INTERVIEW

Economic growth cannot be taken for granted: Need for urgent reforms — an interview with Dr. A. Virmani
Former Executive Director, International Monetary Fund and Former Chief Economic Advisor, Government of India

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KEYWORDS
Growth; Inflation; Current account deficit; Savings; Investment; Subsidies; Reforms; Diplomatic relations; IMF quota

Abstract
Growth of the Indian economy has suffered in the recent years as indicated by decline in industrial production, capital formation, exports, etc. Weakening of aggregate demand and decline in investment could be some of the contributing factors for this phenomenon. While the slowdown can also be attributed to global slowdown, a high current account deficit and gross fiscal deficit, and continuance of a high rate of inflation are some of the most worrying signs for the policy makers. Restoration of fiscal sustainability and macroeconomic balance through stepped-up reforms are some of the key issues that need urgent focus of the government.

Dr. Arvind Virmani is a Non-resident Fellow, Brookings Institute, Washington DC. Earlier, he was Executive Director at the International Monetary Fund (IMF) and before that, Chief Economic Advisor (CEA), Government of India. He has been an advisor to the Indian Government at the highest levels for about 25 years, including as CEA, Ministry of Finance, and Principal Advisor, Planning Commission. He has served as Member, Telecom Regulatory Authority of India (TRAI) and the Appellate Tribunal for...
the Securities and Exchange Board of India (SEBI) Act; Chairman, Board of Trustees of SBI Mutual Fund; and Director on the boards of several financial institutions [LIC, PNB, Allahabad Bank, and UTI (Trustee)]. He has also directed the Indian Council for Research on International Economic Relations (ICRIER) as its Chief Executive and was Affiliate Professor, George Mason University (and Distinguished Senior Fellow, School of Public Policy — Center for Emerging Market Policies (CEMP, GMU). He has published 33 journal articles and 20 book chapters in the areas of macroeconomics, growth and finance, international trade & tariffs, and international relations. His books include, “The Sudoku of India’s Growth” (BS Books, 2009), “From Uni-polar to Tri polar World: Multi-polar Transition Paradox” (Academic Foundation, 2009), “Propelling India from Socialist Stagnation to Global Power” (2006), “Accelerating Growth and Poverty Reduction — A Policy Framework for India’s Development” (2004).

Context of interview

Dr. Arvind Virmani visited the Indian Institute of Management Bangalore on the 19th and 20th of February 2013. He had just returned from the IMF in November 2012 after completing a three year tenure, where one, amongst his many contributions, was battling for a higher quota for India. Prior to his assignment at the IMF, Dr. Virmani was the Chief Economic Advisor, Ministry of Finance, Government of India (GoI). The interview was conducted keeping in view this recent assignment of Dr. Virmani. The following note presents the context of the prevalent economic situation as in February 2013.

The performance of the Indian economy has suffered in recent years. The rate of growth of the Indian economy has been on a downtrend over the last two years. India’s growth rate has been declining after the country recorded a high growth of 9.6% in 2006–07 and 9.3% in 2007–08 and 2010–11. The economy has been slowing down as reflected in industrial production, capital formation, and exports. The slowdown can be attributed to global slowdown and a weak monsoon. As growth slowed, government revenues did not keep pace with spending and with declining government and private sector savings, the balance of payments came under pressure. Consequently, some of the most disturbing signs of the slowdown are high current account deficit (CAD), gross fiscal deficit (GFD) and persistence in high rate of inflation (Table 1).

