179.2
China	31.5	21.1	20.5	17.4	35.4	45.9	68.7	160.8	249.9	371.8	399.3	439.7
East Asia and Pacific	59.0	49.9	45.0	35.3	53.9	70.1	88.4	175.7	293.1	-	-	-
Euro Area	57.1	23.6	-35.0	9.3	47.5	45.9	107.8	27.3	1.2	29.3	-65.5	-54.3
(B) Real Effective Exchange Rate (REER) Index (2000 = 100)												
United States	97.8	96.8	100.0	105.6	105.4	98.7	94.1	92.8	92.4	88.8	83.5	-
Chinese Yuan/ US $ Nominal Exchange Rate	8.28	8.28	8.28	8.28	8.28	8.28	8.28	8.19	7.97	7.61	6.95	-
United Kingdom	97.6	97.3	100.0	97.8	98.7	96.1	101.8	101.3	103.1	107.9	97.5	-
Japan	85.3	94.8	100.0	89.0	83.0	83.6	84.6	79.4	72.0	66.6	69.2	-
China	105.7	100.0	100.0	104.3	101.9	95.2	92.7	92.5	94.4	99.1	105.3	-
Euro Area	117.3	112.9	100.0	101.3	105.8	119.1	123.2	121.5	121.2	125.2	131.5	-
(C) US Federal Fund Rate (%)	5.35	4.97	6.24	3.89	1.67	1.13	1.35	3.21	4.96	5.02	2.26	

Sources: IMF (2008), *World Economic Outlook*, October.
IMF (2008), *International Financial Statistics (CD-ROM)*, December.
World Bank (2008), *World Development Indicators*.

Notes: '*' and 'p' stand for provisional and projections respectively from IMF (2008a). REER and federal fund rate figures for 2008 are averages of the monthly series up to September and October respectively.

[1] "Towards an Asian Regional Mechanism for Addressing Excess Foreign Exchange Reserves, Infrastructure Deficits and Global Imbalances." *RIS Policy Brief # 31,* May 2007.

US consumers (both households and government) could experience the high of overspending without realizing the consequences. In the absence of an external budget constraint, exchange rate changes lost their potency as a corrective because prices (including the exchange rate) matter only if there is a budget constraint. The dollar reserve system with unlimited power of printing internationally accepted money thus became a sort of opiate of the US where exuberance went to the point of exhaustion.

It is sad commentary on the global economic monitoring including that by the IMF, that since the imprudent country happened to be the most powerful country in the world, there was a fear of speaking the truth and euphemisms such as "global imbalances" were invented. However, that euphemism has proven quite costly for the US as well as the rest of the world. Under the terminology of global imbalances, the attention was diverted from where correction was needed (namely the profligacy of the US) to largely irrelevant issues such as "savings glut" in Asia and exchange rate policy of China.

Now the disorderly unwinding of the global imbalances is taking place. Households in the US which have been living beyond their means on credit are facing bankruptcies and the financial system that supported their profligacy is in a meltdown. Starting with subprime crisis. bankruptcies or equivalent of bankruptcies spread through the system like wild fire. Within twelve months there have been failures, or the equivalent of failures, of Bear Stearns, IndyMac, Lehman Brothers, Washington Mutual, Wachovia, Fannie Mae, Freddie Mac and the American International Group. The iconic investment banks such as Merrill Lynch, Morgan Stanley and JP Morgan have all given up their special status and been transformed into banking institutions. The Citigroup the largest bank in the world for years had to be bailed out with official funds and guarantees which add up to $ 320 billion. Each of these failures would be a shock to any system. But coming in succession they constitute a veritable earthquake for the US financial system. The total cost of bail-outs to the federal authorities is estimated to be about $7 trillion. And the saga is by no means over. There are thousands of banks in the US saddled with troubled assets whose rescue will cost another hundreds of billions of dollars.

The contagion is now spreading from the financial sector to the real economy. The loss of wealth of the US consumers (in the form of decline is prices of equities and houses) is estimated to be over $10 trillion, which alone can reduce household consumption by at least $0.5 trillion. When this negative wealth effect is combined with negative income effect, credit squeeze and loss of confidence, decline in consumption could easily be over $1 trillion. In a dramatic illustration of what this loss of consumer expenditure can mean, the automobile sector in the US is facing a severe contraction of sales and the iconic trio of automobile industry in the US – GM, Ford and Chrysler – is facing bankruptcy and pleading for bail-outs by the Government. The bankruptcies of retailers and real estate companies, big and small, are daily news. In this atmosphere, private sector investment is sure to face a decline of substantial magnitude. Even exports which were beginning to grow rapidly in the wake of depreciation of dollar are likely to suffer as dollar has recently appreciated in relation to most of the major currencies in the world. A severe decline in output in the US over the next few years (adding up to 10 per cent of GDP) is now highly probable.

