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Navigating the Changing Geoeconomic Landscape

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Source: View of the Canton Factories, William Daniell, 1805.

ABSTRACT

This Special Report is based on some of the most important ideas shared amongst participants in ORF's roundtable on *Changing Geoeconomic Landscapes*, held on 21 December 2015 in New Delhi. The discussion examined current patterns in world economy, initiatives being taken by the Indian leadership to steer domestic economy, and the need for the country to carefully integrate its domestic economic priorities, including those of reforms, with its foreign policy.

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INTRODUCTION

2015 was, in many ways, a watershed year for the global economy. Between China's growth transition and a consequent slower growth rate there, the latest conflagration on Greece's sovereign debt, an official US recovery from the Global Financial Crisis of 2007-2009 as signalled by an increase in the Federal Reserve policy rate, and the signing of the Trans-Pacific Partnership, the year that went by may rightfully be called the harbinger of the 'new normal'. A constellation of geopolitical risks—from Russia to the Middle East to state- and non-state actors using ICT as weapons of war—adds a grim dimension to the global economic flux.

In terms of the domestic Indian economy, it has been a year and half of the Modi government, elected on an unprecedented mandate to reform and boost the Indian economy which had been losing steam since the last term of the previous government. The Modi government is under serious pressure to deliver on its campaign promises. While the government has indeed taken some bold initiatives – including a revamp of India's manufacturing sector – continuous stalemate in the Rajya Sabha has meant that crucial reform measures, including the much needed GST bill, remain unfulfilled. Weak demand, both domestic and for exports, also continue to affect the Indian economy in a serious way.

As India seeks to navigate the global 'new normal', it will have to carefully integrate its domestic economic priorities, including those of reforms, with its foreign policy. It will also have to factor in the various geopolitical 'known unknowns'. At the same time, India has to keep focusing on domestic economic policy priorities; after all, as the adage goes, the best foreign policy for India is a double-digit growth rate.

GLOBAL RISKS AND OPPORTUNITIES: STATE OF PLAY

As far as the global economy is concerned, it is China's economic future that continues to be the main cause of uncertainty amongst the international community. A slowing China has depressed the global commodities markets, including ones where it is the main supplier, for example, in steel. China's growth transition is inherently contractionary; initiatives like One Belt, One Road (OBOR) may counter some of this contraction. At the same time, China's currency continues to be internationalised; the recent inclusion of the RMB in the International Monetary Fund's Special Drawing Rights is nothing less than a recognition of the country's clout in global trade.

The US, meanwhile, signalled its recovery from the Global Financial Crisis of 2007-2009 by raising its policy rate on 16 December 2015 by 25 bps. While from the point of view of domestic US policy, this rate hike is sensible – with unemployment around the natural rate – such a hike can cause significant capital outflow from emerging markets, as well as cause currency depreciations. However, the hike should be contextualised within an era of greater international transmission of policy signals, and integration of global capital markets. The timing and magnitude of the US rate hike was suspected for some time now, and market participants have had the opportunity to consider the potential consequences of this hike in making their

projections. Having said that, the fortnight since the hike is typically a time of the year when currency markets slow down for the end-of-year season. The full impact of the Fed policy rate hike will become clear only in the beginning of 2016. The increase in the policy rate is most likely going to hurt the Chinese economy further, as a net exporter of commodities. One suspects that China will respond to the increase in the policy rate by further devaluing the RMB which already stands at its lowest since June 2011. This reactive devaluation may add further stress to the global economy.

As one participant noted, there are four principal geopolitical risks in the horizon in the short run: Russia, the Middle East, cyber security, and China. For Russia, the main worry continues to be its projection of force, first seen in Crimea in 2014, and by aggressively entering the Syrian conflict in 2015. Russian economy – with its dependence on income from oil sales – will also continue to be adversely affected; indeed, President Vladimir Putin has warned Russians of impending austerity measures. This may translate to domestic strife and amplify several geopolitical risks. When it comes to the Middle East, the issue is much bigger than the threat posed by the jihadist group, ISIS and lies principally with the millennia-old Shia-Sunni conflict. One tangible way this conflict could have a geoeconomic impact is in terms of a Saudi Arabia-Iran conflagration. Such a conflict will add severe volatility to the international oil market.

Then there is the cyber arena. Cyber risks have increased over the year; previously benign cyber technologies now have the potential to cripple critical infrastructure. Information and Communication Technologies, in various ways, will continue to act as a “threat multiplier.” And finally, while China talks of its peaceful rise, the capabilities of the People's Liberation Army have been steadily increasing. China will most likely continue to hone its A2/AD strategy in the near future.

Climate change presents another class of global risks, though it also serves as a channel of opportunities. From the viewpoint of the financial sector, there is a persistent concern that environmental controls will have a significant impact on that sector. The main opportunity from climate change adaptation is “induced innovation,” a scenario where the threat of climate change spurs a new generation of innovations and innovators. India should look out for such opportunities.