There is a trade-off between inflation and growth in India. While growth rates declined, inflation rates increased sharply in 2008, mainly because of the global commodity price boom. Food inflation was further affected by poor monsoons. The inflation rate had come down from the peak of above 10% from March 2010 to July 2011 to persist at 7%–7.5% in recent months. Food inflation, however, continued to be high and the rising level of food inflation widened the gap between Wholesale Price Index (WPI) and Consumer Price Index (CPI). As per the Reserve Bank of India (RBI) (2012), close vigil on inflation was necessary during 2012–13 to prevent re-emergence of inflationary pressures. The RBI was raising

<table>
<thead>
<tr>
<th>Table 1</th>
<th>Select indicators of the Indian economy.</th>
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<tbody>
<tr>
<td>GDP and related indicators</td>
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<tr>
<td>Growth rate</td>
<td>Percent</td>
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<tr>
<td>Savings rate</td>
<td>% of GDP</td>
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<tr>
<td>Capital formation (rate)</td>
<td>% of GDP</td>
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<tr>
<td>Production</td>
<td></td>
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<tr>
<td>Index of industrial production</td>
<td>% change</td>
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<tr>
<td>Electricity generation</td>
<td>% change</td>
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<tr>
<td>Prices</td>
<td></td>
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<tr>
<td>Inflation (WPI) (average)</td>
<td>% change</td>
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<tr>
<td>Inflation CPI (IW) (average)</td>
<td>% change</td>
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<tr>
<td>External sector</td>
<td></td>
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<tr>
<td>Export growth (US$)</td>
<td>% change</td>
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<tr>
<td>Import growth (US$)</td>
<td>% change</td>
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<tr>
<td>Current account balance to GDP</td>
<td>Percent</td>
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<tr>
<td>Foreign exchange reserves</td>
<td>US$ bn</td>
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<tr>
<td>Money and credit</td>
<td></td>
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<tr>
<td>Scheduled commercial bank credit</td>
<td>% change</td>
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<tr>
<td>Fiscal indicators (centre)</td>
<td></td>
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<tr>
<td>Gross fiscal deficit</td>
<td>% of GDP</td>
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</table>

<sup>a</sup> April–December 2012.
<sup>b</sup> 2012–13 (April–January); WPI — wholesale price index; CPI (IW) — Consumer Price Index-Industrial Workers.
<sup>c</sup> April–September. 2012.
<sup>d</sup> At end January, 2013.
<sup>e</sup> (Up to December 28, 2012).
<sup>f</sup> Provisional actuals.

Source: Reserve Bank of India and Government of India.
the interest rates from March 2010 and these hikes along with policy constraints adversely impacted investments. Although the Government of India has taken some steps since September 2012 to tackle the situation by way of reduction in subsidy for cooking gas and fuel and liberalising foreign direct investment in select areas, the situation had not improved and perhaps calls for further measures. Some of the critical issues that require attention in India include restoration of fiscal sustainability and macroeconomic balance.

**Aggregate demand**

The slowdown in the economy in the last few years could be attributed to weakening of aggregate demand and decline in investment growth. Growth in India is directly related to investment which was declining in 2011—12, mainly due to the decline in the private corporate sector and not the household sector (which recorded a rising trend). The lower investment was attributed to high interest rates, drawdown of stocks, lower demand for exports from rest of the world, and policy bottlenecks such as seeking environmental permissions, land acquisition, and so on. As per the Third Quarter Review 2012—13 by the RBI, released on January 28, 2013, aggregate demand weakened during April—September 2012. The Review mentions that reforms since September 2012 have reduced immediate risks, but there was recognition that there still was a long road ahead to bring about a sustainable turnaround for the Indian economy. The demand revival would require improvement in the investment climate as well as investor sentiments through sustained reforms. To revive demand, policy and regulatory reforms would need to be introduced and competition enhanced in the markets for infrastructure services, land, agriculture and skills. India requires policy, regulatory and institutional reforms.

**External factors**

The collapse of Lehman Brothers in 2008 and the commencement of the financial crisis in 2008 in the US and to an extent in Euro area\(^1\) led to a sharp decline in international trade around the world, gross domestic product (GDP) in advanced economies, and growth in the emerging markets and developing countries. With growth projections and risks relating to the advanced economies (US, Europe, UK) changing from quarter to quarter, the world economy has been on a roller coaster ride since 2008.

