

*Managing Risks in the
Emerging Global Economic Environment*

Keynoter Address

By

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Managing Risks in the Emerging Global Economic Environment¹

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I am delighted to deliver the Keynote Address in this ICWAI Regional Cost Conference hosted by Goa Chapter of Cost Accountants. It gives me great pleasure to be here among the elite and distinguished **participants** of this conference. I would be talking on a subject which is close to the heart of all of us, “**Managing Risks in the Emerging Global Economic Environment**”. There is little doubt that we are in a phase characterized by increasing globalisation. Globalisation facilitates the transmission of impulses from the global economy to the domestic economy, which poses challenges to the policy makers all over the world. The issue is becoming more and more relevant to us as India has shed the closed economy model in the early 1990s and the pace of integration of India and the global economy has significantly accelerated in the more recent period. This has increased both opportunities and risks in front of Indian entrepreneurs. On the one hand, Globalization, technology, and communication channels present new opportunities for international commerce to Indian corporations. Over the next two decades, bulk of the global economy’s growth is expected to take place in emerging economies like India. At the same time, the world's largest corporations are now eyeing Indian markets, changing the nature and character of competition. In each business segment, a strong grasp of consumer needs, continuous innovation in building brands, use of appropriate product ,process, design and pricing would ultimately determine whether Indian corporations will emerge triumphant in the rapidly transforming business envornment. Hence, understanding the unique dimensions of emerging economies is critical to the success of Indian business enterprises.

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1. Issues relating to Global Economy

The positive news about the global economies the process of global recovery is gathering momentum. Global growth remained robust at 5.1 per cent during 2004 supported by an impressive 9.9 percent increase in trade volumes. Growth among advanced economies at 3.4 per cent in 2004 was substantially higher than 2.0 per cent in 2003. Growth performance has been stronger than expectations in US, China, India and most of the emerging market economies, but weaker in Japan and Euro area. The performances of China and India were the focal point of the global growth story. The growth performance of both China and India were influenced by strong domestic demand and large increases in both exports and imports. Looking forward, global economic activity is projected (by the IMF) to grow by 4.3 per cent in 2005 buoyed by strong corporate performance, accommodative macro policies and favourable financial market conditions. According to IMF, inflation is projected to remain moderate at around 2.0 per cent in advanced economies and 5.5 per cent in other emerging market and developing countries during 2005, although the movement in oil prices may alter the calculations.

Globally, financial markets have remained exceptionally accommodative with low interest rate and tight spreads. There has been an improvement in the resilience of the global financial system driven by robust global growth, buoyant financial markets and improvements in balance sheets of households/corporates in several countries. The stability of the financial sector has been maintained . Profitability of financial institutions has improved and the capital base of banks have strengthened due to improved risk management practices and lowering of corporate defaults.

Private capital flows to emerging market and developing countries have been strong in 2004 mainly contributed by modest recovery in private direct investment. Asia continued to be a major recipient, driven by flows into China. Latin America also witnessed a significant increase in capital inflows, mainly in Mexico and Brazil. In these countries, FDI flows were boosted by increased cross-border merger and

acquisition activity in the banking and manufacturing sectors. These positive developments are reflected in the improved macroeconomic fundamentals, including well-grounded inflationary expectations, improved corporate balance sheets and reduced external vulnerabilities in emerging market economies.

Major Risks to the Global Economy

Despite continued global expansion, benign inflation conditions, accommodative financial markets and robust financial system, there are several downside risks in the near term. These could take the form of sharp exchange rate volatility, sharp rebound in interest rates, continued weakness in euro area and Japan, and further rise in commodity and oil prices. Moreover, global imbalance, fiscal weakness in a large number of countries and structural weaknesses are longer-term downside risks facing the global economy. These 'soft patches' in the global economy warrants our attention as we are no longer spectators to the shocks emanating from global imbalances. Let me highlight a few of the global developments that pose risks to the Indian economy. Let me add that while the Government of India and the Reserve Bank of India are trying to protect the Indian economy from adverse shocks through a variety of policy initiatives, there is a need for market participants to strengthen their risk management framework in their own interest.

The major short-term risk that we see is rising and volatile oil prices. Robust global growth, persistent high demand for oil and inadequate spare capacity kept the annual real average price of oil at around US \$ 40 a barrel during 2004. According to IMF, the real average oil price rose by 74 per cent during June 2003 and March 2005. Although the current level and recent increase in oil prices are lower than during the earlier oil price shocks, the current expectations are that such prices are likely to remain high and volatile in the medium-term due to high demand, tight supply situations and susceptibility to shocks. The persistence of high oil prices may have a

bearing on the growth performance of oil importing economies such as US , China, and India.