While acknowledging that US monetary policy signals have major international transmission, participants in the roundtable also noted that US domestic mandate will override any international concerns about its impact on foreign economies. The world is also witnessing the retrenchment of big banks, and the rise of non-bank finance. As noted by one participant: “Big international banks are less international after the Crisis of 2007-2009.” When it comes to global financial institutions, it was noted that while advanced economies do not pay sufficient attention to the emerging financial architecture, developing economies pay a little too much attention to them. IMF reforms remain a key to global financial stability. Towards that end, there were two main recommendations for the IMF: (1) making the IMF at the centre of a swap network; and (2) granting more authority to the IMF to borrow in the international markets.

In terms of the multilateral framework of the global architecture, two points were raised to create a better global economic system. First was to make the G20 more effective and second, as part of the needed IMF and World Bank reforms, to diversify and broaden the selection of the Managing Director. While the G20 was effective in combating the effects of the global financial crisis in 2008, following its abatement in 2010, the G20 has lost some of its relevance. It is thus important to revise the ambit of the G20, which can be done in three primary ways. First, expansion of the agenda is needed through active discussion on other global issues including climate change, cyber security, and development, and not be limited by economics. Second, opinions and advice coming from the developing world were key in the G20's role in abating the economic crisis. Thus a greater leadership role and interaction should be accorded to developing and emerging economies. Finally, the G20 should look towards seeking the participation of regional and other multilateral blocs and organisations. The inclusion of multilateral blocs such as BRICS or regional cooperatives like ASEAN or AU, can help make the G20's role far more robust and far-reaching.

Finally, in reforming the Bretton Woods institutions, which have long been in dire need of major structural reforms themselves, a first step would be to broaden and diversify the selection of the Managing Director of the IMF and President of the World Bank. Over time, the relevance of the Bretton Woods institutions has been questioned and perhaps a change in leadership, from a larger country pool, can make these organisations more relevant to the evolving paradigms. While other steps such as increase in authorised capital and voting rights will require ratification by each country, especially the United States (which has been stalling), these smaller structural reforms can serve as initial moves towards revitalising these organisations.

INDIAN ECONOMY: PERSISTENT CHALLENGES

The Indian economy continues to suffer from the legacy of the previous government's sins of commission and omission. Current GDP projections are less than satisfactory, and other parameters are showing a similarly negative outlook, among them the steadily rising number of job seekers and the lack of adequate infrastructure. While certain economic reforms are in place, they are merely incremental in nature and thus not foreseen to create immediate, substantial impact.

The clear evidence to substantiate this view is the weakening domestic demand experienced over the last 12 months. Exports have continued to fall while rural demand, which is often measured by consumption of commodities like two-wheelers, has also been weak. Previously assumed possible gains—such as a rise in private corporate sector investment, a sign of the corporate sector's historical bias towards BJP's economic agenda—has not come true, either. Despite the many attempts by the central government to attract foreign direct investments, the large majority of current flows of a sizable \$40 billion have been in the nature of private equity flows, which bring in FDI but do not create new capacities. Given the extreme weakness in investment demand and continued decline in external demand, despite

India's low share of 1.6 percent in global merchandise trade flows, and the near collapse in rural demand, the Indian economic scenario requires some well-directed policy intervention to bring the economy back on track.

One of the main problems with the Indian economic system still lies in the lack of confidence of investors—both domestic and international—in the stability and transparency of the country's economic policies. The confusion on GDP growth numbers, recently revised through the adoption of a new methodology, has been on the forefront of such wariness. The sudden change from near-4.9 percent growth to 7.5 percent growth has bewildered investors. Moreover, the emergence of a negative GDP deflator and with CPI inflation being well within target, the RBI does have the latitude to further cut the repo rate to shore up investment demand. The government also seems to be lagging behind on its own disinvestment targets, which could give it more fiscal space to raise aggregate demand.

These issues are obstacles to rebuilding investor confidence and regaining economic stability. The other concern amongst economists lies in the Central Government's inability to carry out the reforms that had been promised in its election campaign. Some argue that the so-called 'shock therapy' of supposedly big-bang reforms which were expected of the Modi government is in fact not necessary; while others argue that gradual or incremental reforms cannot address the pressing concerns of the economic system. Balance is needed to achieve immediate imperatives and set sights on what can be done over time. It is also generally agreed that sub-national initiatives such as the compilation of a state-level 'ease of doing business report' should be encouraged. Increasing competition amongst states, meant to improve business conditions, is a good step towards simplifying, streamlining and strengthening the domestic economic climate. Moreover, the onus of state-based issues—such as agriculture performance and labour market flexibility—must be borne principally by state governments with necessary encouragement from the central authorities.

Agriculture reforms are necessary, too. Food markets in the country, especially due to the huge distortions plaguing the system, are neither unified nor standardised. Moreover, price controls imposed by the government on various agricultural sub-sectors create further distortions. These price controls should be minimised. For example, the price control over urea fertiliser can be replaced by directly transferred fertiliser subsidies to the actual beneficiaries using the JanDhan-Aadhar-Mobile (JAM) system that has already been successfully used to transfer natural gas subsidy directly to the beneficiaries. This has generated large fiscal savings and will also help to restructure and rejuvenate the domestic fertiliser industry. There are also concerns with the current commercial bank debt dynamics. Public sector banks face a massive debt overhang from stalled infrastructure projects. Increasing burden of non-performing assets and the lack of a clear regulatory framework to deal with these are generating significant stress in the entire commercial banking sector.

