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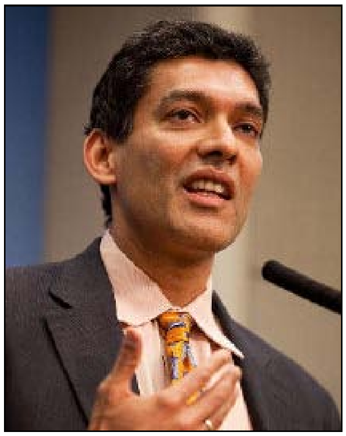
'There's tension in the world economy now on who's going to pull whom'

We are coming back to a position where everyone wants to ride on the coat-tails of the US and that is a serious concern because the American economy itself is in a fragile state. And if the rest of the world is going to rely on the US to import more, that will hamper US recovery.



ESWAR PRASAD, TOLANI SENIOR PROFESSOR OF TRADE POLICY, CORNELL UNIVERSITY.

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Eswar Prasad is the Tolani Senior Professor of Trade Policy at Cornell University. He is also a Senior Fellow at the Brookings Institution, where he holds the New Century Chair in International Economics, and a Research Associate at the National Bureau of Economic Research. He was previously chief of the Financial Studies Division in the International Monetary Fund's Research Department and, before that, was head of the IMF's China Division.

The Chennai-bred Prasad, who schooled at DAV Senior Secondary School and graduated in economics in 1985 from the RKM Vivekananda College, received his Ph.D. from the University of Chicago. Prasad, whose research has spanned a number of areas including labour economics and business cycles, has an extensive publication record in top academic journals and has co-authored and edited numerous books and monographs on China, Hong Kong and India.

His current research interests include the macroeconomics of financial globalisation, monetary and exchange rate policies in emerging markets, and the Chinese and Indian economies. Prasad regularly interacts with the top managers of the Indian economy and has co-written papers with Raghuram Rajan, economic advisor to the Prime Minister.

Recently in Chennai, Prasad spoke at length to Business Line on a variety of issues ranging from the Indian Budget to the Chinese economy and on whether the US can be the engine of growth to pull the world out of a slowdown.

Excerpts from the interview:

The Government's large borrowing programme in the Budget to provide for the Sixth Pay Commission, farm loan waiver and other social schemes has raised concerns about the fiscal deficit reaching unsustainable levels. What are your views on this?

India is facing the tension that most other economies, both emerging and advanced, in the world are facing, in trying to balance the need to generate short-term stimulus without creating too many medium-term problems. I am not quite sure they've got the balance right. The Finance Ministry and the Planning Commission seem to think that a 6.8 per cent deficit is the sort of stimulus that is needed under the present circumstances to make sure that the global financial crisis does not have a serious impact on the Indian economy and keep growth going at a decent rate.

The big concern is that India did not have that much fiscal space to begin with because of the many populist measures taken during the end of the last Government. And this Budget also seems to

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include a number of populist measures. So when one thinks about the medium term, once the short-term recovery is secure, there is a big concern whether one can come up with a sustainable trajectory that keeps the fiscal deficit at a sustainable level.

The problem, of course, is that invariably when you put in place a fairly large stimulus package and a large deficit that goes along with it, many of the expenditures are of the sort that tend to get entrenched. Pulling them back could become very difficult, so that is the problem that the Government clearly has to deal with.

There is the controversy over the monetisation of debt. Though the Government vehemently denies that this is on the cards, some economists say that it is inevitable and the RBI’s open market operations are another form of monetisation. How do you see things panning out in the near term?

The reality, of course, is that the debt has to be paid back one way or the other — either by taking revenue and expenditure measures to bring down the deficit and the debt, or by monetisation. So I don’t think that it is inevitable that debt has to be monetised. But the question is whether the Government has the political ability to do the alternative, which is taking serious steps to increase revenues and reduce expenditures. So the scepticism expressed over whether the Government can avoid monetisation is if it can take these difficult measures. And it remains to be seen whether the Government has a concrete plan to reduce the deficit level and make the public debt level sustainable.