The disparity in growth performance across the major economies is also reflected in further deepening of global imbalances. Over the last few years, there has been a widening of divergence in regional growth patterns. While growth in US has been strong, supported by higher investment and consumer demand, in the euro area, business sentiments remain fragile and consumer demand sluggish mainly on account of faltering exports and weak domestic demand. In Japan, growth prospects have improved with a revival of consumer demand. Growth rates in Asian EMEs are likely to remain strong aided by various factors including strong domestic demand and liberalisation of textile trade.

The issue of global imbalance essentially hinges on an interdependent cycle. The US current account deficit is estimated to be 5.7 per cent of GDP in 2004 matched by current account surpluses in emerging Asia, Japan and the oil producing Middle-East countries. So far, US deficits have been financed by foreign investors with steady demand for debt securities of US. Secondly, fiscal deficit of US continues to remain at historical high levels. Moreover, the net savings of the US economy continue to remain quite low, at around 1.5 percent. With its rising budget deficit and ballooning current imbalance, US is running up a foreign debt of such high proportions that could threaten the financial stability of the global economy. Given the central role of US in world output growth, even an orderly adjustment in US current account deficit may suppress the global output growth. The twin deficits in the US economy thus present a challenge not only for the US economy, but also to the rest of the world.

The issue of global imbalance is gaining in importance as the cost of the adjustments required by global players may become higher when the adjustment is postponed for the future. An orderly adjustment of global imbalances calls for a coordinated and cooperative approach among the major economies of the world. The US, the euro area and the Asian economies like China and India have major role to

play in correcting these imbalances. Key elements of this coordinated approach should include different policy responses in different countries/regions. In the US, there could be a need to curb household and government borrowings and strengthen national savings. However, US policies would need to delicately balance a gradual withdrawal of fiscal stimulus without hurting the recovery and, at the same time, without disruptive adjustment of the US dollar. The Euro area, which continues to depend largely on external demand, needs to pursue some structural reforms, especially labour policies, to boost domestic demand and broad-base the recovery. Japan needs to continue to take some concrete measures to strengthen its financial system, restructure the corporate sector, and reduce large fiscal imbalances. There is a growing perception that flexibility in exchange rate policies in emerging market economies (EMEs) in Asia is worth considering on pragmatic grounds but as appropriate to each country's circumstances.

At the same time, it may also be noted that Budget deficits and public debt in many industrialised countries have reached high levels. These countries have made very little, if any, progress in fiscal reforms during 2004 and the prospects during 2005 in some countries are also not encouraging. Despite well-laid out plans for medium-term fiscal reforms in US, Euro area and Japan, there are concerns about whether the same could be implemented given the socio-political and economic constraints.

On the monetary policy front, the global policy cycle is surely bound northward as both the industrialised as well as EMEs transit from the present soft policy stance to a relatively higher interest rate regime, *albeit* in a cautious and calibrated manner. In many emerging market economies, especially in Central Europe and Latin America, policy rates have been raised substantially. environment. Expectations regarding the gradual monetary policy tightening in US have provided a firm anchor to financial markets. Monetary authorities in US, UK, Canada and New Zealand have been gradually tightening the key policy rates, but these are still below

the rate of inflation and thus kept yield on long term bonds low. The timing and pace of adjustment of interest rates holds the key to global growth process in the long run.

II. India: Coping with Increased Global Linkages

Over the years, India's commercial and financial linkages with the rest of the world have been increasing with trade liberalisation and openness on the capital account. This is reflected in the transmission of international impulses to the real sector and domestic financial markets. Trends in international prices have now significant influence on domestic prices. Indian corporates and institutions are increasingly accessing international markets with consequent asset diversification. While this process has provided important opportunities, it has also brought in new challenges and risks, necessitating fine-tuning of macro policies in a much broader context.

India and Global Growth

On the growth front, India's performance in recent years has been very strong. It is very satisfying to note that, combined with China, India is contributing significantly towards sustaining the global growth process in the recent period. India grew at the rate of 6.9 per cent during 2004-05 backed by strong performance of industry and services sector on top of a growth rate of 8.5 per cent during 2003-04. The real GDP growth for 2005-06 is placed around 7.0 per cent. Encouragingly, the growth performance has been coupled with productivity enhancements in several sectors in the economy, availability of high level of food stocks, and accumulation of large foreign exchange reserves thereby imparting stability to the economy.

