Subir Gokarn: Focus on risks

Risk mitigation is especially important with rising global integration

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Recent events have highlighted the importance of risk mitigation accompanying greater global integration, says **Subir Gokarn.**

As the global economy plunges deeper into crisis, the debate around its impact on India becomes more and more significant. The resolution of this debate, or at least its orientation, is obviously going to have a huge impact on the policy direction of the new government when it comes into office later this year. In an attempt to draw the "right" lessons from the crisis, it is instructive to look at the two extreme positions of the debate and challenge their basic assumptions.

At one extreme is what I would label the "shutters down" view. The essential argument is that the policy changes made over the past 18 years have systematically enlarged India's exposure to the global financial and trading systems. Shocks emanating from these systems can, therefore, cause massive damage to the domestic economy. While we obviously cannot control what happens outside, we can at least insulate ourselves from its adverse effects. The post-crisis policy direction must be towards reducing global exposures and relying more and more on domestic resources and markets to sustain economic growth.

At the other is what I would call the "business as usual" view. The main premise of this view is that the fundamentals of the India story are still very much alive and kicking. All the factors to which the 2003-2008 boom could be attributed to are going to continue to sustain high growth and it is only a matter of time before things return to normal. In this view, while the global turbulence will certainly have an impact on India's economic performance, this is a price that one has to pay for the larger benefits from increasing integration.

There is a fairly simple and straightforward challenge to the "shutters down" view. One has only to compare the performance of the Indian economy in the wake of the oil shocks of 1973, 1979-80 and 1990-91 to the way it has dealt with the huge increase in oil prices between 2003 and 2007 and the subsequent explosion in the first half of 2008. The common thread running through the first three episodes is the enormous vulnerability that the country's Balance of Payments (BoP) showed to the surges in oil prices. Of course, there were other factors at work in each of the episodes, but the bottom line is that when the economy is dependent on imported oil, not having enough foreign exchange to pay for it can severely destabilize things.

The impact of the 1979-80 shock was so severe that the Government of India had to avail of assistance from the International Monetary Fund to the tune of $5.8 billion, the largest such facility up until that time. Inflation soared and growth plummeted putting an already fragile economy at even greater risk. In 1991, the external pressure exerted by rising oil prices was exacerbated by the steady build-up in foreign debt over the previous few years.

By contrast, the pressure on the BoP was non-existent during the period of rising oil prices during 2003-2007. In fact, even as prices were rising, India was dealing with a problem of plenty as far as foreign exchange was concerned. The policy focus was not on how to find that extra dollar but on how to deal with the surplus, which was creating macroeconomic problems of another kind.

Even though that situation has reversed itself in recent months, the accumulation of foreign exchange reserves has provided the government a great deal of comfort in both sustaining the necessary level of imports and

accommodating the capital outflows. This capacity to absorb and manage such an intense external shock has, in fact, been created by the opening up of the economy over the past two decades. Had there been no capital inflows, there would have been no reserves and, therefore, no ability to continue to import energy and other essential commodities without recourse to assistance of some kind. Openness and integration may have increased our vulnerability to external shocks, but they have also given us the means to deal with them. A case for reversing course is simply not tenable.

On the other hand, “business as usual” is also fraught with danger. The events of the past few months, in particular, have brought into sharp focus the vulnerability of various stakeholders to the shock and the absence of any institutional mechanisms to provide them the kind of protection that we have created at the macroeconomic level. Take the case of workers in major export industries, like garments and footwear. The volume of exports has been declining in absolute terms since October and indications are that this pattern will continue for at least another few months.

The Federation of Indian Export Organizations recently warned that up to 10 million jobs are at threat as a result of the sharp slowdown in exports. Whether that number is a fair estimate is a separate question. The point is that the fragmented and unorganized nature of major export sectors leaves its workers completely unprotected in the event of a shock. Employers cannot afford to keep idle workers on the rolls and there is no safety net in place to provide even subsistence support to unemployed workers.

One could go on with other examples of institutional lacunae, but the point is simple. The opportunities and benefits intrinsic to greater integration with the world economy come with their share of risks. A policy that supports more integration is not complete — in fact, grossly inadequate — if it does not put in place mechanisms that help to mitigate these risks across a wide range of stakeholders. From now on, the ability to build a political consensus in support of continuing down the road of economic liberalization and globalization will depend heavily on credible risk-mitigating and shock-absorbing institutions in place.

To conclude, it is wrong to conclude from the developments of the past few months that globalization is no longer a viable strategy. But, it is also wrong to infer that the Indian economy has created the internal capacity to fully realize the benefits by protecting major stakeholders against risks. The sustainability of India’s current economic policy regime will depend heavily on its ability to quickly put these protective devices in place.

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