

Trends and Impacts of Real and Financial Globalization in the People's Republic of China and India since the 1980s

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The dynamic process of integration of national economies has a long history, with two distinct waves: one, from the middle of the 19th century until its interruption with outbreak of the First World War in 1913 till the end of the Second World War in 1945. The second wave is ongoing dating from 1950. Two sub-processes of integration are usually distinguished. The first, called real integration related to flows of goods, services and factors across borders; the second called financial integration related to financial flows of claims on the nominal returns on financial assets. Financial integration has had a checkered history. Private financial flows, particularly debt flows, were evident in the first wave. During the second wave, debt flows, both intergovernmental and private banking lending were dominant during 1950–1980. Only after 1980, private non-debt flows particularly equity flows accelerated.

This paper's primary focus is on the real and financial integration and their impact on trade, growth and poverty in the world's two dominant developing countries in emerging markets, namely the People's Republic of China (PRC) and India. The paper also discusses the reforms of institutional (domestic and multinational) foundations of real and financial integration, particularly the World Trade Organization, the World Bank, the International Monetary Fund, and the Group of 20. The impacts of the 2008–2009 financial crisis on the PRC and India are noted and the need for domestic financial sector reforms in both for them to cope with and respond to future financial crises is pointed out. Attention is drawn to the inadequacy of available analytical tools, in particular the absence of an appropriately integrated model of real and financial sectors to enable a meaningful assessment of the impact of financial shocks on the real sector.

Keywords: two waves of globalization, real and financial integration, trade institutions, real and financial flows, international financial institutions, People's Republic of China, India

JEL codes: F02, F13, F15, F43, F33, F36, F41, F42, F43, F60, F63, G01, 053

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I. Introduction

Globalization, defined as the integration of national economies, is a dynamic process that has a long history going back to the emergence of nation states after the Treaty of Westphalia in 1648. For this paper, globalization in the period since the onset and spread of the industrial revolution from Britain¹ in the 18th century is of interest.

Two waves of globalization—the first from the middle of the 19th century until the outbreak of the First World War and the second, which is still ongoing, from the end of the Second World War—have attracted the analytical attention of economists (Baldwin and Martin 1999; Bordo and Eichengreen 2002; Bordo, Eichengreen, and Irwin 1999; Williamson 2002). Keynes (1920) described the glories of the first wave and lamented its abrupt end in August 1914. During the first wave, as Keynes noted, there were no policy-created barriers to the flow across national borders of people, goods, and capital and adherence to the gold standard minimized uncertainty of currency exchange rates.

The period between the end of World War I in 1918 and the outbreak of the second in 1938 was disastrous to the world economy and the people of the world. The Great Depression that lasted a decade from the stock market collapse of 1929 resulted in a steep fall in output and a large rise in unemployment. The exchange rate system based on the gold standard of the first wave of globalization collapsed, and a steep rise in policy-created trade and other barriers led to a drastic reduction in world trade and financial flows. In an attempt to forestall a repeat of the disastrous interwar experience, as World War II was drawing to a close, the institutions of the International Monetary Fund (IMF) and the World Bank were established, at the initiative mainly of the UK and United States (US), to govern global exchange rates and finances and for funding postwar reconstruction and development. The attempt to establish a third institution, the International Trade Organization (ITO), to govern trade flows failed. In its place, the General Agreement on Tariffs and Trade (GATT), signed in 1947 by 23 customs jurisdictions, called contracting parties, came into operation on 1 January 1948 with a provisional protocol of application. Subsequent attempts to replace GATT which was in effect a treaty among its contracting parties by a formal international organization with a Constitution or articles of association failed. GATT governed world trade until the establishment of the World Trade Organization (WTO) in 1995 (see Srinivasan 1998 for the history).

It is generally agreed that the eight rounds of multilateral trade negotiations (MTN) under the auspices of the GATT, with increasing participation of developing countries over time, succeeded in reducing tariff barriers to very modest levels in nonagricultural trade. By the conclusion of the eighth and last round, the Uruguay Round in 1994, a rule-based system governing trade had taken root and its

¹Britain rather than the United Kingdom is used following the convention in the literature on the Industrial Revolution.

disciplines had been extended to trade in services and trade-related intellectual property rights. Agricultural trade has been substantially though not fully brought under the disciplines that have governed nonagricultural trade. The WTO subsumed GATT and consolidated its achievements. As of 10 May 2012, there were 155 members in total including Hong Kong, China; Macau, China; and the European Union (EU). This compared to the 23 contracting parties who signed GATT in 1947 and the 123 who signed the final act concluding the Uruguay Round at Marrakech in April 2004 (and who later became founder members of WTO). The Doha Round, the first under the auspices of the WTO, was initiated in November 2001. As of 31 July 2012, it is still to be concluded. The prospects of its successful conclusion in the near term do not appear bright.

Two distinct sub processes of globalization are usually distinguished. The first relates to the flow across nations of goods and services and is often termed the process of “real integration” of national economies. The second, the process of “financial integration,” relates to financial flows particularly of claims on the returns from financial assets and/or ownership of such assets (for example, foreign assets and liabilities in balance sheets of individual participants and of the nation in aggregate). There is a near consensus among analysts on the potential benefits of greater real integration on balance for all participants and economies including developing ones. There is no such consensus on whether greater financial integration is similarly beneficial. Economists such as Jagdish Bhagwati who are advocates of greater real integration do not see net benefits on balance from greater financial integration. The issues are well-known and have been laid out in the debate on globalization, for example in Bhagwati (2004) and Stiglitz (2002, 2007) and others. I do not have much to add to the debate and I will not revisit it.

Instead, I will first document the trends in real and financial integration in the People’s Republic of China (PRC) and India in Section II. Then I will focus on the implications of rising financial integration for the international transmission of impacts of financial shocks. It has been suggested that the capacity to absorb financial shocks without significant costs on the real economy, particularly on real growth and welfare of vulnerable socioeconomic groups, is tied to the depth and strength and resilience of the domestic financial system, which in turn depends on progress in financial sector reform. For this reason, I will in Section III look at domestic financial sector reforms in both countries and also the Group of Twenty (G20) decisions on global financial stability. This is followed by concluding remarks in Section IV.

II. Developments in the Global Trading System: GATT to WTO and Beyond

It was previously noted that through the eight rounds of MTN between 1948 (the year of coming into force of GATT) and 1994 (the year of its formal end), barriers to trade had been lowered substantially, trade in services and trade-related

intellectual property services came under multilateral disciplines, and agriculture was substantially though not fully brought under disciplines similar though not identical to those that applied to nonagricultural trade since the beginning of GATT. Real integration of trade in goods since the start of the GATT era in 1948 and of services since the conclusion of the Uruguay Round in 1994 correspondingly grew.

A. Trends in Real and Financial Integration of the PRC and India

It is widely believed that the process of global financial integration accelerated from the early 1980s on, with private financial flows consisting of flows of foreign direct investment (FDI), portfolio investment and also trade in debt (bonds) contributing to the acceleration. The comparison of India with the PRC is interesting for many reasons. Let me mention just one that is salient from the perspective of globalization. After India's independence in 1947 and the establishment of the PRC in 1949, both economies embarked on their similar Soviet-style planned economic development with rapid industrialization and a heavy industry focus as the main planks of their development strategies. Both insulated their economies from external competition and investment.

After Deng Tsiao Ping became the PRC's paramount leader in 1978, he embarked on reforming the PRC's economy. An important element of his reform agenda was to open the PRC's economy to foreign trade and investment or, to put it more broadly, to participate in the process of globalization. India introduced reforms hesitantly and in piecemeal fashion in the 1980s and systemically across most sectors of the economy in 1991, with greater opening to foreign trade and investment as important elements. Since both economies grew at a very modest and similar rate during 1950–1980, or until their reforms and globalization featured significantly in their development processes, it is natural to compare their performance before and after such reforms.