The IMF’s update on the global economy released in January 2013 indicated that the growth rates for 2013 in most countries (advanced and major emerging), have been revised downwards from the projections made in October 2012. The update brought out a downward revision of the growth rate projections for the US and many countries in the Euro area. In the emerging markets, India, Brazil, Russia, and South Africa were the countries for which a downward revision was made. The update also indicated that the space for further policy easing had reduced, while supply bottlenecks and policy uncertainty have hampered growth in some economies, with a specific mention of Brazil and India. An analysis of the growth rate of select major emerging markets over the last decade shows that while many countries recorded large negative rate in the GDP, India and China continued to record positive growth over the period (Table 2).

**Twin deficits**

The slowdown in the domestic economy and the uncertainties in the global economy had an impact on key macro variables in India. By February 2013, India was in the midst of high twin deficits of GFD and CAD and despite continuous efforts towards addressing the twin deficits the situation persisted (Table 3). The global crisis had directly impacted the fiscal situation in India. The sharp slowdown in industrial production led to slowdown in overall GDP growth affecting tax revenues — especially corporate income tax — and the tight monetary policy since March 2010 dampened investment, subdued financial markets, and hampered planned disinvestment by the government. The rising prices of oil and fertilisers implied higher expenditure on subsidy. The GFD, though high, has been on a declining trend but a sustainable fiscal consolidation would require bringing current spending, especially on subsidies, under control and protecting the level of capital expenditure while also raising tax to GDP ratios. The future course of strategy would generally be to

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\(^1\) The Eurozone, officially called the Euro area, is an economic and monetary union of 17 European Union member states that have adopted the euro (€) as their common currency and sole legal tender. The Eurozone currently consists of Austria, Belgium, Cyprus, Estonia, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Malta, the Netherlands, Portugal, Slovakia, Slovenia, and Spain.

**Table 2 Growth rates in major emerging markets (percentages).**

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<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Brazil</td>
<td>5.7</td>
<td>6.1</td>
<td>5.2</td>
<td>−0.3</td>
<td>7.5</td>
<td>2.7</td>
<td>1.0</td>
<td>3.5</td>
</tr>
<tr>
<td>China</td>
<td>10.1</td>
<td>14.2</td>
<td>9.6</td>
<td>9.2</td>
<td>10.4</td>
<td>9.3</td>
<td>7.8</td>
<td>8.2</td>
</tr>
<tr>
<td>India</td>
<td>7.6</td>
<td>10.0</td>
<td>6.9</td>
<td>5.9</td>
<td>10.1</td>
<td>7.9</td>
<td>4.5</td>
<td>5.9</td>
</tr>
<tr>
<td>Mexico</td>
<td>4.0</td>
<td>3.2</td>
<td>1.2</td>
<td>−6.0</td>
<td>5.6</td>
<td>3.9</td>
<td>3.8</td>
<td>3.5</td>
</tr>
<tr>
<td>Russia</td>
<td>7.2</td>
<td>8.5</td>
<td>5.2</td>
<td>−7.8</td>
<td>4.3</td>
<td>4.3</td>
<td>3.6</td>
<td>3.7</td>
</tr>
<tr>
<td>South Africa</td>
<td>4.6</td>
<td>5.5</td>
<td>3.6</td>
<td>−1.5</td>
<td>2.9</td>
<td>3.5</td>
<td>2.3</td>
<td>2.8</td>
</tr>
</tbody>
</table>

P: Projections by the IMF.

Source: World Economic Outlook, International Monetary Fund.
remain on the same path due to inertia. Rather, measures that once an economy has recorded high growth, it will diate future but could do so with some lag and follow a J-
are undertaken need not yield higher growth in the imme-
for reforms in international institutions. The reforms that need significant contributions.) These issues are consistency in global economy. (In these discussions, Dr. Virmani has made
involve measures needed for recovery of the domestic and global economy as well as need for reforms in international institutions. The reforms that are undertaken need not yield higher growth in the imme-
date future but could do so with some lag and follow a J-
curve pattern. Finally, the policy makers should not believe that once an economy has recorded high growth, it will remain on the same path due to inertia. Rather, measures to ensure high growth would imply additional measures. These issues are presented in the following discussion.

