Slower IIP growth, widening current account deficit left economy vulnerable to capital flow reversal: Eswar Prasad

Gayatri Nayak, ET Bureau May 7, 2012, 05.00AM IST

Tags: IIP growth | Eswar Prasad | current account deficit

*With economic recovery in the West faltering and emerging economies losing steam, the global economy may be poised precariously. Eswar Prasad, the Tolani senior professor of trade policy at Cornell University, who also holds the New Century Chair in international economics at the Brookings Institution, and a research associate at the National Bureau of Economic Research, tells **Gayatri Nayak** in an e-mail interview that India has to act quickly to retain the fruits of its past economic reforms. Edited Excerpts:*

The emerging market economies, branded as growth engines during the last crisis, are slowing and have fundamental issues to handle. In this scenario, how prolonged will the global recovery be?

Slowing growth in emerging markets, which have been the main contributors to world growth since the financial crisis began four years ago, will have a negative impact on global growth through direct channels. It will also put a damper on business and consumer confidence worldwide.

China seems to be engineering a soft landing for its economy, although this will not be a smooth process as the economy continues to be buffeted by domestic policy challenges and uncertainties in the global trade and financial environment. If its growth were to slow sharply, China has room to respond with aggressive expansionary policies. This would secure short-term growth of 8% but could set back the long-term goal of rebalancing economic growth and making it less reliant on investment.

Has the recent political instability in China affected its economic reforms and growth?

The leadership transition in China had been expected to bring economic reforms grinding to a halt for the remainder of this year. Interestingly, there have been promising signs in recent weeks that the momentum for reforms has revived. These include steps to increase flexibility of the exchange rate, a frontal attack by Premier Wen Jiabao on the "monopoly" of large state-run banks, and further measures to liberalise capital outflows.

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The recent ouster of the Chinese Communist Party's head in Chongqing municipality Bo Xilai has had the unexpected effect of re-energising some reforms that had seemed stalled. Bo was seen as representing the reactionary wing of the Chinese Communist Party. His ouster has created an opening that has been exploited by reform-minded officials to revive the push for market-oriented reforms.

The India growth story in relation to others in BRICS seems to be over. What went wrong?

India has certainly hit a rough patch, with industrial production growth hitting a wall at the end of 2011, overall output growth slowing sharply, and the current account deficit widening, leaving the economy vulnerable to capital flow reversals. I think it's still an open question whether India has just hit a temporary rough patch or whether the shine is coming off India's growth story.

After a few glorious years, when the economy seemed to have switched permanently to a high growth path, the domestic narrative was that India would soon decisively eliminate the growth gap with China. Unfortunately, rather than pushing forward with reforms to cement these gains, I fear that a sense of complacency set in, compounded by difficult political circumstances.

It is high time for another concerted push on economic reforms - the benefits of those put in place over the last two decades have run their course.

There's a tendency among Indian policy makers to blame global factors. How much of it is true and how much of it is of India's own making?

Like other emerging markets, India is certainly not immune to global economic turmoil. Yet, there is a palpable sense that the economy is losing its direction as political paralysis sets in stalling reforms that the country desperately needs.

The government's backtracking on reforms, such as the overnight retreat on its policy to liberalise foreign direct investment in the retail sector, suggests that it lacks the political resolve to push through even reforms that can have broad benefits.

The policy paralysis has significant costs. Not only has it spooked foreign investors, it has also created a climate that is hardly conducive to long-term investments in sectors such as manufacturing and infrastructure.

India, like other emerging markets, will have to live with the reality of volatile capital flows. The question is whether domestic policies, such as lower levels of public borrowing and better-developed financial markets, will help India cope with or exacerbate the effects of such external volatility.

What measures should India take to reverse its economic slide?

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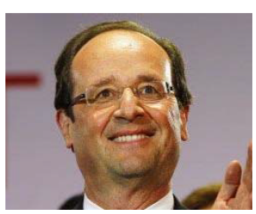

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The benefits of India's growth have largely gone to the elite, while rampant corruption and high inflation have hurt the poor. The challenge is to ensure that reforms deliver greater benefits to the poor and the lower middle class, so they share more in the benefits of India's growth and provide a political base for economic reforms. First, rather than continuing to play defence on the corruption issue, the prime minister needs to expend some political capital and develop a plan for a bold strike against corruption at different levels of government.

