LSE India Summit 2016 Working Paper #1

Sonali Campion, September 2016

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Executive summary

Historically, the global financial system derives from the structures and institutions designed for the post-World War II context, with the United States at the helm. This system has been dominant for over 70 years, but is it fit for purpose today? The Global Finance panel at the LSE India Summit 2016 brought together an expert panel to share their diverse insights on the complex dynamics of global and regional financial systems as well as prospects for reform. The panel concluded with recommendations for restructuring the global financial system and how India might achieve its own economic goals in a constantly evolving context.

Panellists

Erik Berglof, Director of the Institute of Global Affairs, LSE
James Crabtree, Mumbai Bureau Chief, the Financial Times and LSE alumnus
Sam Pitroda, Indian telecoms pioneer and entrepreneur
Nick Stern, IG Patel Chair Professor in Economics and Government at LSE and former Chief Economist of the World Bank

The session was chaired by **Nasser Munjee**, Chairman of DCB Bank and LSE alumnus

Introduction

Historically, the global financial system derives from the structures and institutions that originated at the Bretton Woods Conference, New Hampshire in 1944. They were designed for the post-World War II context and had the US at the helm. The initial presentations by the Global Finance panellists explored the shifts that have occurred since the 1940s and the radical reforms now needed to address the wider problems that the world faces in “the extraordinary times we live in”, as Nasser Munjee said in his opening remarks.

Technology and the changing world order

Sam Pitroda, entrepreneur and Indian telecoms pioneer, called for a new world economic order. He argued that the Bretton Woods design is now obsolete as Western hegemony has been eroded by shifting global power dynamics with decolonisation, the rise of China, the end of the Cold War and 9/11. Furthermore, the digital revolution has transformed the way in which markets operate and interact, to the extent that all the traditional indicators used to measure the economy are now inadequate.

There is no doubt that technology is also reshaping the financial world. Aadhaar (India’s biometric identity scheme) and the expansion of telecoms are facilitating unprecedented access to banking for millions of people in India. ‘Fintech’ is impacting the financial architecture everywhere by reimagining core functions, as can be seen with mobile banking. Crowdfunding, enabled by developments in telephony and the internet over the last twenty years, offers new routes to raising capital. These developments are empowering people who were previously excluded from traditional banking services. This inevitably throws up new governance challenges, but advanced economies in particular should be careful not to over-regulate or focus exclusively on the risk and stability implications of such developments.

The transformation and possibilities brought about by technology became the focus of wider debate during the Q&A. Sam Pitroda outlined a future completely reshaped by innovations that are currently being developed but others urged caution in painting these technological advances as silver bullets. They stressed that development which aspires to societal goals as well as financial ones requires understanding issues of *access* to technology and the *social context* in which it is being used. Technology should not just be seen as transforming financial systems. Harnessing relevant technology for education, health or infrastructure is just as vital to enable the advancement of the poor.

Climate change, infrastructure and investment

Nick Stern, IG Patel Chair Professor in Economics and Government at LSE and former Chief Economist of the World Bank, discussed the need for large-scale investment to deal with the twin challenges of rapid urbanisation and climate change. Economists predict that in 35 years time 70 per cent of the world’s population will live in cities. In order to “create cities where you can move and breathe and be creative”, as well as meeting climate change commitments made at the COP21 conference in December 2015, Professor Lord Stern estimated that $6 trillion USD needs to be invested annually over the next 15-20 years.

Professor Lord Stern argued that the global financial system has not adapted to the needs of the real economy. Plenty of money exists in the system but depression in demand and anxieties about growth have resulted in a widespread shortage of investment. Development banks should lead the change to bring in the big financial institutions and pension funds and make them confident to invest in long term projects.

The other incentive to invest is to achieve growth. One of the basic insights from economic theory is that growth is driven by investment and productivity. The sustained double-digit growth that India aspires to – and that the panel agreed that it has to potential to achieve with the right policies – therefore requires investment at around 30 per cent of GDP. High productivity is also essential, which again requires good infrastructure and an efficient bureaucratic environment.

Multilateral institutions

Erik Berglof, Director of the LSE's Institute of Global Affairs, focussed on the need to recognise interdependence and to create a more level playing field in multilateral development forums. The current global financial architecture is set up in such a way that advanced economies invariably take the lead, and as a result India and others are constantly in a defensive position.

This power imbalance was corroborated by audience member and former Indian Finance Minister Yashwant Sinha. He remarked that when he headed the development committee at the World Bank, an African colleague expressed frustration that whenever World Bank representatives visited his country he would be demoted to a tour guide because officials were more interesting in seeing the sights than discussing development issues. Mr Sinha's example highlighted the gulf between developed and developing nations, which persists in global financial institutions today.

However, changes are taking place in the wake of the 2008 financial crisis, which originated in the advanced economies. China in particular has gained greater status and international influence. However, it is still relatively rare for the emerging economies to set the agenda in multilateral meetings and regulatory responses to the crisis have not addressed key issues which have significant implications for emerging economies. For example, Dr Raghuram Rajan, the outgoing governor of the Reserve Bank of India, has stressed the need for global rules that will incentivise the central banks of individual nations to think beyond their domestic mandates, arguing that unconventional monetary policies often have negative spill-over effects which disproportionately impact the emerging economies.

This point led to a discussion of the new financial institutions that have been established in recent years as a direct result of the lack of influence of emerging economies in the IMF and World Bank. The BRICS New Development Bank was conceived in recognition of where savings and investment are actually located now. China saves more than the US and Europe combined but it also exports a lot of capital, for example to Africa. It is also impossible to ignore the political drivers of both the BRICS Bank and the Asian Infrastructure Investment Bank (AIIB), which were highlighted by the stiff resistance of the US to the AIIB in particular.