International Oil Prices and Domestic Inflation

With increasing globalisation, the risk of increased pass-through of global prices to domestic prices is higher. After reaching a peak of 8.7 per cent during end-August 2004 on account of hardening of oil and commodity prices worldwide, the WPI inflation receded subsequently and stood at 5.0 per cent at end March 2005. At

present, the inflation rate is around 5.7 per cent. The inflation rate would have been still higher but for successful policy interventions which included fiscal as well as monetary measures, and, more importantly, the full pass-through of higher oil prices has not taken place. It is important to note that in contrast to rise in oil prices by 42.3 per cent during 2004-05, the average domestic price of petrol and diesel increased by only 17.5 per cent over the previous year. A part of the impact of increase in global oil prices on domestic oil prices was cushioned by other two stakeholders - Government of India (by reduction in excise and customs duties) and domestic oil companies. In the Indian context, the rise in international oil prices has, thus been shared among all the three major stakeholders. While it is well understood that domestic prices cannot deviate from international trends for long, the policy authorities will ensure that the pass-through of international to domestic oil prices is smooth and non-disruptive.

Managing Capital Flows

A number of studies have confirmed that financial globalisation can contribute significantly to promoting growth in developing countries by augmenting domestic savings, reducing cost of capital, transferring technology, developing domestic financial sector and fostering human capital formation. At the same time, however, it has been recognised that sudden and large surges in capital flows cause several concerns. Large capital flows could push up monetary aggregates, engender inflationary pressures, destabilise exchange rates, exacerbate the current account position, adversely affecting the domestic financial sector. Such capital flows can cause disruptions in domestic growth trajectories if and when such flows get reversed or drastically reduced. Volatility of capital flows, particularly portfolio flows and their consequent impact on the emerging market economies is an area of concern in the current milieu.

In India, the monetary conditions in the economy is driven by large capital flows. The absorption of these flows has expansionary impact on money supply with implications for price as well as financial stability. This necessitates the neutralisation of the expansionary impact of external flows. In general, apart from exchange rate flexibility and foreign exchange market intervention there are several other policy responses that can be used to manage large capital inflows. The Working Group on Instruments of Sterilisation constituted by the Reserve Bank reviewed the various instruments used in India and in other countries and deliberated on the suitability of various instruments to the current conditions in India and possibility for deployment in the future. In the face of strong capital flows especially in the early part of fiscal 2004-05, a Market Stabilisation Scheme (MSS) was introduced in April 2004 to absorb liquidity of more enduring nature by way of sterilisation through issuances of Treasury Bills/government dated securities.

Financial Markets and Financial Stability

With the ongoing financial liberalisation, a number of measures have been taken to widen, deepen and integrate various segments of the financial markets. In India, development of financial markets has been pursued essentially for bringing about transformations in the structure, efficiency, and stability of markets as also integration of markets, both domestically and with global markets. With increasing linkages with international markets, financial markets tend to be driven by the developments in the global economy. In the recent period, the financial markets in India have been generally stable, although interest rates have displayed some upward trend reflecting uncertainties in oil prices, upward trend in global interest rates and increasing domestic demand for credit. The money market and forex market continue to remain stable. There was evidence of increasing collateralisation of transactions and better alignment of interest rates in the money market. The equity market recorded its all-time high in March 2005. A strong macroeconomic outlook, positive

investment climate, continued investment support by foreign institutional investors (FIIs), and encouraging corporate financial results are the main factors driving the market sentiment in the recent period.

The financial sector has acquired greater strength, efficiency and stability by the combined effect of competition, regulatory measures, policy environment and motivation among the banks. The way the Indian financial sector withstood the contagion effect of the Asian crisis in the late 1990s is the reflection of the depth and resilience of the financial sector. Despite introduction of stringent accounting norms, there has been strengthening of banking sector during 2003-04 in terms decline in non-performing loans as well as improvements in capital adequacy position.

Robust External Sector Performance

The external sector of the Indian economy has emerged as the most robust of all sectors. The openness of the Indian economy has increased. India's exports and imports have been increasing rapidly. The Indian exporters are no longer shy of competing with their rivals in any market. In fact, our exporters are going big way to export traditional as well as non traditional goods like cars to several markets. The current account of the balance of payments (BoP) had remained in surplus consecutively over the past three years (2001-04). In the face of large capital flows, India's foreign exchange reserves have reached US \$ 141.5 billion as on May 5, 2005.

So, India has exploited well the challenges emerging from globalisation and increasing linkages with the global economy. Our policies have been in line with these emerging challenges. I would illustrate how we have managed the economy during the last one year in the wake of these challenges.

Challenges to Policy Making

In the face of increasing globalization and transmission of impulses from global economy to the domestic economy, I would dwell at some length on the

challenges faced by us. I must admit that there were some difficult challenges faced by us during 2004-05:

- (i) There was carry forward of excess liquidity in the system, that had to be mopped up to contain inflationary pressures;
- (ii) The WPI inflation had accelerated beyond the anticipated level during the first half of the year coupled with high and volatile international commodity prices,
- (iii) The South-West as well as North-East monsoons were deficient, and
- (iv) The Government Securities market faced adverse reaction and selling pressures in the on account of sharp upward movement in interest rates towards the middle of the year;