1. Exports and Imports of Goods and Services

Both the PRC and India insulated their economies from markets when they began their national development in 1950. Indicators of the attitudes of the PRC and India towards opening their markets during the reform era are their import tariff profiles. First, the PRC at its accession to the WTO as a member in 2001 bound all of its tariff lines, while India as a founder of the organization in 1995 bound only 74% of them. Moreover, the bound and applied most favored nation (MFN) rates in later years were very close to each other for the PRC in agricultural and nonagricultural products, whereas in India's case, the gaps were wide particularly in agricultural products. A major reason for this is not only India's continuing ambivalence about opening its domestic markets to external competition, but also the fact that India

as a founder member of the WTO did not have to sign accession agreements with the other members. The PRC had to do so to become a member in 2001. The PRC applied to be a signatory of GATT in 1986, the year when the Uruguay Round of MTN began, and patiently negotiated accession agreements with the signatories of GATT. The negotiations dragged on even after the conclusion of the Uruguay Round in 1994 and the establishment of the WTO and concluded only in 2001 at the Doha Ministerial Meeting after it had signed its last accession agreement with Mexico. The accession agreements required the PRC to liberalize its trade to a greater extent than the original WTO members had agreed to at the Uruguay Round.

The PRC's signing of accession agreements and determination to become a member of the WTO had been motivated largely by two reasons. First, by committing to liberalize as part of its accession agreements with the contracting parties of GATT at the time and also the Uruguay Round Multilateral Agreement, the PRC formally committed to liberalize trade. To derive benefits of liberalization, it had to undertake the necessary domestic reforms. The commitment to liberalize trade in a multilateral forum meant the implementation of associated reforms also became credible in the domestic politico-economic context. Second, unlike India, the PRC was convinced that opening its economy would be beneficial. In fact, from 1980 to 2000, prior to its becoming a member of the WTO, the PRC had already gained significant market shares in labor-intensive manufactured products while India's share stagnated (Table 1).

Table 2 provides data on the shares of the two countries' trade in goods and services in their GDP and in world trade. In both countries, trade shares in GDP went up particularly after 1990. By 2010, the share of exports of goods and services in India's GDP was 20%, while the share in the PRC's output was a higher 30%. The share of imports in India's GDP in 2010 was 26% and **higher** than the share of exports. The share of imports in the PRC's GDP was also 26% but **lower** than its export shares. These reflect the fact that India had a trade deficit while the PRC had a trade surplus in 2010.

Interestingly, the share of the PRC in world merchandise exports increased 10 times from 1% in 1982 to 10.4% in 2011. India's share went up far more modestly from 0.5% to 1.6% during the same period. In 2011, the PRC was the largest single exporter of goods in the world and India a distant 19th. In commercial services trade, India was sixth in the world with a 3.5% share, while the PRC was fourth with a share of 4.4%, a gap not as large as in goods trade (WTO 2012a).

Table 3 provides the data on the rates of growth of trade. The acceleration of trade (exports and imports) in the post-1980 period, particularly after 2000 in both countries, is evident. During 2000–2010, reflecting the impact of the global financial crisis of 2008–2009, export growth slowed in both countries but to a greater extent in India.

Table 4.1 summarizes the composition of goods exports from India and the PRC during the 1980s and beyond in terms of the SITC (Revision 2) one-digit

Table 1. Participation of the PRC and India in Major Export Markets

World Markets		1978–1981	1982–1984	1985–1987	1988–1991	1992–1994	1995–1997	1998–2000
PRC	Garments	3.93	6.93	8.74	14.95	18.78	19.70	20.45
	Fabrics	5.15	7.48	8.28	8.25	7.87	8.87	9.36
	Leather and leather manufactures	0.41	0.61	0.75	2.55	2.94	4.07	4.82
	Jewelry	1.13	1.05	1.36	2.69	5.97	7.14	9.48
	Others	1.07	1.93	3.27	7.73	14.6	16.9	18.1
India	Garments	3.95	3.43	3.46	3.82	4.40	4.97	5.27
	Fabrics	2.04	1.38	1.45	1.43	1.99	2.10	2.42
	Leather and leather manufactures	8.85	7.45	7.13	5.52	4.03	3.42	3.44
	Jewelry	0.61	1.02	1.40	2.18	2.21	2.97	4.61
	Others	0.31	0.24	0.20	0.25	0.29	0.30	0.31
North American Markets								
PRC	Garments	3.73	8.00	8.81	13.19	21.30	21.42	20.59
	Fabrics	3.73	5.31	5.61	5.66	6.25	5.84	6.52
	Leather and leather manufactures	0.14	0.45	0.49	2.57	6.67	7.65	8.44
	Jewelry	0.50	0.42	0.25	1.77	3.99	5.51	8.13
	Others	0.72	1.51	2.98	9.92	20.89	25.62	26.57
India	Garments	4.89	4.14	4.12	4.60	5.80	5.56	5.34
	Fabrics	6.02	2.64	2.69	2.98	4.62	5.93	5.73
	Leather and leather manufactures	9.38	8.89	6.51	4.09	3.05	2.33	2.05
	Jewelry	0.39	0.83	1.34	2.46	4.57	7.01	9.60
	Others	0.19	0.11	0.14	0.22	1.28	1.09	1.01

PRC = People's Republic of China.

Source: Srinivasan, T.N. (2004).

classification. Based on data availability, the precise period covered is 1980–2010 for India and 1984–2010 for the PRC.

Panagariya (2012) notes three points in discussing the composition of Chinese and Indian exports. First, SITC categories 6–8, which consist largely of manufactures, have accounted for more than half of the total exports of each country throughout the period. Moreover, the joint share of these categories has steadily risen from 55% during 1984–1990 to 62% during 2001–2004 in India and from 57% to 86% over the same period in the PRC. However, during 2008–2010, India

Table 2. Exports and Imports of Goods and Services (BOP data)

	India					PRC				
	1982	1990	2000	2006	2010	1982	1990	2000	2006	2010
As % of GDP										
Exports of goods and services	6.2	7.2	13.1	21.8	20.2%	11.7	16.2	23.3	40.1	29.57
Goods exports	4.7	5.8	9.5	13.6	13.1%	10.5	14.5	20.8	36.7	26.68
Imports of goods and services	9	9.3	16	25.8	25.5%	9.4	13.2	20.9	32.2	25.66
Goods imports	7.2	7.4	11.8	18.3	18.7%	8.4	11.9	17.9	28.4	22.39
As % of the World										
Exports of goods and services	0.5	0.5	0.8	1.4	1.87%	1.1	1.3	3.5	7.3	9.37
Goods exports	0.5	0.5	0.7	1	1.51%	1.2	1.5	3.9	8.2	10.57
Services Exports	0.7	0.5	1.1	2.7	3.48%	0.6	0.7	2	3.3	4.82
Imports of goods and services	0.8	0.7	0.9		2.42%	0.8	1.1	3.2		8.34
Goods imports	0.8	0.7	0.8	1.4	2.20%	0.9	1.2	3.4	6.4	9.02
Memo										
Share of services in total exports	24.1	20.2	27.8	37.9	35.44%	10.6	10.2	10.9	8.7	9.77
GDP (current billion \$)	194.8	316.9	457.4	911.8	1,727.1	202.1	354.6	1198.5	2644.7	5926.6
GDP per capita (constant 2000 \$)	234.2	315.5	450.2	634.0	823.0	208.2	391.7	949.2	1,598.0	2,425.0

Source: World Bank (2012a).

Table 3. Growth Rates of Exports and Imports (%)

Item	India				PRC			
	1983–1990	1991–2000	2001–2010	2008–2010	1983–1990	1991–2000	2001–2010	2008–2010
Imports of goods and services	6.9	10	21.1	18.81	13.7	18.8	20.6	15.3
Exports of goods and services	8.4	10.3	20.3	15.38	12.2	17.6	21.2	11.2
Goods exports	9.2	9.3	18.9	15.97	12.3	17.5	21.4	11.0
Goods imports	6.7	9.3	21.2	18.43	14.2	18.2	20.9	15.6
GDP (constant 2000 \$)	6	5.5	7.7	7.61	9.9	10.4	10.5	9.7
GDP per capita (constant 2000 \$)	3.8	3.6	6.2	6.2	8.3	9.3	9.8	9.2

Note: Figures based on current \$ measure.