Finally, both international and domestic observers recommend that for India to strengthen its economic footprint, it will have to address two major issues quickly. India currently is one of the largest state-owned enterprise employers in the world,

surpassing even China, where SOEs only employ 20 percent of total workforce. While India must address the critical issue of booming number of job entrants—12 million annually—it must also significantly contract the numbers employed by its SOEs. Moreover, India must now look to becoming a larger part of the global trading system, if it is to meet its own targets. While India's involvement in upcoming trading blocs such as the Regional Comprehensive Economic Partnership (RCEP) may not be optimal, a more concerted effort in joining these multilateral trading arrangements, especially within the immediate South Asian and South East Asian regions, would be highly beneficial for India as a global economic player.

POLICY RECOMMENDATIONS

International Issues

1. The conflict in the Middle East—in terms of being a much deeper struggle between the region's Shias and Sunnis—could lead to a conflict between Saudi Arabia and Iran. This, in turn, could wreak havoc with the international oil markets. In view of this, India should carefully monitor its foreign exchange reserves in order to be able to absorb a dramatic upswing in petroleum prices should such a conflict occur. Any serious conflict between states in the region could push oil prices from the current USD 40 a barrel to USD 150. Fiscal planning should take this contingency into account.
2. New and weaponised ICTs can compromise critical infrastructure. Greater public spending in cyber-proofing critical infrastructure should become a budgetary priority.
3. India should push for much greater monetary policy coordination with leading central banks. At the same time, the MOF should develop greater initiative in proposing swap lines, possibly with the IMF at the centre of a new “swap network.”
4. A Chinese slowdown could potentially impact China's commitments to both the Asian Infrastructure Investment Bank (AIIB) and New Development Bank (NDB). India should carefully watch the path that China will take, especially with the latter, before making any further commitments. At the same time, India should make BRICS lending from the NDB Contingency Reserve Arrangement (CRA) a binding right.
5. Climate change presents an opportunity for induced innovation. India should promote climate adaptation technologies through its “Make in India” initiatives. More opportunities should be facilitated for public-private partnerships (PPP) around climate technology innovation.
6. The internationalisation of the RMB means that RMB/INR exchange rate risks should be carefully monitored, and mitigated.
7. The RBI's recent decision to enter the exchange-traded currency derivatives market—if need be, in event of the USD gaining significantly against the INR—is a proactive fiscal risk management decision. This measure should be kept in play over the next year or so, in the event of further and unanticipated rate hikes in the US.
8. As India-US trade gains momentum, known bottlenecks around IPR issues should be addressed. More aggressive promotion of the open licensing model is a first step.

9. If the Trans-Pacific Partnership (TPP) represents a New Normal for international trade, India should explore ways by which it could rationalise domestic laws to mesh with emerging international standards. A case in point is provided by India's agricultural subsidies regime. Instead of price controls, and minimum support prices that distort the agricultural markets, India should explore alternative ways of agricultural welfare—for example through cash subsidies.
10. With the World Trade Organization's (WTO) Nairobi Ministerial meeting, the Doha Development Agenda (DDA) is all but dead. India should articulate what comes after the DDA, and drive the post-Doha WTO agenda.
11. Diversify and widen the selection of the leadership of the two Bretton Woods institutions, representative of the changed global economic architecture. Widening the net to include viable candidates from other regions, not just limited to the EU and USA.

Domestic Issues

1. Clear the air about the uncertainties with the GDP growth rate. Reconcile output growth statistics with other micro-economic indicators as brought out by the mid-term economic review.
2. Stimulate the rural economy and examine whether current subsidies and support practices are depressing rural demand.
3. Inflation targeting is on track. Therefore, respond to the call of the private industry to cut the policy rate.
4. Rationalise subsidies and eliminate those that are a burden to the economic system. Move towards direct cash transfers rather than retaining market distorting price controls used by the previous government.
5. Non-performing assets continue to pose a serious risk to India's banking system. Create a more streamlined system of dealing with stalled infrastructure projects for minimising risks from rising NPAs.
6. Merge different public sector banks to create globally competitive entities.
7. Move to build domestic investor confidence by engaging industry stakeholders. Exclusively focusing on FDI will not trigger the much needed investment cycle.
8. Adopt the ease-of-doing business as a state-level exercise to promote competition between states on strengthening and streamlining ease of doing business.
9. India's share of global merchandise trade is too small. Push the 'Make in India' initiative more aggressively to correct this trend.
10. Push for higher Indian involvement in Asian cooperation and trading arrangements. India must become an active global economic player.
11. Move away from bank finance when it comes to infrastructure, due to the high risk of such investments. Stimulate the corporate bond market.

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