Right now, on present trajectories, it doesn’t look like that is going to be easy to achieve. So it is natural that the market participants are concerned that the Government may resort to the much easier option of monetisation of debt. So I hope that monetisation does not take place because, given the level of debt we have, it is possible that the monetisation could result in an inflationary spiral fairly quickly in India. That would be very difficult to pull back and it would have a very serious negative impact on the RBI’s credibility.

One criticism about the Budget is that it does not contain enough of a stimulus package to kick-start growth in the economy. What is your view?

It is a difficult issue for any Government to balance the short term versus the long term, because ultimately one can try to think about measures in a stimulus package which are going to improve long-term productivity. So one can think about certain infrastructure projects, but the employment generated in the short term may not be very large.

But the long-term pay-offs may be large. That actually can have a very good effect even in the short term. Because if you think productivity growth is going to be higher in future, that can stimulate investment today.

On the flip side, you can take measures that put money directly in the hands of the consumers. In principle, that should help boost consumer demand right now. But the problem is that people see the flip side of the issue, rising deficit and no obvious increase in long-term productivity, then they are going to view this measure as a one-time pay-off from the Government so they might end up saving a part of it. So there is this very difficult balance between trying to do things that are good for short-term stimulus versus long-term stimulus.

But in the Budget, my sense is that there are two problems. One is that there were a number of relatively short-term populist measures, which really do not contribute to either long-term productivity or short-term stimulus. They also have the added disadvantage of getting entrenched and getting ingrained in the public debt, thereby crowding out private investment.

Do you see the US again becoming the engine of growth for the global economy?

There is a big tension developing in the world economy right now in terms of who’s going to pull whom along. The good thing is at least few of the large emerging markets, especially China and India, have begun to grow at quite rapid rates. That is good for the world economy, not necessarily because these economies are going to pull in a lot of imports from abroad. Other than commodity imports, their ability to import consumer goods is very limited. But at least these economies are not relying that much on the world for their revival.

But then, when one starts looking deeper behind what is underlying the growth in some economies such as China, one gets worried. In China, much of the stimulus is being directed towards investment growth that is financed by bank lending.

So, in China, you have these large state-owned banks that are lending to large state-owned enterprises and this lending is not taking place on a commercial basis. There is this fear of creating excess capacity in sectors that already have spare capacities.

So the Chinese may be getting into the position where income and employment growth cannot keep pace, in terms of generating consumer demand, with the amount of capacity that is being built up in the economy. Then they end up in a situation, may be in a couple of years from now, where they have to export this excess capacity. The other concern in particular for China is about any change in their exchange rate policy because their export sector is very important in generating employment growth. Even in the period before the crisis enveloped the world, when they were growing at an average of 10-12 per cent a year in real terms, net employment growth was only 1 per cent a year.

This is because the state enterprises were laying off workers, so it was only the export sector that was generating jobs. Both in terms of generating jobs and exporting, the Chinese are going to need external markets.

Then, when you look around at the other big economies, especially Japan and Germany, they are also very dependant on exports and their economies are very weak right now and can’t pull in too many imports. So, they need exports to maintain whatever little growth they can hope to eke out in the next year or two.

Looking at all the major economies of the world, you find that it is only the US that is left standing in terms of being able to provide a market for these goods.

So we are coming back to a position where everyone wants to ride on the coat-tails of the US and that is a serious concern because the US economy itself is in a fragile state. And if the rest of the world is going to rely on the US to import more, that will hamper US recovery, which is far from settled as there is a lot of headwind in the US economy.

One aspect is that the toxic asset issue in the financial system seems to have come under some degree of control but there is a very serious non-toxic asset problem that is still there.

There are two particular dimensions, one is corporate real estate and the second is credit cards. So there are real risks in the US financial system. The property prices in the US have kept falling and if they do not stabilize reasonably soon many of the assets that the financial institutions have in terms of corporate real estate are going to become non-performing assets.

Credit card delinquencies are already rising so they have tightened lending standards and have reduced the amounts that people can take as loans on their credit cards. So that has a negative effect in terms of consumer recovery. But if the economy doesn’t pick up soon and if credit card delinquencies continue to rise the lending norms are going to get tighter, so it feeds on itself.