Source: World Bank (2012b).

experienced a decline in the export share of SITC category 6 in its total exports from 36% to 27%.

Second, that Chinese exports have shown much greater dynamism than Indian exports during 1980–2004. Recent data from 2008–2010 further illustrate this dynamism. For instance, miscellaneous manufactures (SITC 8) of the PRC, which

Table 4.1. **Composition of Exports (%)**

SITC Code	Item	India					PRC			
		1980–1983	1984–1990	1991–2000	2001–2004	2008–2010	1984–1990	1991–2000	2001–2004	2008–2010
0	Food and live animals	23.6	17.6	14.6	10.1	7.5	12.4	6.7	3.9	2.5
1	Beverages and tobacco	2.6	1.0	0.6	0.4	0.5	0.5	0.6	0.3	0.1
2	Crude materials, inedible, except fuels	10.2	9.0	4.8	5.3	6.0	8.6	2.6	1.2	0.7
3	Mineral fuels, lubricants, and related materials	8.6	4.7	1.9	6.5	16.0	13	3.6	2.6	1.9
4	Animal and vegetable oils, fats and waxes	0.4	0.3	0.6	4.0	0.3	0.3	0.2	0.0	0.0
5	Chemicals and related products, n.e.s.	4.1	5.7	8.9	9.1	11.5	5.8	5.4	4.5	5.4
6	Manufactured goods classified chiefly by material	30.9	37.7	39.3	35.8	26.9	21.1	18.9	16.6	16.5
7	Machinery and transport equipment	7.2	6.9	7.5	9.2	14.5	11.9	24.7	41.8	47.0
8	Miscellaneous manufactured articles	12.2	15.8	19.8	17.9	14.0	23.9	37.1	28.9	25.8
9	Transactions not classified elsewhere	0.3	1.4	1.9	1.7	2.7	2.5	0.3	0.2	0.1
TOTAL		100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

SITC = Standard International Trade Classification.

Note: Data refer to SITC one-digit classification.

Source: Adapted from Panagariya (2012); revised using UNCTAD (2012). Available: <http://unctadstat.unctad.org/UncatadStatMetadata/Classifications/UNCTADstatTables&Indicators.html>

largely consist of labor-intensive products, increased their share in the total exports from 24% during 1984–1990 to 37% during 1991–2000, this declined to 29% during 2001–2004, and declined still further to 26% during 2008–2010. The share of machinery and transport equipment (SITC 7) rose from 12% during 1984–1990 to 25% during 1991–2000, and further to 42% during 2001–2004 and 47% during 2008–2010. Thus, the PRC appears to have shifted exports away from simple labor-intensive manufactured products to more capital-intensive and sophisticated products as domestic costs of production of the former increased relative to other manufactures. The sharp decline in export of labor-intensive manufactured goods experienced during 2008–2010 could arguably be due to the global economic crisis.

Finally, within the same categories (SITC 6–8), while exports of the PRC are concentrated in categories 7 and 8, those of India are concentrated in category 6. Moreover, since the three categories accounted for approximately 50% of total

Table 4.2. **Composition of Imports (%)**

SITC Code	Product Description	India				PRC			
		1984–1990	1991–2000	2001–2004	2008–2010	1984–1990	1991–2000	2001–2004	2008–2010
0	Food and live animals	3.7	2.6	1.9	1.7	6.5	3	1.7	1.4
1	Beverages and tobacco	0.0	0.0	0.0	0.1	0.5	0.2	0.1	0.2
2	Crude materials, inedible, except fuels	8.5	6.5	5.5	5.2	8.7	7.5	8.8	14.5
3	Mineral fuels, lubricants, and related materials	22.3	27.1	30.9	36.2	1.7	5.7	7.6	13.5
4	Animal and vegetable oils, fats and waxes	2.8	2.5	2.9	1.8	1.2	1.0	0.6	0.8
5	Chemicals and related products, n.e.s.	13.2	12.7	9.3	11.3	12.4	13	12.1	10.8
6	Manufactured goods classified chiefly by material	21.5	18.3	16.7	15.3	25.3	22.3	15.1	9.9
7	Machinery and transport equipment	20.7	16.8	19.3	22.0	38.2	40.8	45.6	39.5
8	Miscellaneous manufactured articles	3.1	3.4	4.2	3.4	5.2	5.9	7.9	8.7
9	Commodities and transactions not classified elsewhere in the SITC	4.1	10.1	9.3	3.0	0.3	0.6	0.4	0.7
TOTAL		100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

SITC = Standard International Trade Classification.

Note: Data refer to SITC one-digit classification.

Source: Adapted from Panagariya (2012); revised using UNCTAD (2012). Available: <http://unctadstat.unctad.org/UnctadStatMetadata/Classifications/UNCTADstatTables&Indicators.html>

merchandise exports in India compared with 87% in the PRC during 2008–2010, some of the products with large export shares in India fall outside these three categories. It is also interesting to note that India experienced a sharp increase in the share of SITC code 3 products comprising mineral fuels and lubricants. The share decreased from 8.6% of India's merchandise exports during 1980–1993 to 1.9% in 1991–2000, but has increased steadily to 6.5% by 2001–2004 and 16% by 2008–2010. In the PRC, the share of mineral fuel and lubricants has been steadily declining from 8.7% in the late 1980s to less than 1% during 2008–2010.

The pattern of imports of goods and services of India and the PRC (Table 4.2) indicate notably that machinery and transport equipment (SITC 7) account for nearly two-fifths of the PRC's imports during 2008–2010. The corresponding figure for India is slightly over a fifth (22%). The differential patterns of exports and imports of the PRC as compared to India not only reflects the PRC's emphasis on

Table 5. **Foreign Investment**
(\$ million)

Year	India		PRC	
	FDI	Portfolio	FDI	Portfolio
1995–1996	2,144	2,748	35,849.2	0.0
1996–1997	2,821	3,312	40,180.0	0.0
1997–1998	3,557	1,828	44,237.0	5,657.0
1998–1999	2,462	–61	43,751.0	765.0
1999–2000	2,155	3,026	38,753.0	612.0
2000–2001	4,029	2,760	38,399.3	6,912.0
2001–2002	6,130	2,021	44,241.0	849.0
2002–2003	5,035	979	49,308.0	2,249.0
2003–2004	4,322	11,377	47,076.7	7,729.0
2004–2005	6,051	9,315	54,936.5	10,923.2
2005–2006	8,961	12,492	117,208.3	20,346.0
2006–2007	22,826	7,003	124,082.0	42,861.2
2007–2008	34,835	27,271	160,051.8	18,509.6
2008–2009	41,874	–13,855	175,147.7	8,721.0
2009–2010 (p)	37,745	32,376	114,214.5	28,160.7
2010–2011 (p)	32,901	31,471	185,080.7	31,357.1

p = provisional estimates.

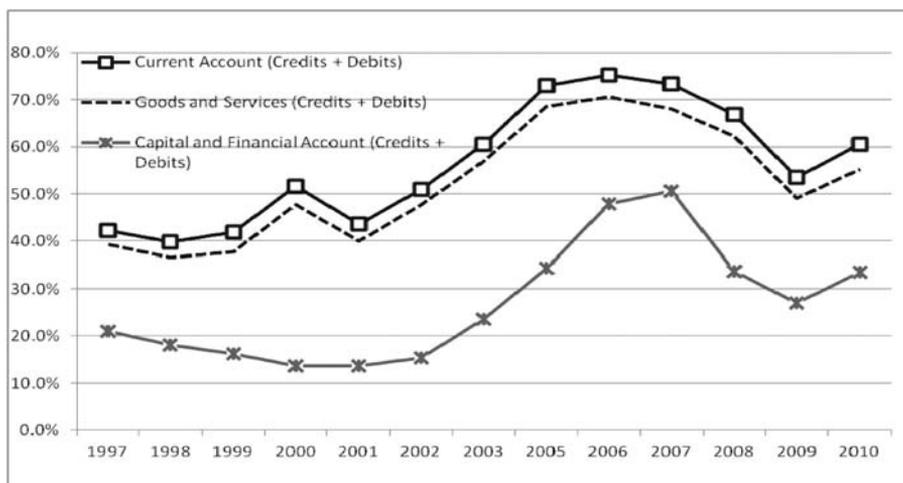
Sources: Reserve Bank of India (2011); IMF (2012e).

labor-intensive machinery in production and exports during its early post-reform years but also, importantly, a shift away from simple labor-intensive products and towards technologically more sophisticated as well as capital-intensive products in the later years. Clearly, this shift required importation of equipment from technologically advanced countries. India, on the other hand, does not exhibit a similar shift in its production and exports, and continues to satisfy the bulk of its machinery needs via domestic production.