Second, the social safety net needs to be strengthened. A system of cash transfers would work better than food and energy subsidies that breed inefficiencies and corruption. Such a system would deliver more benefits directly to the poor and at a lower budgetary cost.

Third, the road to higher and more equitable growth still goes through the financial sector, which needs to be liberalised and broadened further. Steps to bring more people, including those in rural areas, into the formal financial system would help spread risk and share the benefits of growth more equitably.

RBI has been criticised for being aggressive in cutting interest rates. What will be the fall-out. Will it harm or help economic recovery? Is there an inconsistency in the way the central bank has conducted its monetary policy?

A central bank should ideally have price stability and financial stability as its principal objectives. However, a central bank can lose legitimacy and operational independence if it ignores growth and unemployment. This difficult balancing act is complicated further if other policies are not supportive.

RBI has the unenviable task of managing this balance while also having to go slow on other policies that are hampering growth. The public debt overhang and undisciplined fiscal policies make it harder to maintain credible and effective monetary policy.

With industrial production growth slowing sharply, the central bank may have felt its hand was forced to aggressively cut rates. But I do have some concerns about whether the balance of risks has indeed shifted so much from inflation to growth. Indeed, the high inflation numbers that have come out since the rate cut is quite worrisome.

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What do you think the future holds for India's economy?

I remain cautiously optimistic that India's inherent dynamism will shine through and put us back on a path to higher growth. But, this can hardly be taken for granted, especially given the volatility and high-level of uncertainty in the global economy.

There is, of course, a broad reform agenda for getting India back on to a high growth path, including bringing the budget deficit under control, eliminating stifling labour market regulations, freeing up channels for infrastructure investment and improving the education system.

The Indian economy is at a critical juncture and can no longer count on past reforms to continue pulling the country through in difficult times. Policy choices made today will resonate for years to come. I hope India's leaders will respond with resolve and determination to the challenges our country faces.

The effects of monetary and fiscal stimulus in the West seem to be waning. Does that mean the West gets into a double dip recession?

The advanced economies by and large remain on life-support, mostly provided by accommodative central banks. In most of these economies, there is considerable uncertainty about what room is left for aggressive policy responses to counteract weak demand and, in any case, whether those measures will get much traction. With fiscal policy already in a tight spot and monetary policy out on a limb, their room to boost domestic demand is limited. The US recovery is gradually firming up but remains fragile. Equity markets and credit growth have firmed up, helping to give consumer and business confidence a small but noticeable boost.

The political developments in Europe appear to be making policies difficult. What's the future of euro and Europe and what that means to the world?

Many of the distressed European economies are mired in negative growth. Others, including France, are at the edge of recession, and even the mighty German economy appears to be stumbling. A worsening of the euro zone debt crisis is now the major source of global risk. The crisis has eased, but only temporarily, due to massive intervention by the European Central Bank.

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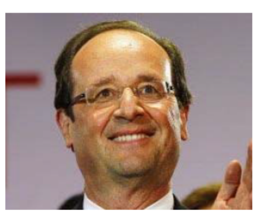

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Many European economies are being forced to restructure their public finances even as they venture to undertake massive structural reforms. This is stifling growth, worsening debt to GDP ratios in the short run and generating an unsustainable political situation. There is a growing sense that Europe has the capacity to summon just enough political will to pull back each time from the brink of a full-blown crisis but without ever reaching a decisive resolution. With the added political uncertainty from recent elections in France and Greece, markets could force a denouement sooner than anticipated.

With unemployment in the US and Europe remaining high, what are the implications for export-dependent emerging economies?

The burden of sustaining world growth is taking a toll on emerging market economies Export-dependent emerging market economies are unlikely to be able to count on much strengthening of demand from their advanced economy export markets.

Commodity exporting economies, both emerging and advanced, have become reliant on strong demand from China and India. A slowdown in these two economies could dampen world demand for commodities unless advanced economies pick up the slack. Unfortunately for India and other oil importers, political instability in the Middle East could keep oil prices high or even drive them higher, despite relatively weak global demand.

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