The second issue is that State Governments in the US are in terrible financial state. Now that has a very important implication on the stimulus package because even if the US Federal Government has a big stimulus package the way the stimulus works is that it has to be matched with money from the State Governments and these Governments do not have the money. So the State Governments are not able to absorb the stimulus money ando that has hampered the effectiveness of the stimulus package in the US.

The third issue relates to consumer demand. Households in the US had a savings of zero per cent of their disposable income until the crisis hit, which has gone up to 7 per cent of disposable income now. In the US direct consumption accounts for about 70 per cent of GDP. So if we have a structural change in the pattern of consumption where the average household savings is around 6-7 per cent and if consumption continues to account for 70 per cent of GDP, there is a potential loss of the GDP which has to be made up somewhere.

In the short run the Government can step into the breach but there is a limit to this as the debt levels are already very high in the US. So the growth has to come from somewhere and the only area left is exports. Right now the other economies given their problems are clearly in no position to absorb US exports. So these issues are going to create fairly serious tension in the coming days in terms of the world economic recovery.

The endgame has to involve the value of the adjustment of the dollar. There are two possible scenarios here, one is that the dollar continues its depreciation against other major currencies right now so then the US will start having a smaller trade deficit. But that puts a very painful adjustment to the rest of the world economy.

Another scenario, which will be very benign in the short term, is to go back to where we were in 2007. So the US starts going crazy with its consumption again, the rest of the world happily exports its goods and services to the US to fuel this consumption binge and also buys US Treasury bonds, which keeps interest rates there low. So we go back to an era of large global macroeconomic imbalances but at least everybody is as happy as they were in 2007.

But then you increase the risk of a very substantial dollar adjustment because the level of the debt in the US gets even more worrying. So we could face a very sharp and abrupt dollar adjustment. That is the big concern right now. None of these scenarios is particularly benign or pleasing but there is some appeal to the latter scenario which, at least in the short run, appears benign.

But eventually the dollar has to depreciate as the US has built up so much obligation to the rest of the world that debt has to be paid back. It was remarkable that the rest of the world was willing to fuel US consumption at such cheap interest rates for such a long time, it clearly served the rest of the world’s interest but this cannot go on.

Q: How does the Indian savings rate compare with that of China? How effective is India in channelising its savings into private investments?

A: There is an interesting quirk about savings rate in China and India. There is this notion that savings rates in China are very high. In terms of the national savings rate in China is in fact very high; it is about 55 per cent of the GDP. But that includes household, corporate and Government savings. In India corporate savings are relatively modest and Government saving is quite small. Now the Government can have savings even if they run a deficit that is because money that is taken by the Government and put into investment is counted as Government saving. But in China the big story about increase in savings in the last five years is not about household saving. Household savings as a share of disposable income (27 per cent) is rising very gradually but is lower than India’s household savings (33 per cent). In China corporate savings are quite large. Many State and private sector enterprises have been making very good profits in recent years. And since their dividend payouts are quite small most of the profits are retained and these are counted as corporate savings. So corporate savings have really taken off. Household savings as a proportion of the GDP in China is around 23 per cent and corporate savings around 27 per cent, those are the rough estimates.

In India, household savings account for the major chunk of savings. Corporate savings, though they have increased in the last few years, and Government savings are quite small. Nevertheless, the fact that India has a fairly large pool of household savings suggests that it could be used for productive domestic investments. The other side of this is the savings-investment balance. India is saving a lot, 35-36 per cent of the GDP, but the current account deficit is very high, so investment is already slightly higher than savings. In China it is the reverse, the savings are about 55 per cent of the GDP and investment is about 45 per cent of the GDP. So there is a current account surplus of around 10 per cent of GDP. So India has the potential to use this high savings for investment. But the big question is whether India's financial system is doing a good job of effectively channelising these savings into productive investments. So the critical issue is whether the financial system is providing credit to SMEs and the more dynamic parts of the economy and not only to the large firms which have access to the equity markets.

Q: Do you think India's cautious approach towards opening up the financial sector helped in insulating itself from the recent global financial meltdown?