2. Foreign Investment Flows

Table 5 shows the pattern of foreign investment flows. The PRC has attracted and still attracts more FDI than India, but the picture is mixed on portfolio investment—the PRC seems to have attracted larger net flows than India in the second half of the decade 2000–2010. The impact of financial crisis resulting in a net outflow from India and a sharp drop in net inflow to the PRC in 2008–2009 is evident.

Figure 1. Measures of Integration (PRC):
Trade in Goods and Services, Current Account, and Capital and Financial Account



PRC = People's Republic of China.

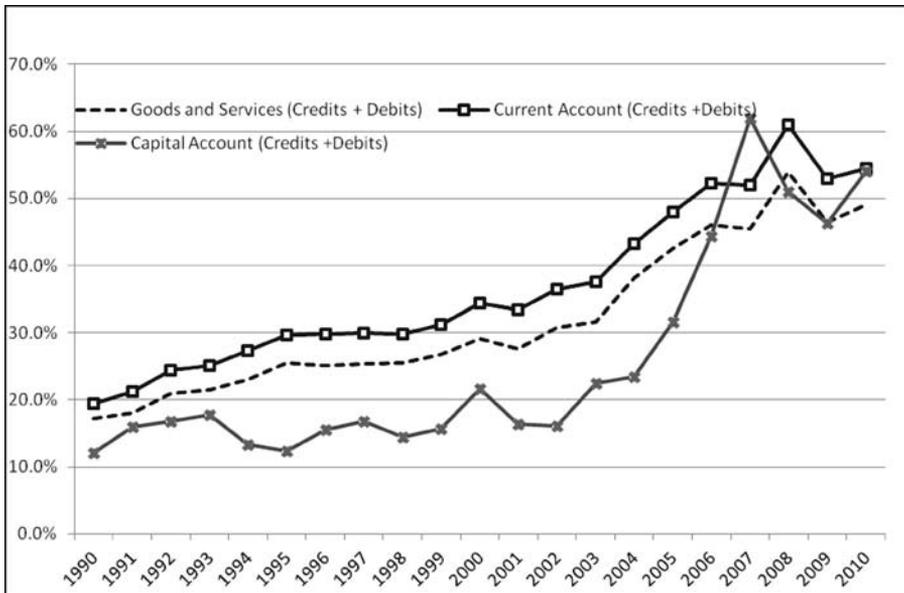
3. Three Integration Measures

It is now standard to measure integration of economies in trade in goods and services—or real integration—by the share of exports and imports of goods and services in GDP. The credits and debits in the current account of the balance of payments (BOP) include, in addition to exports and imports of goods and services, entries such as factor income inflows and outflows and inward and outward remittances. Some of the flows in the current account could be financial flows. The credits and debits on the capital account, meanwhile, obviously reflect transactions on the capital account. Their sum as a proportion of GDP is the measure of financial integration.

Figures 1 and 2 depict the trends of the three integration measures for the PRC and India. The rising trend in the three measures of integration of the two countries is evident in the figures. In the PRC, financial integration as measured by the trends in the capital and finance account did not take off from 14% of GDP until 2002 and rose relatively rapidly to 51% in 2007, fell to 27% during the financial crisis in 2009, then recovered to 34% in 2010. In India, capital account integration also hovered around 15% until 2002, rose rapidly to a little over 60% in 2007, but then subsequently fell to a little under 40% in 2008 at the height of the global financial crisis, recovering to around 45% in 2010. Broadly, though not precisely, India integrated financially faster and to a greater extent than the PRC.

Trade and current account integration measures also show significant differences in the extent but not as much in time patterns. The PRC's trade (current

Figure 2. **Measures of Integration (India):**
Trade in Goods and Services, Current Account, and Capital and Financial Account



Note: Data reported are gross flows, i.e. credits + debits. The vertical axis measures share of GDP. Time periods are not consistent across all countries due to data limitations.

Sources: IMF (2012e).

account) integration began in the 1980s though Figure 1 begins only in 1997. It rose steadily from a little under 40% (around 40%) to a peak of 71% (75%) in 2006, then declined to 49% (54%) in 2009, and later recovered to 55% (61%). Indian data go back to 1990. Here, trade (current account) integration rose steadily from 1990 onwards from below 20% (20%) to a peak of a little over 50% (60%) in 2008, then fell in 2009, and recovered in 2010 to around 53% (in both measures). Clearly, the impact of the global financial crisis appears to be larger on the PRC in trade and current account measures consistent with the larger share of exports in its domestic expenditure (i.e., greater dependence on foreign demand).

B. Growth Outcomes and Prospects

1. Economic Growth in a Historical Perspective

Table 6 drawn from the work of economic historians, the late Angus Maddison and Robert Fogel, shows that starting from roughly the same per capita income in purchasing power parity (PPP) exchange rates in 1870, India did much better than the PRC during the first wave of globalization from 1870 to 1913 with a 26% increase in its per capita income compared to just a 4.2% increase for the PRC. During the

Table 6. **Per Capita GDP in Historical Perspective**
(constant 1990 international \$)

	PRC	Share in World GDP	India	Share in World GDP	World
1820	600	32.9	533	16.0	667
1870	530	17.1	533	12.1	–
1913	552	–	673	–	–
1950	448	4.6	619	4.2	2,111
1973	839	–	853	–	4,091
1990	1,871	–	1,309	–	–
2003	4,803	15.2	2,160	5.5	6,447
2010 ^a	6,890	12.8	3,280	5.3	10,594
2030	15,763	23.1	7,089	10.4	11,814
2040 ^b	85,000	40.0	24,000	12.0	35,382

Sources: Fogel (2007); Maddison (2007, 2008).

Table 7. **Growth of Real GDP**
(%)

	1950– 1980	1980– 1990	1990– 2000	2000– 2008	2008	2009	2010	2011	Projections ^a			
									2012		2013	
									WB	IMF	WB	IMF
PRC	4.40 ^a	10.30	10.60	10.40	9.60	9.10	10.30	9.2	8.2	8.0	8.6	8.5
India	3.75 ^b	5.70	5.90	7.90	6.80	8.00	8.40	7.4	6.6	6.1	6.9	6.5

Note: Except for 1980–1990 and 1990–2000 data for other periods represent fiscal years so that 1950–1980 relates to 1950–1951 to 1980–1981, 2000–2006 to 2000–2001 to 2006–2007, 2007 to 2007–2008, 2008 to 2008–2009, and so on.

^a Projections based on IMF (2012f) and World Bank (2012b).^b Maddison (2008).^c Authors' estimates.

Sources: Maddison (2008), IMF (2012f), World Bank (2012b).

disastrous period between the beginning of World War I in August 1913 and the start of their planned development in 1950, both experienced a decline in their per capita incomes. With a bigger drop seen in the PRC during the period, India's per capita income in 1950 ended up 38% higher than the PRC's. Moreover, roughly during the Mao era (1950–1976), the PRC merely caught up with India in terms of per capita income. Only after Deng Tsiao Ping's reforms did the PRC vastly outpace India, and by 2011, its per capita income grew to more than twice that of India. Interestingly, Table 6 also shows that the PRC and India accounted for half of the world's GDP in 1820, and according to Fogel's projection, will do so again more than two centuries later, in 2040.

