Monetary and Financial Policy Responses to Global Imbalances*

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I would like to compliment Bank Indonesia for arranging this conference on the theme "Monetary and Financial Policy Responses to Global Imbalances" at the Annual International Seminar 2006. This is an issue that has been among the top concerns of central bankers in the last few years: so the opportunity to have this discussion at this opportune time is very welcome for all of us.

The issue of large global imbalances has been debated at length since the beginning of this decade, both at international fora and also in regional conferences and seminars. In India, we have regularly highlighted this issue in our Annual Reports and Annual Policy Statements. Dr. Y.V. Reddy, the Governor of the Reserve Bank of India has also addressed these issues in two of his recent speeches.

It is pertinent to note that whereas the existence of global imbalances is well recognised, there are still no definite answers on its possible impact and what policy responses need to be considered. Therefore, seminars of this kind assume importance in exploring the implications of global imbalances for Emerging Market Economies (EMEs) and developed countries alike.

In my talk today, I will first give a brief introduction to the concept of global imbalances, while highlighting some of the recent global initiatives that have been undertaken to correct these imbalances. This will be followed by discussion of the efforts that are further required in this direction. Thereafter, I would present the Indian perspective on global imbalances against the backdrop of the strength and resilience of the Indian economy exhibited in the recent years.

I. Global Imbalances: Concept and Contributing Factors

Concept

Conceptually, from a single country perspective, imbalances arise when the economy exhibits, on a sustained basis, large current account deficits or surpluses that are essentially external manifestations of large domestic saving-investment gaps in a macro economic framework. From a global perspective, however, the balance of payments identity, in principle, should ensure that high surpluses in some countries are matched by deficits in other countries. Thus, the emergence of a large surplus or deficit in one country's external account implies the mirror image elsewhere. Hence, the global concerns are not about the existence of current account deficits or surpluses *per se*, but the *persistence* of large deficits and surpluses, particularly in large and systemically important economies.

In reality, global imbalances in the international economic system today refers to the large and increasing current account deficits (CAD) of the US and correspondingly large surpluses in other regions, particularly in Asia. The extent of these imbalances has become large, particularly in the aftermath of the Asian crisis and has generated issues of unsustainability of such global imbalances and chances of disorderly adjustment hampering the global economy, in general.

The Contributing Factors

(i) Twin Deficits in the United States

The current global imbalance is largely attributed to the large and increasing CAD of the US that has been financed by surpluses elsewhere, especially in emerging Asia, oil exporters and Japan. The US has been experiencing a current account deficit in each year since 1982. The US deficit remained below 3 per cent of GDP till the mid-1990s. Since then, however, it has risen substantially. The period following the bursting of the information technology bubble in the US was marked by highly accommodative monetary policy along with expansionary fiscal policies. On the one hand, the decline in the rate of interest led to the housing boom and increase in housing and other asset

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prices while, on the other hand, fiscal stimulation led to increase in consumption. While real activity in the US did provide a stimulus to activity in the rest of the world, it has been accompanied by large and growing twin deficits - fiscal as well as current account deficits. In absolute terms, the CAD of the US has seen a seven fold increase from US $ 114 billion in 1995 to US $ 791 billion in 2005. As a percentage of GDP, the CAD of the US almost doubled itself every 5 years since the early 1990s. During 2005, the CAD to GDP ratio was close to 6.4 per cent of GDP, the highest ever CAD for the US (Table 1).

It is widely agreed that wealth effects arising from increasing asset prices, particularly of housing, have also contributed significantly to lower savings rates and higher consumption rates in the U.S. The large current account and fiscal imbalances in the US also find its reflection in the savings-investment mismatches that have risen substantially in the present decade. The private net savings in the US has declined from 8 per cent of GDP in the 1980s to less than 2 per cent in 2005.