A: Clearly the RBI and other regulators have done a good job of making the Indian financial system reasonably robust to these external shocks. But the difficulty is always in trying to see the counterfactual. Because when you see a crisis hit that is very painful and avoiding a crisis is clearly a good thing. But the question is whether a price is being paid in terms of protecting the system and making it that safe. Inherently financial systems are very unstable and this instability can create a lot of damage. So you do want to be very careful in dealing with this system. But then if you keep the financial system very closed and protected the problem is you do not let the financial system do its basic role that is of financial intermediation, and boost growth. So one can always ask the question if the system were working better would we have had a higher growth rate that would have got us to a different plane right now? Of course, the cost of this is that we would have a much greater exposure to global crises. So rather than asking the question of whether a very protected financial system is good, the right question to ask is how can one maximize the ability of the financial system to deliver growth outcomes, while not exposing it enormously to risk. The fact that India did not get hit by the global crisis in its system suggests that we got one part of it right but it's not clear whether we got the balance right. If we think about how much further the Indian economy would have gotten in the last decade if we had had a better functioning financial system then it's not obvious that we're that much better off.

But I think the issue for India right now is less to focus on keeping the system protected than thinking in terms of thinking about the more basic elements of financial system reform. I think these basics are something that even the most conservative of financial regulators agree about. One is strengthening the banking system. Even if one is not thinking about opening up the banking system, there is a great deal to be done to make the banking system more efficient in terms of its intermediation services.

Second we need to have a much broader set of markets, especially corporate bond markets where some progress is being made, but there is a lot more to be done.

The third issue is to make plain vanilla derivatives markets work better. Here again the interesting thing is the emerging markets including India and China have taken a much more mature approach to this in the midst of the crisis. While the crisis was being set off even in the US which is supposed to have a much more sophisticated financial system we had crazy knee-jerk reactions like trying to ban on short-selling. The Indian regulators dealt with it in a much more sensible fashion.

So once again the counter factual is very difficult to establish. It is easy to say that India may have grown at a faster pace but in the short term we have to deal with a painful crisis. So getting the balance right is always going to be difficult. There is no doubt that economies like the US had gone too much in the other direction with fairly reckless financial innovation and more importantly the basic regulatory failure. The regulatory framework was in place there were many financial shenanigans going around in plain view and the regulators did not step in to check them.

But in India's case, in during the crisis we were working towards setting up the currency derivatives markets and they have been doing well in the last few months and volumes have been increasing even though we are in the midst of a crisis. So these are the core elements that India needs to focus on. And the other important element is that of financial inclusion agenda. Even though we have a large banking system, there are still large segments of the Indian population which is not served by the banking system. Small entrepreneurs, farmers and other people in the rural areas are seriously constrained in having access to the financial system, not just in getting credit but also having access to savings instruments, insure against risk and so on.

So the key issue is to focus on now what needs to be done to make the Indian financial system work better. What India needs now is not excessive financial innovation but getting the basics right.

Q: So what do you thing are the key steps that need to be taken to get the basics right?

A: If one goes back and looks at the Raghuram Rajan Committee report which actually listed out a set of things to be done. Although there is a sense that the report has been overridden by events that have happened since, in fact most of the points made in the report are even more relevant today. One of the key issues in the report, which the Obama administration in the US is taking up as well, is to set up a body that can actually provide regulatory coordination among the various regulatory bodies, to make sure things do not fall between the cracks. Also is it is a way of ensuring that financial institutions do not seek regulatory arbitrage. In the US it was a serious problem where many new financial instruments fell through the cracks and nobody was regulating them. That recommendation is still a very important one.

The second issue is to strengthen our banks. We already have a fairly vibrant private banking *system but the other public sector banks should improve their efficiency. Of course, the best of the public sector banks such as the State Bank of India seem to be performing as well as the best of the private sector ones. But there clearly is a large number of other public sector banks that need to improve efficiency.*

The other issue is of course to is make sure that the corporate bond markets start working very well. Now that is important for a variety of reasons, one it provides competition to certain entrenched parts of the system by giving the households and firms an alternative options to invest. Also it makes the smaller firms a little less dependent on the banks and the equity markets where larger firms have easier access. So there is a set of missing markets which will make the system a lot more efficient.

Ultimately in terms of the broader goal of inclusive growth, unless we have financial inclusion it’s going to be very difficult to ensure that the growth process is broad based. Access to the financial system is an essential requirement for people to be able to benefit from the overall growth process.

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