



A Seat at the Table for Emerging Markets

Arvind Subramanian sees an increasing role for China, India, Brazil, and other emerging-market countries in shaping the global response to the financial crisis at the meeting of leaders of the G-20 nations November 14–15.

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Steve Weisman: Welcome to Peterson Perspectives. This is Steven Weisman at the Peterson Institute for International Economics. Our guest today is Arvind Subramanian, Senior Fellow at the Peterson Institute and at the Center for Global Development. We'll be talking about the upcoming summit of G-20 countries and especially the role of the emerging-market countries at that summit. Welcome, Arvind.

Arvind Subramanian: Thank you, Steve, for having me.

Steve Weisman: The summit of the G-20 will take place November 14 to 15. The G-20 is a group that was created in 1999 to include countries that were not in the annual economic summit. The invited guests will be not only the central bankers and finance ministers of the major Western powers, but also other countries. What's the significance of having these other countries at the table later this month?

Arvind Subramanian: I think what is happening now is that this crisis reveals that the world is truly interdependent. We saw the epicenter of the financial crisis begin in the United States and then spread out on to Europe and then to emerging-market countries and then the serious risk that that could then rebound back and affect the industrial economies. So, the sense that now we're truly intertwined is what now creates the sense that therefore, anything going forward, anything that we need to do to fix the system in terms of preventing this from recurring, in terms of preparing for crises when they happen in the future, that that decision-making now cannot be restricted to a few industrial countries and has to be extended beyond to include the major emerging-market countries, which are now very important for the global economy.

Steve Weisman: Only a few months ago, there was some hope that the crises that began in the United States and Europe would not spread to the emerging-market countries. Why did it spread there?

Arvind Subramanian: Exactly. I think, the impression early on was that in the aftermath of the

financial crisis in the 1990s, a number of large emerging-market economies such as China, Brazil, Russia, India, and Korea had, in some sense, tried to insulate themselves from future crises by building up their reserves, creating good, sound physical positions, ensuring that their corporates were not overly exposed. So, there was an impression that they were well cushioned, and therefore relatively immune to any financial contagion that could spread from the outside. It turned out, however, that the crisis was more severe than anything that people had expected. More importantly, I think, the world had somehow forgotten that despite all these efforts at self-insulation, these countries are actually much more integrated than before. They are much more integrated in terms of trade and much more integrated in terms of capital flows. Just to give you one example, Steve: India is one of the most notoriously closed countries. But in the last three years, India has seen an explosion in inflows of capital, foreign capital. And India now, I think, gets something like \$100 billion to \$120 billion. But this is not counting the foreign borrowing by many of the Indian companies that went on this overseas shopping spree. So, when the crisis happens, it's really not just what people within India have borrowed or also what Indian corporates have borrowed overseas—that certainly becomes the liability of India Inc. And when all these companies and banks then found funding drying up, they had to turn to their own countries and their own reserve banks of foreign exchange. That puts pressure on the currency, and that's how the crisis spreads. The bottom line, I think, is that it turned out that the world was much more integrated than before—that's one. And of course, for commodity-exporting countries, the collapse in prices was really unforeseen, and that's hit commodity exporters like Russia and Brazil quite significantly.

Steve Weisman: And commodities, in the case of Russia, would be ...

Arvind Subramanian: Oil, yes, and in the case of Brazil, a lot of agricultural commodities.

Steve Weisman: What steps have these countries taken to help control the contagion and get themselves out of this crisis?

Arvind Subramanian: Following the model of the responses by the European Union and the United States, I think a number of countries have taken action to preserve financial-sector confidence, which consists of, for example, guaranteeing foreign-currency debt, guaranteeing interbank liabilities, putting money into financial institutions. All the kinds of things that we saw that the European Union and the United States did, I think, were also emulated by many countries, for example: Korea. So, on the financial-sector front, basically governments backed up the liabilities of the banking sector in the corporate system.

Then on the macroeconomic front, I think a number of countries have tried to pump liquidity into the system, lower interest rates, in response to the fact that their export

markets are shrinking. So they need to counterbalance that with increased domestic demand. And lots of them are taking policies to increase domestic demand. The complication, of course, is that for these countries, unlike the United States and the European Union, whatever they do is happening against the backdrop of declining currencies. So they, in some sense, have to be a little bit more watchful and mindful of what kinds of domestic aggregate demand or policies they follow, because if you cut interest rates too aggressively, that could add to pressures on the currency. So, they have a kind of delicate balancing act, too. But most of them have gone in favor of really trying to boost domestic demand by providing more credit and cheaper credit to the economy.