(ii) Surpluses in the emerging economies

Contrary to the US that has fed the domestic demand, in Asia and other emerging economies, growth since the late 1990s has been led by external demand. The current account has recorded large surpluses since 1999, particularly for China and other East Asian emerging market economies (EMEs) (Indonesia, Malaysia, Taiwan, Thailand). Surpluses of two island economies, *viz.*, Hong Kong and Singapore have also increased significantly. India too registered current account surpluses between 2001 and 2004, *albeit* small.

In the post Asian crisis period the savings rate in most East Asian EMEs, which has generally remained higher than the industrialised countries exhibited a modest decline. Investment rates, however, showed sharp declines resulting in the widening of the savings investment gap in the EMEs (Table 2). India, however, remains an exception to this trend, and still continues to have a negative savings investment gap.

Table 1: Macro Parameters of the United States

(in per cent, annual average)

Period	GDP Growth	CAD/ GDP	General Government Fiscal Balance/ GDP	Savings –Investment Gap/GDP
1	2	3	4	5
1981-85	3.3	-1.3	-2.9	-1.6
1986-90	3.3	-2.4	-2.4	-2.2
1991-95	2.5	-1.1	-3.1	-0.9
1996-2000	4.1	-2.6	-0.2	-2.2
2001-2005	2.4	-5	-3.5	-3.9

Table 2: Savings-Investment Gap in Emerging Economies

(as % to GDP, annual average)

Country	1981-85	1986-90	1991-95	1996-2000	2001-05
1	2	3	4	5	6
China	-0.1	-0.4	1.5	3.2	2.4 *
Hong Kong	3.9	9.8	3.2	1.1	8.6
India	-2.2	-1.5	-0.4	-1.4	-1.3 *
Indonesia	2.0	1.5	1.5	5.5	6.7
Korea	-1.7	4.1	-1.1	3.7	2.6 *
Malaysia	-2.7	7.6	-1.6	13.9	19.7 *
Singapore	-2.9	4.6	11.8	16.4	23.6
Thailand	-4.4	-1.8	-5.3	6.4	4.5

Note : * Average for four years 2001-04.
Source : World Bank online database.

(iii) Surpluses in oil exporting countries

The large current account surplus of the oil exporting countries has also emerged as a new source contributing to the global imbalances. The Middle East region recorded current account surpluses of 18.5 per cent of GDP in 2005. Oil revenues in the Middle East region have risen further in the first half of 2006 because of both higher prices and some expansion in production. The surplus for 2006 is projected by the International Monetary Fund's *World Economic Outlook (WEO*, September 2006) to rise further to 23 per cent of GDP (almost US $ 280 billion). Higher net savings by oil exporters are also believed to have contributed towards the softening of global interest rates and consequent boost to demand in economies with market based financial systems such as the US. The depth of US financial markets together with rapid innovation of new products for effective risk management have made US an attractive destination for global investors' funds. Any correction of global imbalances on this account depends on what oil producers do with their surging oil revenues in terms of their domestic absorption.

II. Move towards Correction

Currently, there is an emerging consensus that US consumers cannot continue to support worldwide demand indefinitely and Asian EMEs and oil exporting countries cannot continue financing these perpetually. Yet there are differing views on the process of correction, its nature, pace and consequences. In this context, the International Monetary and Financial Committee (IMFC) Communique, April 22, 2006 reiterates 'Any action for orderly medium-term resolution of global imbalances is a shared responsibility, and will bring greater benefit to members and the international community than actions taken individually'. Key elements of an orderly global rebalancing which are generally advocated include increase in US savings, structural reforms in the Euro area and Japan and exchange rate flexibility in EMEs.

Some developments observed in the recent months may contribute towards correcting global imbalances in future. These are set out below.

First, in the US, the fiscal deficit has come down to 2.0 per cent of GDP in the second quarter of 2006 mainly because of revenue buoyancy. Federal tax revenues have remained buoyant in 2005 and 2006 so far and expenditure discipline has been maintained, suggesting that the federal budget deficit in fiscal 2006 is likely to outperform initial budget estimates and fall modestly to 2.25 per cent of GDP (IMF, 2006c). The US fed funds rate has risen to reach 5.25 per cent. The U.S dollar in the recent period has depreciated marginally against some other major currencies.