Even worse is the scenario on future of the US dollar. Through its bail-out and stimulus packages, the US is pumping more and more dollars into the world economy, seriously aggravating the burden of external holdings of the US which were estimated to be over $20 trillion in late 2007. If the confidence in the US dollar is shaken and the dollar goes into a free fall, we may well have what has been called "mother of all monetary crises."

The ongoing financial crisis in the US now clearly poses a serious threat to the stability of the world economy. Already the crisis has spread to Europe, Japan and major emerging economies. Among the developed countries, UK resembles the US situation most closely with serious risks of downturn in the economy and loss of confidence in the British Pound. Faced with fall in demand including exports, major economies may well embark on competitive devaluations and protectionism leading to a downward cobweb of production and employment in the world.

We believe that urgent global actions are needed to prevent two imminent risks. First is the risk of serious decline in global demand which can lead to global depression (which we define as decline in global GDP in two consecutive years) and second, a dollar crisis. According to the Managing Director of IMF, global stimulus of about 2 per cent of GDP (about $1 trillion) is needed to prevent global slowdown. This, however, may be an underestimate. The sharp increase in consumer expenditure in the US and UK associated with bubble in equity and housing markets is going in reverse. Between 1981 and 2006, household consumption as percentage of GDP increased from 62.5 per cent to 70.5 per cent in the US and from 58.7 per cent to 64.1 per cent in the UK while the ratio was relatively stable below 60 per cent for Euro area and Japan. If this ratio in the US and UK goes back to its level in early 1980s, it may create a hole of about $1.2 trillion dollars (at 2006 prices) in the effective demand of the world economy. To this must be added the decline on consumption and private investment due to decline in income in the developed countries in 2008/09 and slow down in growth in developing countries. Altogether, decline in global demand coming from private consumption and investment may be nearer $2 trillion (4 per cent of global GDP) in 2009 than the figure of $1 trillion mentioned by the IMF.

There are many stimulus packages in preparation. Even if they can pump in $1 trillion of new demand, GDP decline of $1 trillion or 2 per cent of GDP is highly likely in 2009. There is a need for a global stimulus package to prevent that outcome, i.e. just to maintain global GDP at 2008 level. However, in order to correct the global imbalances of the past, the global stimulus cannot be across the board, but has to involve a restructuring of demand away from deficit countries to the surplus countries. Both the US and the UK are now highly indebted countries and their huge current account deficits have to be converted into surplus over time to work out their external debt. Since in recent years the net exports from Asia have been a substantial part of the net imports of the US and UK, Asia may have to live with a substantial reduction in its net exports to these countries. To prevent a decline in output in Asia due to decline in net imports of the US and UK, alternative sources of demand have to be created in Asia. They could be a combination of increased investment and consumption at national and regional level. Since private consumption and private investment are endogenous variables responding, among other things, to income changes, it is the public sector, through its investment and consumption that has to lead the process of demand stimulus in the region. Fortunately the region seems to be well-endowed with possibilities of sound public expenditure programmes as well as means to finance them.

Role of Physical and Social Infrastructure for Near-Term Stimulus and Long Term Development

In *RIS Policy Brief 31*, we noted the huge infrastructure deficits of at least $200 billion per year that exist in Asia, both at a national and regional level. To these can be added the needs of expenditures for mitigation of and adaptation to greenhouse gases. In addition, there are expenditure needed to meet the Millennium Development Goals (MDGs). Thus, the demand stimulus measures to compensate for decline in net exports to the US and UK do not have to be in the nature of what Keynes called digging holes and filling them up. These investments are needed for long-tern sustainable growth. Activating them now will be a bonus in the present global economic crisis.

The situation can be illustrated with reference to the Indian conditions. The Eleventh Five Year Plan (EFYP) puts a figure of $502.8 billion (at 2006-07 prices) for investment in physical infrastructure during the period 2007-12. This will mean a rise in infrastructure investment from about 5 per cent in 2006-07 to 9.0 per cent in 2010-2011. Eleventh Plan puts emphasis on private sector's role[2] in financing infrastructure in public- private-partnership (PPP) mode, with private sector providing 30 per cent of investment. It also expects 48 per cent of this investment to be financed from debt resources, of which 12 per cent is expected from external commercial borrowing.

[2] EFYP was designed to rely " as much as possible"on private sector investment in infrastructure through various forms of PPPs, though it also noted "it must be recognized that it will not be easy to bring in private investment at the scale required".