Steve Weisman: How much are these countries blaming the United States for their problems and how much of that blame is fair or is justified?

Arvind Subramanian: Well, the epicenter of the crisis is the United States. This is where a lot of the financial innovation took place. A lot of the kind of breakdown of regulation and the whole overleveraging, all of that happened in the United States. But, of course, the whole world participated in the borrowing binge. And to that extent, I don't think they can consider themselves completely exempt from having participated in the origins of the crisis. But I think in terms of the perceptions in these countries, clearly, there's always a constituency that likes to say, "Look, this was the fault of the outsiders." I mean, that's a very common tendency. But I think in terms of the way they're reacting to it, they're being much more pragmatic. And a good example of that, I think, is last week, when the Federal Reserve extended swap lines, i.e., provided dollar liquidity, to four major emerging-market countries, these countries very happily accepted that. Think of this, Steve. The atmosphere is so different from ten years ago when, in fact, these countries felt they were humiliated by the IMF when they got too little money and got money with all these conditions attached to it. Compared to that, now they are getting—not just the Fed, now the IMF is following suit—lots of money is being provided quickly, and with relatively little conditionalities. So I think we have learned from the past and there is a pragmatism going beyond the obligatory blame game and finger-wagging that takes place in these situations. I think people are responding very pragmatically and fully. Let's be cautious, but the last few days we've seen some really positive signs in terms of the worst of the contagion being—not behind us, but at least seeing some improvement in that.

Steve Weisman: What will be the agenda of these developing countries when they meet at the G-20? Do they want institutions like the IMF to change to reflect their voting rights, for example?

Arvind Subramanian: Yes. I think developing countries will broadly be looking at three important

agenda items. First, I think in the short term, they will want to participate in any globally coordinated effort to prevent the world economy from going into a tailspin. So I think coordinated calls for macroeconomic stimulus, coordinated calls for making available liquidity to each other, and similar actions like that, maybe even some kind of exchange rate intervention if, say, one currency was to get too much out of line.

On the macroeconomic front, I think the world is going to be united and there's not going to be that much discord. I think developing countries will be particularly keen to send a signal and for everyone to commit to keeping markets open. I think that's a really important commitment that they will be seeking because we know from the 1930s that the Great Depression partly was aggravated by the fact that once the economic macro crises hit countries around the world—beginning with the United States—they started slapping up trade barriers, and that just creates a vicious downturn for everyone. I think that everyone will be keen to ensure that we don't repeat that.

The second item is going to be reforming the architecture. I can't be too confident, but I think there is a growing consensus that the IMF needs to be strengthened in terms of getting more resources to be able to handle such crises in the future. I mean, what this crisis shows is that you need a lot of money and quickly available so that a crisis of confidence can be addressed quickly if that's what it's about, and also crises that affect many, many countries at the same time. So increasing the capacity of the Fund to respond to crises, I think, we'll see some progress on that.

Steve Weisman: That means the money will have to come from places where it hasn't come before, like China and the Gulf States.

Arvind Subramanian: Yes. I think it will probably have to come from a few sources. One, I think countries themselves will all have to increase their own contributions. But second, you're absolutely right, Steve. I think some countries that have huge foreign-exchange reserves like China and the Gulf will have to start supplying new lines of credit, as, in fact, the IMF did in the aftermath of the first oil crisis with Saudi Arabia and so on. So I think that's going to be very important. And the third item, of course, is that I think there's going to be an effort to try and ensure that this whole G-20 process, which is more representative and therefore more legitimate than the G-7, is maintained on an ongoing basis.

Steve Weisman: Finally, Arvind how long do you think this global downturn will last?

Arvind Subramanian: Steve, that's a really tough question. But I think if forecasts about the United States and the European Union are correct, which is that it's going to be a deep and a prolonged slump, I think for that duration, I think the world

economy will be suffering a downturn. I would say it all depends upon how long the United States and the European Union take to get out of this recession, which could be six to twelve months.

Steve Weisman: Thank you, Arvind Subramanian, for joining us today on Peterson Perspectives.

Arvind Subramanian: Thank you, Steve.