2. Growth since 1950

Average annual real GDP growth rates of the PRC and India for selected periods since 1950 are shown in Table 9. In the pre-reform era, both countries

grew at modest average rates with the PRC growing at a slightly faster rate, the difference likely to be within the measurement error band around the difference in the average rate. Remarkably, after Deng Tsiao Ping's reforms, the PRC grew at annual growth rates averaging over 10% for nearly three decades, during 1980–2008. The global financial crisis of 2008–2009 slowed down growth to 9.6% in 2008 and 9.1% in 2009. However, growth recovered to 10.3% by 2010. The uncertainties associated with the eurozone crisis lowered the growth rate to around 9.2% in 2011 and to projected growth rates in the ranges of 8%–8.2% in 2012 and 8.5%–8.6% in 2013.

In India, growth rates averaged at slightly below 6% a year during 1980–2000 and close to 8% during 2000–2008. During the last three years of this period, in 2005–2008, the average growth rate exceeded 9%. A growth slowdown started in the fourth quarter of 2008 even before the global financial crisis of 2008–2009 hit India. The slowdown continued during the crisis so that the growth rate declined to only 6.8% in 2008. The recovery from the financial crisis raised the growth rate to 8.4% in 2010, but uncertainties arising from the eurozone brought this down again to 7.4% in 2011. IMF and World Bank projections for the calendar year of 2012 and 2013 are not encouraging—even by 2013, the growth rate is projected only to a range of 6.5%–6.9%.

C. Trends in Poverty

Table 8 documents the trends in poverty in the PRC and India. The data indicate trends in the proportion of people deemed poor in the total population.² They are based on household consumption expenditure (or income) surveys and poverty lines drawn to distinguish the poor from non-poor. A national poverty line in terms of the domestic currency and an international one in terms of US dollars at PPP exchange rates are used to measure the extent of poverty. The data suggest that, regardless of the poverty line used, significant reductions in the proportion of the poor in the population took place in both countries only in the post-reform era. In general, the level of poverty based on the national poverty line is higher but the trends are similar.

The empirical evidence on trends in real and financial integration and growth and poverty all suggest a possible structural break in the data for both economies around the onset of reforms. In the PRC, the onset can be more or less identified to be 1980, representing the assumption of Deng Tsiao Ping as the paramount

²I will not go into the enormous conceptual literature on poverty and on measurement of the extent of poverty in a society at a point of time and over time. For the history of poverty lines in India going back to the late 19th century, see Srinivasan (2007) and for trends in the decline of poverty see Srinivasan (2012).

Table 8. **Poverty**

India (official)	1951-2	1961-2	1973-4	1977-8	1983-4	1987-8	1993-4	1999-00	2004-05*	2009-10*
Rural India	47.4	47.2	55.7	53.1	45.7	39.1	37.3	27.1	41.8	33.8
Urban India	35.5	43.6	48	45.2	46.8	38.2	132.4	23.6	25.7	20.9
Combined	45.3	46.5	54.1	51.3	44.5	38.9	36	26.1	37.2	29.8

	1981	1990	1996	1999	2002	2005	2008**
PRC: National Poverty Line	52.8	22.2	9.8	7.6	7.3	5.2	
PRC (World Bank, \$1.25/day PPP, 2005, Poverty Line)	84	60.2	23.7	36.4	28.4	16.8	13.1
India (World Bank, \$1.25/day PPP, 2005, Poverty Line)	59.8	51.3	46.6	44.8	43.9	40.3	
South Asia (World Bank, \$1.25/day PPP, 2005, poverty line)	61.1	53.8	48.6	45.3	44.3	39.4	36.0

*Based on Planning Commission (2009, 2012).

**For India, data sourced from Datt (1998, 1999), Deaton (2003), and MoF (2008, Table 10.4); for the PRC, data based on Chen and Ravallion (2007).

Note: Poverty figures refer to proportion of population below the poverty line. The Planning Commission (2009) revised the poverty line and estimated poverty at 41.8% in Rural India and 25.7% in Urban India, or 37.2% combined. Preliminary estimates for 2009–2010 by the Planning Commission is 32% combined.

Sources: Planning Commission (2012) Delhi, India; World Bank (2012b).

leader in 1978 and the start of his reform agenda. In India, the reform process in some sense could be deemed a continuous one, without a sharp and identifiable break except for the reforms after the severe macroeconomic and BOP crisis of 1991. Moreover, in the PRC, there was pressure for reforms from the population following the disastrous Mao era and the assumption of power by Deng Tsiao Ping, who had been purged more than once earlier by Mao for his pragmatic approach to economic policy (as paramount leader). In India, there was no popular pressure for reforms, which were initiated by political and bureaucratic leadership. Empirical (econometric) searches for possible structural breaks in the data (aggregate and sectional) without postulating one based on prior considerations and testing for it vary in their findings. However, viewing the break in terms of policy changes more or less across the board rather than in the observed growth data, which are influenced by and which in turn influence policy changes, it is natural to identify the breaks with Deng Tsiao Ping's reforms beginning 1980 for the PRC and post-1991 reforms for India.

Leaving aside the structural break issue, the empirical finding that growth seems to have accelerated and poverty reduced significantly in the post-reform era in both economies suggests a strong association between reforms and growth acceleration and poverty reduction. But association is most assuredly not causation. Other than flagging it, I will not discuss this deeper issue in this paper.

III. Financial Sector and the Real Economy: Reform Issues

A. Financial Sector and the Real Economy

Shocks to the financial sector such as booms and busts in nominal credit and liquidity, asset prices, bankruptcies, etc., as well as shocks to the real sector such as to demand and supplies in the aggregate and/or major sectors have impinged on individual economies fairly regularly over time. Not infrequently, shocks to the real and financial sectors have occurred simultaneously across countries. However, the transmission of shocks—both between real and financial sectors within an economy and also across economies in a globalizing set of national economies—and their intensities vary so that not all instances of shocks lead to outcomes that could be characterized as crises. But in some instances in the past, they did indeed lead to crises. Reinhart and Rogoff (2009) in their well-known book look at financial crises and financial follies over nearly eight centuries in 63 countries including the most recent one of 2008–2009.

Their analysis explores the commonalities and differences across crises. Their basic and simple message as stated in the very first paragraph of the preface is “. . . no matter how different the latest financial crisis or crises always appears, there are usually remarkable similarities with past experiences from other countries and from history. Recognizing these analogies and precedents is an essential step both to reduce the risk of future financial crises and to better handle catastrophes when they happen” (p. xxv).

While this is very pertinent, it is most unlikely that any future crisis will be an exact analogue of the most recent one. This being the case, it would be, first of all, a mistake to focus exclusively on trying to avoid the same mistakes of the most recent crisis (as well as replicating successes), like the proverbial generals preparing to fight the most recent war better. Second, not only are the analytical tools for identifying the likelihood of a serious crises like the previous one or pinpointing the features of a different future one in advance inadequate, but also the needed policy reforms for avoiding past mistakes and replicating past successes seemingly quite rare—at best difficult, and at worst not feasible.

Reinhart and Rogoff (2009, xxvi) aimed to be “expansive, systematic, and quantitative” in their empirical analysis. As I am sure they would readily admit, there is no formal analytical and empirical model that integrates the financial and real dimensions of a crisis underpinning their analysis. It is best viewed as analytically driven description that yields valuable insights described in the concluding chapter for further exploration with formal tools.

It happens to be the case that formal macroeconomic models that incorporate a demand function of money (or more generally nominal assets) in an open economy in a general equilibrium framework turn out to be formed on an ad hoc behavioral foundation (Srinivasan 2010b). Be that as it may, the literature on open economy

macroeconomics of the global financial crisis has emphasized that the spread to and impact on any individual country's economy depends significantly on the depth and efficiency of the domestic financial sector and the distributional (across domestic socioeconomic groups) consequences of the crisis depend in particular on how well the groups can access and make efficient use of the financial instruments available in the country's domestic financial sector, i.e., the extent of so-called "financial inclusion." The literature on the global financial crisis has also amply demonstrated the gaps not only in the global financial architecture, particularly its constituents such as the international financial institutions (IFIs), but also in the domestic financial architecture. The literature articulates an agenda of reforms.