### Global complacency

When the global financial crisis struck, the US economy and world exports and industrial production crashed during the second half of 2008, and the world stood at the brink of the abyss of a second great depression. However, almost every large economy undertook quick and effective fiscal and monetary policy loosening, many in tandem at the behest of the IMF. This led to limiting of the fallout and induced a V or U shaped recovery in 2009—10, in terms of production in the advanced countries and growth in the emerging economies. This in turn induced a misplaced confidence in the resilience of each economy among economists and informed public opinion makers, and engendered a sense of complacency in governments and political establishments across the world (GOI, 2009). This resulted in the neglect of basic economic reforms that were essential for restoring economic growth to its full potential, both in countries where the crisis originated and in emerging economies that suffered collateral damage from this "great recession" (Virmani, 2012a). With the underlying problems remaining unresolved, persistent political gridlock in the US and the Euro area countries further aggravated the financial crisis in mid-2011. Since then, other financial crises have taken off from the Euro area. This has created a high risk atmosphere in economies across the world, including India where growth continued its downward spiral (Virmani, 2011a).

### Need for quota reforms

The recent financial crisis revealed that China and India could withstand the crisis and maintain high growth while the advanced countries were not only at the epicentre but could not stage a recovery for nearly five years after the crisis. Similarly, there are emerging markets such as Brazil, Russia, Indonesia, and South Africa which are performing well. Therefore, much has changed in the world economic situation since 2008, and China and India are gradually emerging as potential superpowers. Accordingly, it is essential that quota reforms are undertaken in the IMF to reflect global reality. The IMF uses a quota formula to guide the assessment of a member’s relative position that

### Table 3: Select Indicators: External sector.

<table>
<thead>
<tr>
<th>Year</th>
<th>Total external debt to GDP</th>
<th>Short term debt to total debt</th>
<th>CAD/GDP</th>
<th>CR/CP</th>
<th>DSR</th>
<th>CR/GDP</th>
<th>Import cover of reserves (months)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1995–96</td>
<td>27.0</td>
<td>5.4</td>
<td>–1.6</td>
<td>88.8</td>
<td>26.2</td>
<td>14.0</td>
<td>6.0</td>
</tr>
<tr>
<td>2005–06</td>
<td>16.8</td>
<td>14.0</td>
<td>–1.2</td>
<td>94.8</td>
<td>10.1</td>
<td>24.0</td>
<td>11.6</td>
</tr>
<tr>
<td>2011–12</td>
<td>20.0</td>
<td>22.6</td>
<td>–4.2</td>
<td>87.0</td>
<td>6.0</td>
<td>28.6</td>
<td>7.1</td>
</tr>
<tr>
<td>2012–13</td>
<td>20.6</td>
<td>24.4</td>
<td>–5.4</td>
<td>na</td>
<td>5.8</td>
<td>na</td>
<td>7.3</td>
</tr>
<tr>
<td>End-Dec</td>
<td></td>
<td></td>
<td></td>
<td>na</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

CR — Current Receipts; CP — Current Payments; DSR — Debt Service Ratio; CAD — current account deficit; GDP — gross domestic product.

Source: Reserve Bank of India and Government of India.
includes gross domestic product (based on market exchange rates and also on purchasing power parity), openness, economic variability, and international reserves. Traditionally, these variables have been chosen to reflect the multiple roles that the quota formula was designed to address — vote share, resource contribution, and access to loans (Cooper and Truman, 2007). Thus, the quota formula determines both the quota contribution and the vote share of the members of the IMF (except for the basic vote which is assigned equally to all members). In a rapidly changing global economy, a rational and reasonable quota formula reform is fundamental to the credibility and legitimacy of the IMF (Virmani, 2011b, 2011c). Unless the power balance in the IMF changes to reflect the changes in economic power in the world economy, the IMF will inevitably lose credibility as an international institution (Virmani, 2012b).