The above assumptions of EFYP need to be revisited in the current context of global financial crisis. Both reliance on private sector and that on external commercial borrowing may have to be revised downward. Although no firm figures on investment in infrastructure for FY 2008 or 2009 are available, investment in infrastructure, in particular that by the private sector is falling short of Plan expectations. Credit to the private sector, both domestic and foreign, is facing tight squeeze and that may continue for some time. It would be unrealistic to assume that the Eleventh Plan targets on physical infrastructure can be met without additional public investment. And so far as external sources are concerned, greater resort to public funding may be essential to meet the targets. We may be moving back to the earlier period where public investment and multilateral agencies were the main sources of funding infrastructure.

In the remaining three years of the Plan (2009-12), infrastructure investments were expected to be about 8.3 per cent of GPD. However, on business as usual scenario, this ratio cannot be expected to be more than 6 per cent. Thus, there is a gap of at least 2 per cent of GDP or about $70 billion to be filled in the next three years just for meeting the infrastructure investment targets of EFYP.

For management of climate change the Indian policy paper, *National Action Plan on Climate Change, (NAPCC)*. has put forth a programme of eight "missions" relating to solar energy, energy efficiency, sustainable habitat, water, sustaining Himalayan ecosystem, green India, sustainable agriculture and strategic knowledge for climate change. There is no estimate in NAPCC of the level of expenditures needed for funding these missions. However, if we use the global figures on resources needed for managing climate change, (about 1 per cent of GDP), these missions in India can be expected to absorb at least $10 billion per year. Now is the time for implementing these programmes effectively and mobilize necessary resources, some of which may come from regional funding agencies.

In the social sector, poor performance of India is well known. Among others, Amartya Sen has been tirelessly highlighting the serious deficiency in provision of basic social services in India. EFYP aims at increasing the expenditures (as per cent of GDP) in social sector (defined as including education, health, nutrition, water and sanitation) to about 8 per cent of GDP. However, as of 2008-09, this ratio seems to be falling short of the targets by at least 1 per cent of GDP. The need for economic stimulus is a good occasion to increase allocation of public expenditures in this sector and to identify efforts to improve implementation.

Taking the need for physical and social infrastructure and green expenditures, a stimulus package of about 4 per cent of GDP or about $50 billion per year for the next three years may be entirely appropriate in the current conditions. If about 50 per cent of this expenditure, can be mobilized from external sources, these programmes will not create excessive pressures for internal deficit financing. Some $3-4 billion per year of this additional funding can come from global sources such as the World Bank. But a more promising source is regional financing mechanism for which a target of about $20 billion per year for the next three years may be envisaged.

Low Returns on Foreign Exchange Reserves

In *Policy Brief # 31*, we noted that foreign exchange reserves in Asia were about $3.3 trillion in December 2006 and nearly $2 trillion of these could be considered "excessive." Since then reserves in Asia have been increasing and are now estimated to be about $4.3, a large part of which is probably excessive as before.

The situation in India about "excess reserves" remains unchanged. Even after decline in recent months, reserves in India as of December 26, 2008 were $254.6 billion, about $100 billion more than in December 2006. Allowing for reserves for transaction needs (as 3 months of imports expected to be less than $300 billion in 2009), precautionary needs as full provision for short term debt ($50 billion as of end-September) and FII investments ($53.2 billion as of January 2, 2009), the reserve requirements at present are no more than $178 billion, which leads to an estimate of "excess" reserves as above $75 billion.

The rate of return on these reserves is now extremely low, even lower than before. The yield on one-year US Treasuries on December 30, 2008 was 0.4 per cent per year as against 3.4 per cent a year ago. With the risk of depreciation in US dollar, the reserves held in US Treasuries are certainly set for negative real rates of return. There is a need, more than ever before, to see how at least the "excess" reserves of Asia can earn a better rate of return

Regional Co-operation Mechanism

With the total reserves of Asia at about $ 4 trillion, some $400 billion can be safely used for more aggressive management at a regional level. We suggest a two-track approach.

First, in view of the urgent need for a stimulus package in Asia, a deposit of say $50 billion can be made in Asian Development bank (ADB) by Asian countries with current account surplus for on-lending in the three areas noted, namely, physical and social infrastructure and green expenditures.[3] The rate of interest paid by ADB to the deposit-making countries could be 100 basis points higher than what US Treasuries are offering. ADB can re-lend these funds with a modest margin to Asian countries in need of stimulus package but with limited fiscal and balance of payments (BOPs) space. Channelling funds through ADB, the premier regional development institution, would be better than just bilateral assistance because of the technical capacity it has and because of the apolitical atmosphere for assistance that it would provide.

Secondly, a dialogue should be initiated immediately for a long-term restructuring of regional financial architecture. As noted above, basically Asian demand has to be increased to substitute for loss of demand from the US and UK of about $1 trillion per year over the next few years. A stimulus of about $300 billion per year can, over time, sustain, through multiplier and accelerator effects, an increase in effective demand of about $1 trillion per year over the medium term.