B. The G20 on Financial Sector Reforms

The G20 grew out of the earlier G22, which consisted of a group of central bankers and finance ministers of 22 economies (the current G20 minus Turkey and the EU plus Hong Kong, China; Malaysia; Poland; and Thailand) gathered to coordinate a collective response to the Asian financial crisis. This ad hoc group did not disband after the Asian crisis was over but survived because a member, Canada, wanted to create a permanent forum that would meet regularly. Thus, the G22 was reincarnated as the G20.

The original membership of the G20 was drawn by G7 and has not changed since its formation. Practical considerations meant that the group had to be of a manageable size. The G20 is arguably a manageable group of countries that on balance could be reasonably justified as legitimate and relevant for global leadership on economic and financial matters. Arguable or not, the issues of legitimacy and manageability are now moot. The G20 not only exists but has also designated itself to be the premier forum for international economic cooperation in its Pittsburgh, Pennsylvania Summit of 24–25 September 2009 (Paragraph 1a of the Preamble to the Pittsburgh Summit Declaration).³

Thus far, seven summits of the leaders of the G20 have been held, including the most recent one in June 2012 at Los Cabos, Mexico. Future summits in the Russian Federation in 2013, Australia in 2014, and Turkey in 2015 are scheduled. The declaration of the Cannes Summit in France in 2011 states, that "As part of our reforms to the G20, annual presidencies of the G20 will be chosen from rotating regional groups." It is unclear why such a choice is deemed a reform of the G20.

The dominant topic of the very first summit in November 2008 had been financial markets and the global economy, while that of the most recent had been the eurozone crisis and the global economy. Reform of the international financial architecture and in particular of IFIs, specifically the IMF and the World Bank

³The declarations of all the six G20 summits are available at <http://www.g20.org/en/leaders-summit/previous-leaders-summits>

and other multilateral trade and development banks (MDBs), is also a continuing theme. The declaration at the Cannes Summit in 2011 devoted several paragraphs to financial sector reform issues. These include a reiteration of their commitment at the Seoul Summit a year earlier to build a “more stable and resilient international monetary system” (paragraph 9) and affirmation of a commitment to move more rapidly towards a more market-determined exchange rate system and exchange rate flexibility (para. 12 and 13), and to strengthen IMF surveillance (para. 17–20). Other paragraphs relate to actions addressing factors identified as having contributed to the 2008–2009 global financial crisis such as inadequate capacity to cope with crises, the “too-big-to-fail” issue, and gaps in the regulation and supervision of the financial sector. On reform of IFIs, other than a commitment to implement in full the 2010 governance reforms of the IMF (para. 16), there is not much else. I have reviewed the issues of IFI reforms and the actions of the G20 relating to these in Srinivasan (2010b). I concluded that except on financial-crisis-related issues, the declarations are long on action plans and commitments but short on specific national and global actions. The most recent Los Cabos Summit is no exception.

The most conspicuous example of the failure to act on commitments is that of failing to conclude in 2010 the Doha Round of MTNs after having committed to do so in more than one summit. Notwithstanding fervent declarations warning against reverting to protectionism when faced with financial crisis and vowing support for multilateralism in several summits including the summit of Los Cabos 2012, the fact remains that as of 31 July 2012, the Doha Round is neither concluded nor anywhere near conclusion.

In my view, the G20 leaders by and large have identified the problems with the global and national financial architecture and, in a broad sense, their proposals for reforms are appropriate, needed, and well designed. However, some relevant issues have not been recognized or sufficiently explored. To take just one example, in India, nearly 12% of GDP, or roughly about a third of gross domestic savings and capital formation, are direct savings in the form of physical assets by households. In other words, these savings/investment flows apparently do not involve any financial intermediation at all. Taking into account all transactions, not just saving/investment transactions, the share of transactions that are not monetized and do not involve the financial sector is significant. Sources of finance include institutions regulated by India’s central bank (i.e., the Reserve Bank of India) and also a variety of non-formal institutions, most of which are out of the regulatory system. They are by no means the analogues of the weakly regulated shadow banking system in developed countries. Also, a large share of the assets of India’s banking system (nearly 60% or more) and even larger share of employment in the banking sector are in public sector banks, which makes closing failing public banks virtually impossible. Also, the almost inevitable recapitalization of failing public sector banks using public resources not only creates moral hazard by eroding the incentives of banks to avoid the need for recapitalization, but also adds to the fiscal deficit.

My reading of the G20 discussions suggest that the leaders were mostly concerned with the strongly or weakly regulated parts of developed country financial systems that are quite similar across developed countries and not so much with the very heterogeneous developing country systems. Issues of jurisdiction shopping as well as capture of the regulatory system by those it seeks to regulate are well known and widely discussed in the literature in developed countries. These are not only likely to be important in developing countries but also may take different forms given endemic political and administrative corruption. The focus of the G20 on developed country financial systems was probably driven by the perceived origin of the virus of the financial crisis in developed countries and their spreading to infect the rest of the world. While this is understandable in thinking about reforms of the global financial system, a much broader perspective is needed to avoid the all too tempting “one-size-fits-all” approach. Besides, the checkered progress of financial sector reforms (particularly on consumer protection) in the US in the context of sharp domestic political divisions on these reforms suggests that regulations reflecting a political compromise over conflicting approaches there may not be relevant for other political economy contexts.

At the summits, the G20 has delegated many tasks to its creation, the Financial Stability Board, and also to the IMF, the World Bank, and MDBs. Presumably, the leaders have confidence in the capacity of these institutions to deliver on the delegated tasks. Unfortunately, there are serious concerns that such confidence may be unwarranted. Let me raise a few starting with the strengthening of IMF surveillance mentioned in the 2011 Cannes declaration. Just a year ago the Independent Evaluation Office (IEO) delivered a scathing report on the performance of IMF surveillance during the run-up to the financial crisis (IEO 2011a). The high points of IEO (2011a) were: (i) the IMF provided few clear warnings about the risks and vulnerabilities associated with the impending crisis before its outbreak; (ii) in its bilateral surveillance of the US and the UK, the IMF largely endorsed policies and financial practices that were seen as fostering innovation and growth; (iii) surveillance paid insufficient attention to risks of contagion or spillover from a crisis in advanced economies that were not included in the vulnerability exercise launched after the Asian crisis; (iv) although the risks that materialized subsequently were recognized in other IMF reports, they were undermined both by their presentation in general terms and by the accompanying sanguine overall outlook, and above all, they were not reflected in flagship publications such as the World Economic Outlook and public declarations; and finally, (v) although the IMF appropriately stressed the urgency of addressing the large global current account imbalances that in its view risked triggering a rapid and sharp decline in the US dollar, it did not link these imbalances to the systemic risks building up in financial systems. The report claims, using pop-psych jargon, that the IMF’s ability to correctly identify the mounting risks was hindered by a high degree of group-think and intellectual capture, resulting in a general mind-set that a major financial crisis in large advanced economies

was unlikely. The report refers cryptically to political constraints and poor internal governance and incentives to work across units and raise contrarian views, these factors presumably playing an important role.

The report makes five recommendations, outlining what the IMF needs to do in the future: (i) create an environment that encourages candor and considers dissenting views, (ii) modify incentives to “speak truth to power,” (iii) better integrate macroeconomic and financial sector issues, (iv) overcome the silo mentality and insular culture, and (v) deliver a clear, consistent message on the global outlook and risks. These recommendations are unexceptionable but do not identify who in the IMF hierarchy would be responsible for implementing them and whether and how they would be held accountable. IEO (2011a) makes no reference to the needed research at IMF for it to provide relevant advice during surveillance. IEO (2011b), which evaluated IMF research, was appointed almost a decade and half after the Mishkin Committee of 1998 (IMF 2000), where I was a member and which had done an independent evaluation of IMF research. In effect, IEO (2011b) repeats many of the findings of the earlier Mishkin committee and makes recommendations that are strikingly similar. It found that some of the recommendations of the Mishkin Committee have been carried out, but several remain to be implemented even 15 years after.

