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Can cash cleanup lead to bigger reforms, asks Eswar Prasad

Speaking to CNBC-TV18 Eswar Prasad, Professor of Economics at Cornell University, said Narendra Modi hasn't solved the problem yet of black money. But he has created a momentum through his demonetisation drive.

The key question is whether he will follow through with it, he said.

Another major pain area Prasad highlighted as a result of the demonetisation move were technical problems that the common man faces. Resolving them, going forward, will be key, he maintaine.

The key issue from his point of view is what this cleanup drive does on a broader reform effort. "If it turns out to be a building block to other broader economic reforms, it would push India in the right direction," he said.

Below is the verbatim transcript of Eswar Prasad's interview to Latha Venkatesh, Sonia Shenoy and Anuj Singhal on CNBC-TV18.

Latha: Larry Summers has written a blog speaking against demonetisation. Yesterday Ruchir Sharma had a telling article comparing a lot of countries and the amount of currencies in circulation and again saying that you can't use revenge against the tax evaders as a national policy. What are your own first thoughts of demonetisation? Is it plus or minus, all things put together?

A: In the short run clearly based on events on the street not a big positive, in fact significant negative in many ways. But in the long run, it is going to be good for India. Corruption is a cancer that has been eating away at our society for a very long time and it has been very difficult to do anything about it. Does what PM Narendra Modi has done solved the problem, certainly not. But it certainly creates momentum towards right sort of reforms. So, there are two big questions right now. Having taken this bold move, is he going to follow through in terms of what needs to be done on the ground, which is changing the incentive system which involves taking government out of the economy where it doesn't have a place and trying to change the basic incentives that many public servants face in terms of their dealing with temptations for corruption.

The second issue is whether the technical problems that have been caused right now for the man on the street are going to be resolved and that is going to be the key issue in terms of implementation. There was no easy way in my view to do this unmessily given the context in India it would have been very difficult to provide a long lead time for this sort of action but the question now is whether there is going to be a follow through in getting the ATMs recalibrated soon, getting enough supply of new currency notes and there certainly things are going a little slower than one would have liked.

The key issue from my point of view is what this does in terms of the broader reform effort. If it is seen as one step and the Modi government then declares victory on corruption that is not going to help the economy but if it turns out to be a building block towards other steps to deal with the corruption problem and as a building block for other broader economic reforms for which I hope PM Narendra Modi will have a little more support that would push India in the right direction. So, I am hopeful but I understand the concerns of the street right now.

Anuj: The other issue is can something be done in the near-term to stimulate the economy both on the fiscal side and on the monetary side. This talk of maybe an immediate rate cut bringing down petrol prices by Rs 5-6 per litre by passing on the excise benefits which were earlier hiked, do you think that would be a good move?

A: We need to give this some time to settle down. Taking any monetary policy or fiscal policy action in order to deal with the turmoil in the market I don't think could be well advised. Ultimately macroeconomic policy can do two things. Number one, it provides a stable environment for other policies, other reforms and for the economy to work well and second controls situations when there is a market meltdown. Certainly the financial markets are not doing well right now but is there a real meltdown? Certainly if you are on a particular side of the market you might argue so. But it is time we should wait for things to settle down a little bit and have calm restore before taking any decisive policy actions.

Certainly, if this turmoil continues for another couple of weeks or so and then things having settled down and then the narrative begins to change and then there could be more serious consequences for the economy. But right now, one can well see inflation if anything getting dampened because some of the money has taken out of the system and we certainly have demand for high-end luxury products for real estate declining as a consequence of this move. So, if anything will have a slight dampening effect on inflation, which could give the Reserve Bank of India (RBI) some room to move but I don't think they should take any precipitous action now.

Sonia: You started the conversation by saying that it is a significant negative in the very short run. What do you think the immediate damage could be on growth because there are many forecasts, which include brokerages like Ambit saying that the October to March gross domestic product (GDP) could slow down to as low as half percent? Is that something that you think is possible?

A: These are forecasts and forecasts are notoriously wrong. We don't have an idea because this is in many ways unprecedented. But there are interesting parallels from other parts of the world. China is an interesting example where the anti-corruption drive led to knock on effect on consumption especially for high end retail goods, consumption in restaurants fell. So, when President Xi Jinping in China got aggressive about the anti-corruption drive, of course he didn't do it so drastically but still there was a significant negative effect on consumption but the broader confidence effects in the economy, the broader effects on investment all kicked-in and more than made up for that. I suspect that is what is going to happen in India as well.

Again conditional on PM Narendra Modi being able to control the narrative and putting in place for the next two or three weeks measures to quell the calm and get the product markets and financial markets working together again. This will turn out to having a relatively small blip and if PM Narendra Modi can build on that then investment will start coming back. So, I am not that concerned but again all depends on what happens in the next couple of weeks.