This would reflect in the ability of the IMF to influence important economic policy decisions in different countries. This was reflected in the fact that during the Euro crisis, the emerging markets could not influence some significant policy decisions at the IMF (such as capital flows, stricter regulation and supervision of financial institutions, and easy monetary policy) and countries in the Euro areas. These policy measures, after five years of prolonged crisis, are now being reversed by the IMF.

There is a tectonic shift taking place and there is a very high probability that in terms of global power, the world will become bipolar by 2025 and tri-polar by 2050 (Virmani, 2005b). China’s economy is likely to equal the US economy in size by 2020 and to become about twice its size by 2050. By then, India will be the second largest economy in Purchasing Power Parity (PPP) terms, having overtaken the US in 2040. The gap in “power potential” between China and the US will be eliminated by 2040. Therefore, the IMF should recognise the role of emerging markets in the global economy and grant them more powers at the IMF.

J-curve hypothesis

A number of reforms were introduced in India in September 2012 but they did not make any visible impact on industrial output and on general growth in the economy. This raised a fundamental question as to whether there is a lagged effect of reforms on growth. Earlier, a number of reforms were introduced during the 80s and 90s in India. The country achieved a considerably higher growth trajectory, due to the limited economic reforms of the 1980s, though with a lag. Later, India carried out deep and wide ranging liberalisation of domestic and external policies in the 1990s. The economic reforms of the 1990s raised the growth potential of the Indian economy and put it on a higher growth path (Virmani, 2009). Yet, the growth rate in 1990s did not increase significantly and immediately. An important question that logically followed was how the limited reforms of the 1980s could increase the growth rate by two percent points, while the relatively major reforms of the 1990s had virtually no effect on the growth trend. This issue was discussed in detail by Rodrik and Subramanian (2004) who argued that reforms in the 1990s were pro-market, not only favouring the interests of existing businesses but also new entrants and consumers and therefore took some time to get reflected. Singh (2005) discussed the political economy aspect of the reforms in the 1990s. Helpman (2004) argued that major inventions can trigger an uneven growth trajectory which starts with a prolonged slowdown followed by a fast deceleration. There could be many reasons for this and Helpman and Rangel (1999) had argued that on-the-job training that raises the productivity of workers also means that technology specific skills are lost when a new technology replaces the earlier one. As per Virmani (2005a) and Virmani and Hashim (2011), due to the enormity of the change following economic reforms, the transition from the old globally inefficient structure to a new more efficient structure takes the J-curve shape in productivity and output growth. The organised manufacturing sector in India has also witnessed J-curve pattern of productivity growth in the post reform period. Transformation of an economy from low income to upper-middle income takes many decades. A country is required to keep working towards facing changes taking place and challenges from within and also outside the country. Faster the growth, greater the change; with such growth, the trade-offs are constantly changing, and require a constant re-evaluation of the existing policies and institutions. Ironically faster growth also brings along some negative effects. As a country shifts from a low income category to the lower-middle income category, institutional adaptation and reforms also become essential.