Second, higher investment witnessed in some Asian emerging economies may contribute towards correcting imbalances. China has recently exhibited a very rapid investment growth, though concerns have been raised about the possibility of an investment boom-burst cycle (WEO, September 2006). In the first three quarters of 2006, the total investment in fixed assets in China has been 27.3 per cent higher than that in the same period last year. As has been advocated repeatedly by the Chinese policy makers, the need now is for Chinese consumption to increase faster than their investment growth.

Third, increased exchange rate flexibility has been observed in some of the Asian countries. The US dollar has seen some depreciation while the non-US currencies have appreciated. During 2005 currencies in many developing countries have also appreciated steadily against the US dollar accompanied by some movement towards more flexible exchange rate policies. This is noticed most notably in China, which has revalued its currency against the dollar by around 2.1 per cent. Malaysia has also taken similar steps. During 2006, there were significant changes in the exchange rate of Euro/US dollar (from US $ 0.84 per Euro in early 2006 to US $ 0.78 per Euro by September 2006), yet there has been little significant impact in US Euro trade patterns. In view of this, the efficacy of the exchange rate as an equilibrating mechanism needs to be investigated. For industrial countries, the exchange rate pass-through to consumer price inflation has been found to have almost halved in the 1990s compared to the pre-1990s period (Gagnon and Ihrig, 2001). Furthermore, the pass-through has reportedly declined more in developing countries in the 1990s than in the advanced economies (Frankel, Parsley and Wei, 2004). Financial innovations such as the availability of hedging products have also lowered the degree of pass-through by enabling exporters and importers to ignore temporary shocks and set stable product prices despite large currency fluctuations. Besides, studies have also shown that within EMEs, the impact of exchange rate movements on trade balances varies significantly depending upon whether they are predominant exporters of manufactures, non-oil commodities or oil (Allen, 2006).

The increasing share of non-tradables in GDP has also worked towards containing the exchange rate pass through. Non-tradables generally approximated by services have increased their share in all major industrial countries as also in China and India. As populations age, demand moves more in favour of services than for goods. Thus, the aging population in industrial countries has provided much of the growth impetus for services. With the shift in demand composition in favour of services, the extent of exchange rate pass-through, which works primarily through tradables has been limited. The role of exchange rate movements or policy induced adjustments in influencing behaviour of economic agents through the domestic price mechanism appears to have been significantly truncated. If exchange rate depreciation (appreciation) does not appreciably increase (decrease) domestic prices of imported goods, there would be little reason to expect a reduction (increase) in demand for imported products. Hence small exchange rate changes can scarcely be expected to help significantly in effecting changes in the current account (Mohan, 2005).

Thus, the following issues assume importance

- Will the recent developments see some domestic correction in the US, leading to a decline in its CAD?
- Are there chances of investment increasing in the Asian countries and whether this would reduce their surplus?
- Can exchange rate adjustments contribute significantly towards correcting current account imbalances?

Further Efforts

Notwithstanding the progress that has been made towards correcting imbalances, further efforts are desirable–with every country doing its part–to help reduce medium-term risks associated with the imbalances.

The US will have to try to curb household and government borrowings and strengthen national savings, without hurting recovery and excessive dollar depreciation. The focus of fiscal consolidation in the US has to remain on the expenditure side, though revenue measures aimed at broadening the revenue base and tax system with greater emphasis on consumption tax rather than income tax cannot be ruled out (WEO, September 2006). With the housing market slowing down in the US, some increase in private savings is expected. This will be further helped by policy initiatives such as introduction of health savings accounts that would raise incentives for household savings and passing of pension legislation.

The Euro area needs to pursue structural reforms, especially product and labour market policies, to boost domestic demand and broad base the recovery. Japan has started recovering finally. Its current account surplus has begun to narrow down from 3.8 per cent of GDP in 2004 to 3.6 per cent of GDP in 2005 and the trend is continuing in 2006 with domestic demand strengthening. It is widely agreed that Japan should further strengthen its financial system and carry out other structured reforms to provide further flexibility in the economy.