Surprisingly, IEO (2011b) does not recognize the importance of IMF research, particularly in-house research that the earlier report had emphasized—specifically, the need for the fund to stay relevant and have adequate knowledge of factors that could end up precipitating a serious systemic financial crisis. Saying that the fund did not provide adequate and clear signals of the vulnerabilities accumulating in the system is simply not adequate without examining whether its research and analytical capability could have been the main constraint that precluded it from providing such warnings. Had it recognized the importance of research, it would have gone back to the earlier reports that provide an evaluation of research and asked why the fund had apparently not done enough research on domestic financial sectors, particularly in major financial centers, and the global financial sector.

The Independent Evaluation Group (IEG) of the World Bank Group had a few critical things to say on the contrasting responses of the different agencies of the group to the financial crises (IEG 2010). Like IEO (2011a), IEG (2010) did not apparently recognize the importance of in-house research and did not evaluate it. However, an independent evaluation chaired by Professor Angus Deaton was very critical of World Bank research and its relevance for the bank’s mission. I chaired a committee that evaluated the research at the Asian Development Bank’s (ADB’s) Asian Development Bank Institute in Tokyo. We also found some of the research to be of poor quality, although there were also many instances of good research relevant to ADB’s mission. In sum, the evaluations of the research at the three major IFIs—the IMF, the World Bank, and the ADB—indicate that the institutions may not yet have the analytical capacity or understanding to deliver independent policy

advice to their member governments, particularly, or to fulfill adequately the many tasks that the G20 has been delegating to them.

C. Global Financial Stability

IMF (2012b, p. 1) points out that “in late 2011, the euro area’s banks and government bond markets came under stresses that pushed financial stability risks to a new peak of intensity. Subsequent policy actions eased bank funding strains and helped stabilize sovereign markets, but the risks of global financial stability remain elevated.” I will discuss the eurozone issues in Section IV.

My understanding of IMF (2012b) is that, as far as emerging markets of Asia are concerned, their financial sector could be particularly exposed to a sudden reversal of bank-related and portfolio flows. The report argues that if portfolio flows come to a sudden stop, the fall in asset prices would decrease the net worth of firms and negatively affect bank balance sheets, diminishing an economy’s capacity to generate credit (IMF 2012c, Box 2.5). For example, the report projects the percentage of nonperforming loans (NPL) in total loans in the PRC under various macroeconomic scenarios. A severe negative shock that lowers the growth rate to 4% and property prices by 26% would raise the share of NPL to 8%, roughly four times its level of around 2% if there were no adverse shocks.

However Asian emerging markets, particularly the PRC and to a significant extent India, have sufficient foreign exchange reserves and room to adjust monetary, fiscal, and credit policies to counter a range of financial shocks such as from the eurozone if the current policies in the eurozone and elsewhere continue. But the reserves and policy room are not unlimited. Table 2.4 of IMF (2012b) illustrates these problems. IMF (2012c, p. 22) on Asia reinforces the analysis of IMF (2012b) by saying “looking ahead, Asia’s policy makers still have ample room to respond aggressively to a sharp deleveraging of banks arising from a euro area shock. The space for a macro policy response is smoother than it was before the global financial crisis.”

D. Domestic Financial Sector Reform

Unlike the US and Europe where commercial banks are largely if not wholly privately owned, in Asia, particularly in the PRC and India, the public sector owns and controls a large share of the assets of the banking system. The government decides the extent of private ownership. For a number of reasons, the divestment of public ownership stakes in parts of the economy has been in the agenda of reforms in India. Instances of infusion of public capital to shore up public banks (i.e., bailouts) have not been infrequent. Only the capacity of the treasury to bail out these banks limits such actions. In the PRC, with the fiscal situation being stronger than India’s, the bailout capacity is higher. By creating a public sector reconstitution and

recourse agency some years ago and transferring NPLs away from banks' balance sheets, Chinese banks were made solvent. This is nothing but a bailout. Other than foreign-owned banks, there are no private banks in the PRC. In my view, reform of bank ownership and control is essential in the PRC. In India, as mentioned earlier, the fiscal capacity to recapitalize public sector banks, which dominate the banking system, is lower and the stock of NPLs in bank portfolios alarmingly high as of July 2012.

The depth and efficiency of financial markets affect the capacity to absorb financial shocks but also limit the range and effectiveness of financial policy interventions. For example, domestic bond markets in Asia generally are not very deep and not deemed efficient. In particular, the market for private corporate debt either does not exist or remains very shallow. Public debt held outside the banking system is small in most of Asia. Few countries in Asia can successfully float bonds denominated in their own currency abroad. Reform of debt markets is another major issue.

It is well documented that access to finance from the formal financial sector is limited for large sections of the population in Asia. The currently fashionable cliché, "financial inclusion," is a pompous description of the widening of financial access as a plank of the agenda for financial sector reforms. Those with limited access include some of the more productive segments of the economy such as small and medium enterprises, exporters, and firms. The experience of Bangladesh and India in microfinance and the problems that microfinance institutions have run into suggest not only the need and scope for further expansion but also for intelligent regulation.

In his very thought-provoking and insightful comments on the occasion of the release of the updated *Festschrift* for Manmohan Singh, India's Prime Minister and the chief architect of the country's 1991 reforms, Raghuram Rajan listed the needed and urgent next-generation reforms and what stood in their way. Among the evidently successful financial sector reforms since 1990, he mentioned the spread of ATMs and the ease with which one could withdraw money from US bank accounts from a nearby Indian ATM and how a migrant worker could now send money using a cellular phone to his or her family's bank account in a remote village. Another achievement had been the creation of a national stock exchange with one of the lowest, if not the lowest, transaction costs in the world. That said, he rightly pointed out that despite the tremendous success of the first-generation reforms, some of the next-generation reforms have been stymied. It is too soon to tell if the announced intention to implement some of the next-generation reforms in October 2012 will actually be implemented, but the post-announcement market reaction suggests that the market expects they will be.

Since his talk, the government has announced reforms that have been characterized by the financial press as "big bang reforms." These are meant to induce foreign investors to invest in the real economy and reduce India's dependence on

volatile short-term financial flows. Whether the reforms will increase the less volatile and non-debt creating flows such as FDI remain to be seen.

Rajan also referred to the then depreciating Indian rupee, which has since depreciated more since his talk, as a first warning sign of an unstable economy. He did not however touch what he considered to be the needed reform of the current exchange rate policy of nonintervention in the market (i.e., not targeting a particular *level* of the exchange rate but intervening only to reduce its *volatility*) nor did he mention the related issue of capital control. I would argue that a reconsideration of exchange rate and capital control policies are urgent and needed. Although Rajan referred to reform of public ownership and even monopoly in sectors deemed “commanding heights of the economy,” to use Lenin’s phrase, other than divestment and sale of shares in some public enterprises, serious reconsideration of public ownership has not taken place. As mentioned earlier, the large share of public ownership of banking system assets is a matter of concern that needs to be addressed.

Rajan mentioned many issues requiring reforms that fall under the category of political economy using phrases such as “lack of political will” and “opposition to economic liberalization.” I am afraid that at best these could be characterized as symptoms of deeper causes that originate from the structural features of India’s economy and polity. Nonetheless, he is absolutely right in emphasizing that the “full extent of those (1991) reforms, to liberalize so as to enhance competition and efficiency, to move from a producer to a consumer bias and allocate national resource opportunities fairly” has not been realized in a number of areas of the economy.

In an interview after becoming the chief economic advisor in the Department of Economic Affairs of the Ministry of Finance and with the government’s announcement that it will resume the reform process with a slew of reforms, Rajan reiterated that these reforms had been debated and the only surprise was that government went so far as to put all of them together. He presumed “the reason is (that) the political equation changed somewhat so that the government saw space for it and knew it.” Unfortunately, he did not elaborate on the political equation perhaps for the reason that he was not privy to it. His presumption of a change in the political equation is more of an ex-post rationalization that follows from his emphasis of “lack of political will” as a contributor to the stalling of reforms previously rather than an ex-ante causal story.