In order to successfully manage these challenges, the Reserve Bank had to balance the considerations of growth, while containing inflationary expectations. Towards this direction, several steps were taken by the Reserve Bank and the Government of India during 2004-05 in a measured and calibrated manner. Some of the major ones were::

- (i) The market was sensitized about the supply-induced nature of inflation and the differential behaviour of inflation at the producers' and the consumers' level;
- (ii) In order to arrest the acceleration in inflation in the wake of rising oil and commodity prices, the Government responded with several fiscal measures including reduction in duties on petroleum products and steel;
- (iii) With a view to sterilize capital flows, the Government also raised the ceiling of MSS from Rs.60,000 crore to Rs.80,000 crore;
- (iv) The fixed reverse repo rate under LAF was raised by 25 basis points to 4.75 per cent (raised further to 5.00 per cent on April 28, 2005). However, the repo rate and the Bank Rate were left unchanged at 6.0 per cent .
- (v) The CRR was raised by one-half of one percentage point to 5.0 per cent.

The financial markets responded positively to the package of measures and, consequently, interest rates stabilized, credit flow to the commercial sector remained uninterrupted and the government borrowing programme could be completed smoothly.

Thus, while the economy has the resilience to withstand supply shocks, the upside risks do exist. As such, the inflationary situation needs to be watched closely and there could be no room for complacency on this count. The Reserve Bank will

continue to ensure that appropriate liquidity is maintained in the system so that all legitimate requirements of credit are met, consistent with the objective of price stability. Towards this end, RBI will continue with its policy of active demand management of liquidity using the policy instruments at its disposal flexibly.

IV. Emerging Challenges to Indian Business in the Changed Economic Environment

Successful conduct of business in the changed economic setting is fraught with a variety of challenges that are needed to be addressed expeditiously. These challenges need to be clearly understood and appropriate defenses, be developed.

Improving competitiveness

India's simultaneous movement towards a market economy and liberalization on the external front has multiplied manifold the challenges to the competitiveness of Indian enterprises. The task of transitioning businesses from a relatively protected environment to the rigours of a globalised market requires upgradation of capabilities to international standards. This implies a major change in mindset, backed by substantial investments in modernization, scaling up and skills upgradation. Business portfolios will, therefore, need to be rationalized and restructured for focused attention so that the deployment of scarce resources is confined to those areas that best match organizational capability with market opportunity.

Challenges posed by information technology

The explosion in the use of information technology is further facilitating the process of globalization by erasing geographical and political boundaries. Even as Internet based electronic commerce has opened up enormous opportunities for the relatively smaller Indian enterprises by facilitating instant access to the developed

markets of the world, simultaneously, it is creating opportunities for global players to access the Indian market, therefore, exposing us to global competition.

Emphasis on Quality and Efficiency

A key challenge for business enterprises today is the availability of multiple brands to choose from. Both in rural and in urban India, consumers are now being exposed to and are trying a wide variety of consumer durables and non-durables, which were once considered as luxury items. Business enterprises are expected to meet the ever changing and ever increasing consumer preferences to stay in the business. With increased competition for a share in the consumer's purchasing power in today's market environment, driving business growth much more than provision of just a product or service; but rather better quality product and most efficient service.

Implications of new Global Trade Agreements

The WTO schedule for trade reforms is a challenging and compelling agenda for Indian industry. It is in this context there is an imperative need for the Indian business houses to rapidly restructure and relocate their operations in their preparedness to face competition and phase their transition from an era of regulation and protection to the fully globalised market successfully. Maintaining superior competitive capability can alone guarantee sustainable growth and profitability of business houses. Each business house needs to make a Strength-Weaknesses-Opportunities-Threats (SWOT) analysis to evaluate their existing capabilities and make a realistic assessment of required capabilities to face the onslaught of the competition.

Smooth transition to a globalised business environment

In the globalized setting, the need to strengthening and upgrading the structure of the business enterprise through appropriate restructuring is critical. There is a compelling need to rapidly reposition Indian companies through mergers and

acquisitions to reap the benefits of synergy and support their successful transition from an era of domestic existence and protection to the fully integrated world market market. To address the multifarious challenges in the new economic order, the business enterprises need to evolve new strategies and drastically improve their 'business competencies'. Managing and adjusting the company to the multitude of risks and benefiting from the opportunities brought forth by globalisation is the need of the hour. Strategic planning alongwith sound risk management policies will be key to success of an organisation.

Finally, let me stress that the Cost and Management Accountancy function as a powerful tool in the hands of the management in any organisation. There are several challenges to your profession, which have emerged in the context of globalisation of the Indian economy. There is an urgent need to scientifically explore the opportunities, challenges and threats emanating from the world economy as India as an integral part of the global economic set-up. Keeping abreast of economic developments and developnig appropriate methods to assess the impact of economic forces on the pricing and costing of products within organizations will be a key challenge.