Further flexibility in exchange rate policies is desirable for the emerging market economies. Any attempt by EMEs to intervene excessively and sterilise their forex reserves to maintain their competitiveness will further delay the adjustment process. However, as indicated earlier that unless there are substantial changes in exchange rates, it seems that one cannot expect corrections to global imbalances. Studies have shown that with unchanged growth rates in the US and the rest of the world, the US dollar would need to depreciate by nearly 33 per cent - equivalently, the non-US currencies would have to appreciate, on average, by 50 per cent - to balance the US trade account (Obstfeld and Rogoff, 2004, 2005). Another study has pointed out that dollar should depreciate by 30 per cent in real terms to bring US CAD within 2 per cent (Mussa, 2004).

Promoting efficient absorption of higher oil revenues in oil-exporting countries with strong macroeconomic policies should also be a key element of this correction mechanism. It is suggested that these countries could boost expenditures to some extent in areas where social returns are high like education, health, infrastructure and social security. Given economic interlinkages, all countries and regions will have a role to play by increasing the flexibility of their economies and adapting to changing global demand patterns.

Let me quote our own *Mid-term Review of the Annual Policy Statement* announced on October 31, 2006,

'Global imbalances have continued to widen during 2006. With some central banks actively reassessing their stance now, the potential drainage of global liquidity would test the resilience of world financial markets and weigh upon the outlook on the global economy. It is in this context that the IMF's projection of the U.S. current account deficit at about 7 per cent of GDP in 2007 with large surpluses continuing in Japan, emerging Asia and oil-exporting countries is disturbing. The sharp rise in the net foreign liability position of the US raises the risks of abrupt and disorderly adjustment of major currencies as the global imbalances unwind. However, there is an interesting lull in the serious concerns expressed both by policy makers and financial markets in regard to the global imbalances, possibly on the assumption that universal recognition of the problem would per se lead to harmonised actions that would avoid hard landing.'

III. The Indian Setting

In recent years, the Indian economy has seen a massive transformation from a closed, controlled, slow growing economy to a more open, liberalised and one of the fastest growing economies of the world. Economic reforms in India since July 1991 have accelerated growth, enhanced stability and strengthened both external and financial sectors. India has remained an attractive destination for foreign investors. Despite high capital flows, India has been successful in managing liquidity. India's foreign exchange reserves are in excess of the total outstanding external debt of the country. The trade as well as financial sector is considerably integrated with the global economy. Even during difficult times, *i.e.*, the East Asian crisis, the Russian crisis during 1997-98 and post-Pokhran sanctions, Indian economy has shown substantial resilience in withstanding the contagion.

Since the 1970s, India's current account has exhibited surplus only on six occasions (Table 3). The deficit has

Table 3: Range of India's Current Account Balance Since 1970-71

(as % to GDP, annual average)

Range of Current account balance/GDP	Frequency
1	2
Current account surplus	**6**
equal to 1 per cent	2
between 1 to 2 per cent	4
Current account deficit	**30**
between (-)1 to 0 per cent	15
between (-)2 to (-)1 per cent	11
between (-)3 to (-)2 per cent	3
between (-)3 to (-)4 per cent	1 (in 1990-91 when CAD was 3.1 per cent)

Source : Handbook of Statistics on Indian Economy, RBI.

been modest and has remained below 2 per cent of GDP in most years. Only in 1990-91 on the brink of a balance of payments (BoP) crisis, the CAD to GDP ratio had marginally crossed the 3 per cent mark. Thus, in so many years, India has had a balanced external account that has also been reflected in the corresponding savings-investment gap.