Governance has been transformed, and it is hoped the new institutions will raise the standards for international investment across the board. At the same time, this does not negate the need for reform and greater inclusion within the IMF, World Bank and others. The older institutions have valuable experience and knowledge that needs to be harnessed to achieve the leverage that Professor Lord Stern outlined.

The IMF's effectiveness in helping developing countries out of financial straits was also raised in the Q&A, as there is a lot of evidence that suggests those countries that have not gone to the IMF for assistance have fared better than those that did. Nasser Munjee indicated that part of the problem has been that the policy prescriptions the IMF imposed often treated countries as if they were completely at fault, rather than acknowledging that problems endogenous to the global system may have created or exacerbated the causes of a given crisis. The right type of global institution – whether regional or global – should be able to differentiate between problems that derive from national policy mistakes and those which are linked to the knock-on effects of policies introduced by others. A discussion ensued as to who should be responsible for anticipating financial crises and taking preventative action. At the moment, this is one of the roles of the IMF but it is compromised in its ability to analyse risk by the fact it has so much money and other responsibilities tied up in the system.

Liberalisation, jobs and the national picture

James Crabtree, Mumbai Bureau Chief for the Financial Times, pointed out that India is much more globally integrated than is often assumed due to economic liberalisation since 1991, but that there is still a long way to go. He suggested that India's elite is culturally globally-orientated, in terms of language, education, entertainment, and so forth. This gives it an advantage over many of the East Asian economies and the potential to compete at the top level with China and the US. However, success will depend on the decisions that are taken over the next few years. Dr Rajan has pursued a policy of cautious liberalisation which could go much further, for example, by removing restrictions on trade and enabling foreign investment in debt markets.

Further liberalisation will inevitably entail new risks and vulnerabilities. Dani Rodrik, Professor of International Political Economy at Harvard, has discussed the disruption that open capital flows can have on emerging markets, and we saw examples of this in 2013 when India struggled with capital outflows and a falling rupee, and today, with the knock-on effects from the slowdown in China. It is these challenges that India will have to navigate if it is to achieve its development goals and achieve success with campaigns like *Make In India*. Even with the support from development and regional banks it is unlikely that the funds needed for urbanisation can be raised domestically so stable foreign investments need to be nurtured.

The issue of jobs was picked up in the discussion. An audience member identified job creation as the biggest challenge facing India with its huge young population and questioned the extent to which changes in global finance can deliver this. The panel recognised this concern, noting that even when there was 8-9 per cent growth employment did not increase. 35 million people were employed in the formal sector five years ago and that figure remains the same, despite the fact that millions more people are entering the job market every year. However, when it comes to jobs, industrial and labour policies are as – if not more – important than global financial developments. If the current Indian administration wants to deliver on socioeconomic mobility it needs to grow the manufacturing sector, as no emerging economy has shifted its citizens from lower to middle class with such a small manufacturing industry. Economic history shows that the future of employment does not lie in agriculture, the shift has always been towards services and manufacturing. Farm income even in rural villages is dropping rapidly and people are taking on other income-generating activities.

Audience member Dr Manisha Priyam also suggested that variations between states in India may offer as many solutions as efforts to reshape the global financial system. She cited the example of Bihar which has achieved significant advances in recent years – largely with a focus on agriculture and older technology e.g. to provide electricity – and thus challenges some of the narratives emerging from the panel. This prompted the speakers to conclude on a local note, recognising that small interventions can change lives dramatically, for example, solar lighting or the provision of safe drinking water. The state-level successes show what is possible, the challenge is how these may be scaled up, and particularly how the process might be governed and funded.

Recommendations for policy making

- A comprehensive redesign of the global financial system is long overdue. It needs to promote inclusion, environmental sustainability and responds to demographic change and should reflect the globalised nature of markets, as well as the way in which markets are being reconfigured as a result of technological innovations.

- A permanent international secretariat should be established to anticipate and prevent future global financial crises. Those who are tasked with analysing risk should be clearly separated from those who have responsibilities for, and money invested in, the existing financial system.

- The multilateral institutions such as IMF and World Bank established at Bretton Woods need to be reformed in order to achieve a more level playing field for emerging economies such as India.

- Central bankers around the world should be incentivised to think beyond their domestic mandate and consider how unconventional monetary policies might negatively impact other countries.

- There needs to be greater reflection on how the global financial system operates in emerging economies in the wake of the financial crisis. This is an opportunity for India, which can initiate deep research and establish centres of excellence to enable it to be more proactive and influential in global dialogues.

- In order to build its reputation as hub of research, India also needs to attract talent back to India. The diaspora is extensive and in many cases highly educated, but at the moment the academic ecosystem of economics and social science in India remains underdeveloped.

- Substantial investment is needed urgently, particularly in urban infrastructure. This should be led by development banks and supported by regional banks to provide enough capital to enable the private sector to invest with greater confidence. The financial system also needs to be shaped so it takes early risk, thus allowing long-term loans of a suitable scale.

- More partnerships are needed, particularly in India. Private-private partnerships are happening, as can be seen in the Corporate Social Responsibility (CSR) activities which are making money available for development. However, public-public partnerships are still in their infancy and at the moment a lack of trust is hindering public-private partnerships.

- The Indian government needs to grow India's manufacturing industry to create jobs. More open trade policies would facilitate this, as even if the companies that produce goods are Indian, demand will come from all over the world.

- If India wants to achieve double-digit growth, further liberalisation and integration is required. The current government is taking steps in the right direction in terms of trade and foreign investment with its emphasis on ease of doing business and *Make In India* but efforts need to be extended and sustained.

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