Latha: The narrative from Delhi and this is entirely source based is that with demonetisation the assumption is that out of the 15 trillion notes that have been rendered non-legal about 5 trillion will not come back because that was anyway tax evaded money and that will be taken by the central government as a dividend from RBI. The short point is a huge fiscal stimulus is what is being planned from Delhi and the expectation is that precisely for the reasons you said that aggregate demand has been crunched, the RBI will chip in with radical rate cuts. If that is the scenario that plays out then what is your take on the economy?

A: Certainly, some measure of macroeconomic policy support through both monetary and fiscal policy might turn out to be needed. My sense again is that if the cards are played right, that is not an obvious issue. The question again is going to be whether there is going to be confidence building up from the other reforms that the Modi government uses this as a stepping stone for.

One of the critical issues in thinking about this from a broader perspective is that it is very difficult in an economy like India or even an economy like the US to undertake certain reforms because there is a narrative, a very powerful narrative and a plausible one that many of the benefits of these reforms end up being taken over by the political and the economic elite and the poor are left to deal with the crumps and they may get the benefits in the long run but that is not clear. So, this is a reform where clearly the rich are more disadvantaged than the poor and it creates credibility in the minds of the masses that PM Narendra Modi may be on their side.

But again the follow through both in terms of this specific action in cleaning up the mess and in terms of other reforms is the key. If there is sufficient follow through in the short run and especially in the medium-term by which I mean the next three to twelve months then much of the damage can be contained and we not even need a huge amount of stimulus.

Anuj: The other issue that the market is dealing with is a Trump win because we have seen after that the strength in the dollar, the emerging market index is down 6 percent in dollar terms. Do you get a sense that Trump is going to follow his pre-election rhetoric or would we see a difference between the rhetoric and the governance and its impact on the global financial markets?

A: Who knows but the very notion of who knows is what markets are reacting to because markets hate uncertainty and Trump has taken both sides of many issues -- on the trade issue certainly there was a lot of protectionist rhetoric coming out of Trump and also a little bit on the democratic side.

The question is whether calmer heads will prevail and Trump will recognize that many of the promises he made -- getting tough on China, trying to pull back on the deals like the Trans-Pacific-Partnership (TPP) that President Obama had negotiated with eleven other countries but had not yet been ratified by Congress or even longstanding trade deals like naphtha, the trade agreement with Canada and Mexico whether that is going to be torn apart, these are all open questions.

The Republican Party has traditionally been a party favouring free trade but Trump's message resonated very well because there is a lot of disruption in the society right now, technological disruption, some disruptions related to trade, a lot of sectoral shifts, these are very difficult issues to deal with plus they are creating more economic uncertainty especially employment uncertainty.

If Trump were to carry through on these promises and the real risk is that the fundamental reforms that are necessary to improve US competitiveness, like spending more money on infrastructure, improving the education system, reducing regulations, the proper sort of tax reforms, all of those are very difficult to do. So, it is very tempting to take the position that he is going to get tough on China or tough on the US's trading partners more generally and that could have a negative effect because the US is seen as a traditional champion for free trade, the free flow of goods, capital and labour across countries and if the US disengages from the rest of the world economy then it is going to be a very difficult time for free trade, which is already not doing very well and that could have consequences for the US economy and the world economy at large especially at a time of weak business in consumer confidence.

Latha: A large part of India's employment and its stock market investments are in IT companies, should they worry?

A: I think they have some reason to be worried in the short-term, there could be disruptions because of changes to the immigration policy and to trade policy but in the longer-run again, I hope that calmer minds will prevail in the US because ultimately Trump is a pragmatic businessman or so we hope and many of the people that may surround from the republican party are still committed to free enterprise, to free trade. So I hope that they will act as a tempering influence but in the short run and especially in the US economy's growth were to weaken either in terms of GDP growth or employment growth, that could certainly bring to the fore some of these protectionist sentiments. So right now, we are all in a wait and see mode and the IT company should follow that approach as well but in the long run much depends on what happens to the US economy.

Sonia: If you had to just summarize for us your world view on the developed versus emerging market economy the perspective over the next six-twelve months what do you see as the way forward?

A: The US economy is doing quite well. All things considered. GDP growth has been moderate, the labour market looks in very good shape and we are talking about a possible Fed rate hike in December because all the signs coming from the labour market from the inflation numbers and so on suggests that economic growth is stabilising in the US.

The same certainly cannot be said of the euro zone and Japan. So what I think we are likely to see in the coming weeks and months is a further divergence of monetary policy stances on the G3 with the Fed possibly hiking rates and the European Central Bank and the Bank of Japan going in the other direction.

For emerging markets overall, there is some ground for optimism not necessarily because certain emerging markets like Brazil, Argentina, Venezuela, Turkey are in great shape but I think they have bottomed out and even some of these economies are in very difficult shape, such as Brazil and Argentina have in fact put in place a few reforms that if they can generate some growth momentum might start paying off.

In China, growth seems to have stabilised somewhat although the medium-term risks are building up. So I worry a lot less about China in the next year or two but I worry a lot more about China two years on because at that point many other financial system risks are certainly going to become even greater and could hold bad growth and with India of course, I remain eternally optimistic and I hope that I will be proved right.