In the recent period, *i.e.*, 2001-02 to 2003-04, India experienced a surplus in the current account though the magnitude was small and it was essentially the consequence of business cycle slow down in early part of the decade along with corporate restructuring. With a turn around in business cycle, investment picked up in 2004-05 and India moved back to a current account deficit scenario. The current account deficit further widened during 2005-06 reflecting the cumulative impact of the high level of international crude oil prices and growth in imports emanating from strong industrial activity. The sustained rise in its invisibles surplus during 2005-06 emanating from the buoyant software exports, remittances and various professional and business services continued to moderate the impact of a growing merchandise trade deficit. According to current projections, during the 11th Plan period (2007-08 to 2011-12), current account is projected to remain in deficit and the normal and stable capital flows are expected to finance the deficit comfortably.

Unlike in many of the Asian EMEs where current account surpluses have mainly contributed towards greater accumulation of reserves in these economies, in India reserve accumulation has been mainly due to large capital flows and the current account surplus had only a minimal role to play in this regard, for a few years. Thus, it is clear that India, as such, has not contributed towards enhancing global imbalances.

India's macro policy has clearly laid a lot of stress on maintaining financial stability. The Indian economy as a whole and the financial sector in particular is now more resilient and in a better position to absorb financial shocks. This resilience has been achieved by improving the macroeconomic fundamentals and regulatory frameworks. Besides, unlike some EMEs that have seen demand to be predominantly driven externally, the Indian economy is mostly domestic demand driven. While India's exports constituted 11.5 per cent of GDP, its share in world trade is only 0.8 per cent. Second, India's export basket is fairly diversified (Reddy, 2005). Hence, its exposure to volatility in growth patterns across the world is limited than most EMEs. Higher GDP growth in India during last three years has also seen a rise in savings rate from 23.5 per cent in 2000-01 to 29.1 per cent in 2004-05. A significant turn around in public sector savings has been a major cause for the increase in domestic savings. Given the reform initiatives envisaged under the Fiscal Responsibility and Budget Management (FRBM) Act, public savings are expected to improve further. Besides, households in India are the major contributors to savings and given the favourable Indian demographics over the next 20 years, the savings rate in India is expected to remain high. This is in sharp contrast to other East Asian countries as well as in the US, where major contributor to savings are the corporates that largely depend on the cyclical path of the economy.

IV. Possible Impact of Global Imbalances on India

Fiscal

India continues to have a high fiscal deficit by international standards though it has declined significantly in recent years. In order to achieve sustainable fiscal correction and consolidation, both the central and state governments have adopted fiscal responsibility legislations, *i.e.*, Fiscal Responsibility and Budget Management (FRBM) Act. The combined fiscal deficit of the centre and states is budgeted to come down to about 6.5 per cent by 2007 (Table 4). Even if it is assumed that the centre and the states comply with their respective FRBMs, their combined fiscal deficit would continue to remain above 6 per cent by 2009-10. Generally, one would presume that India remains somewhat vulnerable to the impact of global imbalances on this account. However, the Indian case is unique as

Table 4: Combined Gross Fiscal Deficit of Centre and States

(average per annum, as per cent to GDP)

Period / Year	Combined deficit
1	2
1980-81 to 1984-85	7.19
1985-86 to 1989-90	8.88
1990-91 to 1994-95	7.75
1995-96 to 1999-00	7.73
2000-01 to 2004-05	9.00
2005-06 RE	7.45
2006-07 BE	6.50

RE : Revised Estimate. BE : Budget Estimate.

Source : Handbook of Statistics on Indian Economy, 2005-06, RBI.

the Government does not resort to external financing to finance domestic debt. This would help India in not being subject to the consequences of global imbalances.

In addition, both Reserve Bank of India and Government of India have undertaken various initiatives to develop the government securities market. The earlier features of an administered market with automatic monetisation have been done away with. The Indian G-sec market today is more broad based, characterised by an efficient auction process, an active secondary market supported by an active Primary Dealer system and electronic trading and settlement technology (Mohan, 2006).