Moreover, in order to help the US to reduce its net imports without protectionism, there has to be a tighter external budget constraint on the US and an end of the US$ reserve system which enabled the US to fund its deficits simply by printing money. The proposal for issuing Asian Currency Unit (ACU) as a parallel currency made, among others, in *RIS Discussion Paper # 133* (March 2008,) should be seriously considered. ACU could provide a mechanism for concerted appreciation of major Asian currencies with respect to the US $, which may be essential for helping the US to reduce its net imports without protectionist measures. Moreover, issuance of ACU as the regional parallel currency will also generate the seigniorage (which is currently appropriated largely by the US) for funding regional public goods, including cross-border infrastructure investments. With the imports of goods and services of Asia at about $2.0 trillion, and growing at about 10 per cent per year, additional reserve requirements (estimated as 3 months of imports) would be about $50 billion per year which can be met by issuance of ACUs.

As proposed in *RIS Policy Brief # 31*, a Reserve Bank of Asia (RBA) may be established with subscribed capital of $300 billion, 10 per cent of which can be paid up. In addition, Asian countries will deposit $300 billion in RBA on a long-term basis at 100 basis points above the rates prevailing on 30-year US Treasuries. RBA will invest these

[3] This may require an amendment of ADB Charter enabling it to take on such deposits.

funds in Asian equity indices and Asian bonds which can be expected to give rates of return higher than the cost to RBA on these deposits. These funds would be largely liquid and available to participating countries in cases of unexpected balance of payments needs. Investment in indices of equities and bonds in Asia will give a much needed boost to these markets in Asia. Moreover, the profits made by RBA combined with the seigniorage obtained through the regional currency should provide substantial funds to fill up the financial viability gap to the extent it exists in the $300 billion per year of investment expenditures mentioned above. Basically, the seigniorage that the US has been getting through the dollar reserve system will in part accrue to Asia in the proposed scheme.

India, China and Japan can contribute 20 per cent each of the resources required for setting up the Bank, with the rest 40 per cent coming from other partners in Asia.[4] This will mean $60 billion of deposits from India's foreign exchange reserves and $6 billion of paid-up capital from India. In view of India's "excess" reserves of over $75 billion in 2009, such allocations to regional fund are entirely feasible, particularly because the scheme provides for BOP support when necessary. The amount of borrowing from RBA that India can do will depend on availability of projects and need for support from the Bank. But over the next three years, RBA can meet a substantial part of the "stimulus" package of $150 billion envisaged above. Thus, with a one-time deposit of $60 billion, India can get a substantial stream of annual funding (say $20 billion per year) at concessional rates for the foreseeable future.

[4] These are only indicative figures, but the objective is to suggest that the three major players in Asia - India, China and Japan - should have equal voice in the RBA and none should be in a dominating position.

In this proposal, the large countries with substantial current account surplus and large foreign exchange reserves such as China and Japan would be the major contributors, without necessarily receiving much support for their stimulus package, which they can fund from their own domestic resources. The rationale for their participation will come from the need to find alternative markets for their exports to the US which are likely to decline in the medium term. The major western countries such as the US, UK and Euro Zone countries would also benefit to the extent the increase in effective demand in Asia will increase demand for their exports thus enabling them to increase their net exports and work down the external debt they owe to Asian countries. Thus the regional scheme will also be of some benefit to the global community in so far as it helps to restructure the global effective demand towards a more sustainable pattern.

It has been argued that lack of project preparation and implementation capacity is a major constraint for infrastructure investment in Asia. Armed with $300 billion of capital and reserves, RBA can become a substantial regional financial institution to help in improving the capacity of the Asian countries for preparation and implementation of projects as well as for improving the regulatory environment for infrastructure projects. More generally, RBA could become the key agency for developing policy paradigm suitable for the Asian conditions. A sample of such an Asian development paradigm is provided in the *RIS Discussion Paper # 133*.

These ideas may seem somewhat far fetched. But given the economic crisis due to declining effective demand in the US and UK and risk of dollar crisis, there is no time to lose. Using the East Asia Summit (EAS) framework, an official level committee should be set up immediately to review the feasibility of a regional financial mechanism to address the emerging problems and prevent the nightmare scenario of a prolonged stagnation or stagflation in the world economy.

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Research and Information System for Developing Countries

Core IV-B, Fourth Floor
India Habitat Centre
Lodhi Road, New Delhi-110 003, India.
Ph. 91-11-24682177-80
Fax: 91-11-24682173-74-75
Email: publication@ris.org.in
Websites: http://www.ris.org.in
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