In a recent paper, Rangarajan (2012) reviews the reforms of the 1990s, external sector performance (the current account and its components, especially exports and imports of goods and services, and invisibles, particularly private transfers), and capital flows. The review is followed by a discussion of a major policy concern, i.e., how to narrow the current account deficit, to a sustainable level estimated at 2.3% of GDP based on an analogue of the conventional and well-known debt sustainability framework. What seem interesting are the analytics and empirics of recent exchange rate movements and exports. The paper concludes with the way forward in the short and long term.

The paper is very interesting and an important contribution by providing needed injections of analysis to the debate on the external sector. Rangarajan lays out the reasons why “true” aggregate trade elasticities may in fact exist as stable parameters but conventional empirical analysis may not reveal their existence in the context of reforms intended to change policy regimes. As he himself notes, these reasons are not new, and there have been studies, which he cites, that attempt to overcome some of them. While I am in strong support of more micro level studies for India for their own sake, I am not entirely persuaded that they would contribute significantly in “getting a good understanding about true trade elasticities for India” as Rangarajan suggests.

My skepticism arises from the fear that some of the deep conceptual problems associated with the estimation of aggregate trade elasticities are irresolvable. Rangarajan’s policy recommendations include preventing an appreciation of the real exchange rate. It is not clear whether he intends it to be an intrinsic and desirable social objective in and of itself or only an instrumental goal to achieve other objectives (intrinsic and instrumental). Certainly, in the context of a sustained incipient current account deficit, the need for capital inflows to finance them will rise. An appreciation of the rupee through its impact on exports and imports would worsen the current account deficit as well as incentives for foreigners to invest in India and stoke inflationary forces. All these *ceteris paribus* effects do not necessarily suggest that policies be deployed to prevent real appreciation. After all the current level of the exchange rate is not necessarily its long-term equilibrium rate, which can be computed only with an appropriate theoretical framework and its empirical version. Without knowing the equilibrium rate, it would be impossible to tell whether policy intervention to maintain the rate at its current level is appropriate. Rangarajan does not suggest any implicit or explicit macroeconomic model from which to derive policy recommendations, including on the exchange rate, by maximizing the expected present value of social welfare. This is unfortunate.

In the short term, Rangarajan suggests boosting investor confidence to attract capital inflows. In his view, fiscal consolidation, lowering of inflation, and an undefined “careful” liberalization of capital flows could all contribute to creating a conducive investment environment for all investors, domestic and foreign. In this context, he supports recent reforms of raising FDI in retail, aviation, and insurance, and allowing foreign investment in government securities. On capital control, other than approvingly referring to the well-known Tarapore committee reports, Rangarajan does not take a position. On the common presumption that foreign institutional investments (FII) are more volatile than FDI, Rangarajan argues that even in the worst environment following the bankruptcy of Lehman Brothers, FII outflows were modest.

Taken together, the short-term reform proposals are plausible. His conditional conclusion that if India continues to grow at 8% a year (which means a significant rise from the 6.3% a year during the first quarter of 2012) and if the fiscal deficit

remains controlled (there is no evidence of this happening yet), the ability to attract capital flows will remain strong is conceivable hinged on the conditions being met. In my view, however, they are unlikely to be met in the near term.

Rangarajan's long-term reforms consist of nine disparate proposals. Some such as on the need for improving infrastructure covering all forms of transport have been pursued for quite some time with limited success. An evaluation of the reasons behind successes and failures and drawing on them to formulate proposals for improving the chances of reforms already being implemented and suggesting new ones would have been helpful. Such an evaluation necessarily has to be based on available analytical tools, which may be inadequate for the task. Hence, policy recommendations from such an evaluation may be incomplete at best, infeasible at worst. In any case, I have no idea what the marginal social cost/benefit ratios would be of the nine disparate proposals.

On imports, Rangarajan mentions only policies for reducing oil imports through a drive to reduce domestic consumption and raise domestic production. By not discussing the issue of a complete or partial pass-through to domestic prices of trends in international prices independently of subsidies on tariff-inclusive landed prices on the use of petroleum products, Rangarajan missed an opportunity to clarify that the two are in principle separate and serve different objectives. For example, an ad valorem tariff will allow a complete pass-through but with a proportional wedge between the two. It will ensure that domestic producers and consumers would face the true opportunity cost of oil in a small open economy. Whether or not domestic producers and/or consumers should be sheltered from facing international trends in opportunity costs of international prices is a separate issue.

Rangarajan argues that controlling inflation will tend to reduce investment in assets deemed to be hedges against inflation such as gold. However, such assets could have other potential uses besides serving as inflation hedges. He assumes that gold imports have to be reduced, and controlling inflation has the plausible benefit of enhancing intertemporal social welfare. But what if reducing gold imports, considering the effects from all its uses, would reduce social welfare? If I may caricature the tone of the paper, it prefers discretionary rather than rule-based interventions in the economy and implicitly views all exports to be good and all imports to be bad for the economy as a whole and not just for reducing the current account deficit.

IV. Concluding Remarks

The process of real integration of national economies into a global system of multilateral exchange of goods, services, technology, and knowledge and the associated emergence of multinational supply chains and networks have been beneficial to the participants, and both are likely to continue. The pace is unlikely to be

smooth, unidirectional, and devoid of significant reversals followed by recoveries. The current reality is that multilateral negotiations of the Doha Round for reductions in remaining barriers are at a standstill. The G20, after committing to conclude the Doha Round in 2010 with a balanced outcome, conspicuously failed to deliver. In the meantime, virtually every member of the WTO is involved in some preferential trade agreement (PTA) or the other.

It is very unlikely the drive towards concluding PTAs would be blunted by the facts that, first, notwithstanding the operation of many PTAs, nearly 85% of global trade takes place on a nondiscriminatory MFN basis, and second, most empirical evaluation of PTAs do not suggest that they lead to greater expansion of trade than multilateral trade liberalization. This being the case, it is disappointing that the G20 at their Los Cabos meeting in June 2012 did not credibly and strongly commit to reviving and concluding the Doha Round before the next scheduled ministerial meeting of the WTO in 2013 in Indonesia. In the Asian region, there is further room for reduction of trade barriers in South Asia and elsewhere including, in particular, procedural barriers. Infrastructure investment in the region has to be expanded and ways of financing such investments have to be found both for accelerating and sustaining growth but also for expanding trade.

It was noted that the process of financial integration of national economies has been accelerating since the 1980s, particularly with greater private sector participation. Not surprisingly, financial integration opens up a channel for the international transmission of financial shocks. The data clearly show a slowdown in financial integration after the 2008–2009 financial crisis in 2010 and at the end of 2011, as the uncertainties of the euro area had their impact. Economists are divided on the issue of whether financial integration is fundamentally different from and not necessarily as beneficial as real integration. On balance, I would argue that, in principle, both processes would be socially beneficial net of costs given an appropriate domestic policy and institutional environment. However, the domestic environment needed to gain from financial integration is in general more difficult to establish than the one needed to benefit from real integration. Among the policy actions needed is to reform the domestic financial sector.

In the near term, the festering uncertainty emanating from the eurozone is the major risk facing the global economy. Again, economists are divided on whether the fundamental design defect of the euro area, namely the absence of fiscal union, can be resolved by means other than bringing about a formal fiscal union. In my view, proposed arrangements other than a formal fiscal union are not credible and the eurozone **as is** cannot be sustained. This means that the eurozone's collapse is inevitable and certain, but it is uncertain when and how soon this will happen. Policy actions needed in anticipation of the collapse to minimize potential costs when it occurs have to be devised and implemented.

Lastly, Asia by and large has benefited greatly from global integration. It has chosen to build significant financial barriers and undertaken prudential actions.

Economies in the region have the policy space to take further actions as needed. Having said this, I must add that as pointed out almost unanimously by all IFIs, the Asian region with its financial and policy buffers can withstand the uncertainties from the euro area, but there are limits to their capacity to absorb adverse external shocks. Excessive and prolonged risks from the euro area would be beyond the capacity of Asian buffers to withstand. It is essential that the region supplement its buffers and above all urge the euro area to resolve the basic flaw of its design.

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