The effect of global imbalances, however, could be indirect through a rise in domestic interest rates as a consequence of rise in international rates. There could be an increase in the cost of borrowings of the Government. However, since most of the outstanding debt is at fixed rates and not on floating rates, the rise in the borrowing cost will be incremental. This situation also provides greater headroom for a flexible monetary policy to adjust policy rates, as and when warranted, without any excessive impact on the fiscal deficit (Reddy, 2005).

Private Corporate Sector

Private corporate external borrowing has been liberalised substantially in India. The stock of private external debt rose from about US $ 5 billion at end-March 1996 to US $ 15.6 billion at end-March 2001 and has further risen to US $ 32.4 billion as at end-March 2006 (Table 5). Potentially, corporates are expected to borrow more in future and hence, could be susceptible to the consequences of global imbalances. If there are sharp fluctuations in interest rates and exchange rates on account of the adjustment process, corporates that have borrowed at variable rates would be subject to both

Table 5: Exposure to Foreign Capital of Private Corporates: External Debt of the Private Corporate Sector

(average per annum, as per cent to GDP)

Year	in US $ billion	as per cent to reserves
1	2	3
1991	—	
1996	5.0	23.0
2001	15.6	36.9
2006	32.4	21.4

— : Negligible.

Source : India's External Debt: A Status Report, Ministry of Finance, Government of India.

exchange rate and interest rate risk, depending on the magnitude and efficacy of the risk mitigation activities. However, without full capital account convertibility in India, the Government and the Reserve Bank of India administer the overall incremental debt exposure and put ceilings on total external commercial borrowings. Besides, corporates in India are encouraged to hedge their foreign exchange exposure.

Financial Intermediaries

In India, exposure of the financial intermediaries to external debt is limited and regulated. Their foreign currency borrowings have been subject to the prudential limit of 25 per cent of their Tier-I capital. These limits amounted to US $ 2.7 billion as on March 31, 2006. With a view to enabling banks to raise resources overseas, the latest monetary policy announcement on October 31, 2006 has enhanced this limit to 50 per cent of their Tier I capital, or US $ 10 million, whichever is higher. Foreign currency borrowings by the banks beyond this ceiling are linked to their net worth, exclusively for the purpose of export finance. With a move towards fuller capital account convertibility, banks are likely to access forex markets more, underscoring the need for further enhancement of the risk management capabilities of the banking system.

Banks in India have been financing investment in assets, home loans and retail market as well as equities. Like in many EMEs, asset prices and the equity market have seen a rising trend in the recent past in India as well. Should there be any reversal of capital flows, asset prices could potentially decline as did happen in May 2006. The most significant impact on banks' balance sheet, however, could be felt through their investment portfolio. Banks in India hold substantial investments in Government and other fixed income securities. To the extent a rise in international interest rates impacts the domestic interest rates, it would entail marked-to-market losses on the investment portfolios (Reddy, 2006).

To prevent any unforeseen eventualities, the Reserve Bank has been constantly monitoring the Banks' exposure to risky assets and has put ceilings on their exposure to equity markets. In addition to a capital to risk-weighted assets ratio (CRAR) for the sector of 12 per cent, specific steps have been taken to meet the interest rate risk. Separate provision for capital against market risk has been introduced.

Conduct of Monetary Policy

More importantly, one needs to look at the impact on monetary policy. As indicated in a speech that I made sometime back in Colombo (Mohan, 2004), in a globalised world, it is difficult to formulate monetary policy independent of international developments. Monetary policy has become more complex and central banks will have to take into account, among other issues, developments in the global economic situation, the international inflationary situation, interest rate scenario, exchange rate movements and capital flows while formulating monetary policy. Besides, in developing countries like India considerations relating to maximising output and employment weigh equally upon monetary authorities as price stability. As far as the impact of the adjustment policies on India's monetary policy is concerned, any significant readjustment of the currencies and rise in interest rates could affect global growth inturn affecting growth prospects of several emerging economies including India. The conduct of monetary policy will have to factor in these downside risks to inflation and any kind of turbulence to financial markets due to repricing of risks while maintaining the delicate balance in terms of growth *vis-a-vis* price stability. A key feature of Indian monetary policy formulation in recent years has been to look at both domestic and global factors and to guard against various risks as and when they evolve. The Indian economy now is more resilient and in a better position to absorb a financial shock.

As indicated in our Mid-Term Review on Annual Policy Statement for 2006-07 announced on October 31, 2006,

"Barring the emergence of any adverse and unexpected developments in various sectors of the economy and keeping in view the current assessment of the economy including the outlook for inflation, the overall stance of monetary policy in the period ahead will be

- *To ensure a monetary and interest rate environment that supports export and investment demand in the economy so as to enable continuation of the growth momentum while reinforcing price stability with a view to anchoring inflation expectations.*
- *To maintain the emphasis on macroeconomic and, in particular, financial stability.*
- *To consider promptly all possible measures as appropriate to the evolving global and domestic situation".*

Downside Risks

Notwithstanding these positive aspects of the Indian economy, downside risks remain as indicated in the various monetary policy statements released by the Reserve Bank of India.

First, moderation of demand on account of high oil prices poses the biggest challenge. The oil market remained highly volatile during 2005 and first half of 2006 on account of geopolitical uncertainty and supply disturbances. The average international oil prices increased from about US $ 25 per barrel in 2002 to US $ 54 per barrel in 2005 and further to US $ 73 per barrel around mid-July 2006. Though oil prices have softened in the more recent period (US $ 61 per barrel during September 2006), they still continue to remain at high levels. The medium term outlook also does not give much comfort, especially to the oil importing developing economies, in view of the continued geopolitical tensions in the middle-east and possible disruptions in other major oil producing regions, along with the tight global demand supply scenario. Though pass through of the hike in international oil prices to domestic consumers is limited in the Indian context because of Government policies, its impact on the trade deficit *via* increase in oil imports bill cannot be ruled out. This further worsens the global imbalances by creating higher surpluses in the oil exporting countries.

Second, as mentioned before, India has not directly contributed to the global imbalances and has built in enough stabilisers to keep it insulated from the consequences of global imbalances. Yet any disorderly unwinding of global imbalances is likely to have global ramifications and may affect the Indian economy indirectly. The speed at which the US current account ultimately returns towards balance, the triggers that drive that adjustment, and the way in which the burden of adjustment is allocated across the rest of the world have enormous implications for the global exchange rates. Private corporates and financial intermediaries are bound to get exposed to exchange rate risks if these variables exhibit substantial fluctuations, though the impact might be less than other EMEs.

Third, any reversal of global capital flows from emerging and developing economies in the case of realignment of interest rates and slow investment growth on account of higher interest rates with the tightening of monetary policy stance by major central banks remain the other downside risks.

Fourth, domestic developments exhibit strength and resilence with some down side risks. There is a pick-up in the momentum of growth which also appears to be spreading across all constituent sectors of the economy. Domestic financial markets have exhibited stable and orderly conditions. In the external sector, there are signs of abiding strength and the current account deficit has been well-managed so far. On the other hand, there are indications of growing demand pressures and potential risks from rapid credit growth and strains on credit quality. High levels of monetary expansion and the evolution of the liquidity situation will need to be continuously monitored for any signs of risks to inflation. The elevated levels of asset prices also represent a risk to the outlook for macroeconomic and financial stability. In brief, at the current juncture, for policy purposes, the two major issues that exert conflicting pulls are exploration of signs of overheating firming up to warrant a policy response, and, the impact of lagged effects of earlier policy action on the evolution of macroeconomic developments.

V. Concluding Observations

To sum up, being a closed economy earlier India had remained relatively insulated from global developments and hence, had little experience in dealing with them. During the last fifteen years, India has opened up considerably, while simultaneously reforming the financial sector, improving its fundamentals and creating some built in measures to ensure financial stability. The overall approach has given the Indian economy enough resilience to withstand some major global risks. Indian growth prospects remain bright in the future and any significant correction to global imbalances *via* abrupt and sharp changes in exchange rates and international interest rates will be taken into account.

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