Shooting stars or sprinters

There was a general belief held by some policy makers and part of the media in India that once having achieved a growth rate of an average of 9% or above, the economy would never go down below 8%. The expectations of the people and politicians in the country were also high and there was pressure on the Planning Commission to factor a growth of 10% or more in the next Five Year Plan. However, there were some economists and policy makers in the country who cautioned that growth inertia does not carry too long and far, unless fundamental reforms are implemented and the investment levels are maintained at a higher level. Similarly, it appears that many people across the world believe (a misconception) that achieving an average growth rate of 9—10% over 10 years is a simple task. Scores of countries have grown very fast, with GDP growth rates of over 8.5% for a few years, but only a limited number have sustained this average for a decade. To sustain growth, a number of factors are important. Hsieh and Klenow (2007) show that price of capital goods is an important determinant of investment and rising prices of capital goods could slowdown investment. Eichengreen, Park, and Shin (2011), find that substantial impact on growth can be ascribed to decline in contribution of total factor productivity where investment, FDI, and policy environment have a role to play. Virmani (2011d, 2012a, 2012c) terms this short term high growth which peter off easily and sustained long-term growth as the phenomenon of “shooting stars” and “sprinters”, respectively. Generally, fast growth of a country in one decade is not a guarantee of equal success in the following decade. The key to transforming a low income economy to a middle income one is sustained, fast economic growth. Sustained fast economic
growth cannot be taken for granted. Growth can successfully result in a structural transformation from a low income economy to a middle income economy and from a middle income economy to a high income economy. Many countries have experienced fast growth (average of five years or more — shooting stars), but very few countries have sustained fast growth for a period of a decade or more (sprinters). Sustaining fast growth over decades is a very challenging task. Also, policy reforms required for sustaining fast growth are not necessarily the same as those required for accelerating growth.

Interview with Dr. A. Virmani

Prof Charan Singh (CS): To begin the interview, we would like you to tell us something about the Indian economy. It has been slowing down recently, in the last two or three years. And we would like to know your views on the remedial measures to arrest this decay and to reverse the trend in the Indian economy.

Dr. Arvind Virmani (AV): Since 2011, if one looks at the quarterly data, Indian industry and economy have been showing a clear downtrend. In one sense it is not a surprise, given that one was located in the global economy, and the external situation was so bad. By the end of 2011 it was quite clear that the economy would slow down unless remedial measures were taken. The main policy measures which have to be taken are fairly clear. The most important is a correction of the macroeconomic management which has resulted in one of the longest periods of sustained high inflation, sustained rise in the current account deficit, fall in the savings rate, the rise in gold (which has been noted) and so on. All these indicators have simultaneously worsened over the last three years. One of the key reasons for this is macro policy and in particular the fiscal monetary mix. What we need to do first and foremost is to dramatically reduce the fiscal deficit and simultaneously loosen the monetary policy. These elements, which I have pointed out above are clearly indicative of various supply and demand imbalances at different levels, from the micro to the macro economy. So the first order of business right now is to correct the fiscal trend, and the second is to focus on reviving private investment which again has declined dramatically over the last few years.

CS: Sir, as you have been the Chief Economic Advisor to the Government of India, we would like your comments on the following: Just before the budget, we have seen that the prices of diesel, petrol, gas, have been delinked. We understand that there is a problem with subsidies and the budget. But do you think that this is the right way to do this? Would such an adjustment not be inflationary for the country?

AV: The ideal situation in my view would be that administered prices be totally freed up so that they have no relationship with the budget at all. Unfortunately they have come to be linked with the budget and it is useful to understand why this is so. Basically it is because prices are controlled, and related to that is a subsidy which must be paid to the oil companies, many of which are public sector companies. So willy nilly the two get linked because subsidies have to be provided for in the budget. The budget makes a provision for subsidies on diesel, petrol, gas etc. which is based on two factors. One is projection of the international price, and second is administered price decisions of the Government to the extent these are controlled by the petroleum ministry. Ideally, they should not be so linked because if they were market linked then they would rise when international prices rose and fall when international prices fell and there would be no link to the budget at all. That would be the ideal situation.

What I have long suggested and fortunately what is beginning to come into play now is the following: What really hurts the middle class and particularly those with relatively fixed levels of income are the sharp changes which result when you hold off on price increases for months and years and then increase them sharply. So if you could let them loose and maybe prescribe a maximum limit, maybe maximum of one rupee per month or two rupees, then people would not even notice that the prices were changing.

CS: How about the inflationary impact of petrol, diesel, gas prices? Any special study done and any predictions?

AV: That’s a good question because everybody assumes that it is a cost push world and whenever you raise diesel prices, inflation will rise. But I have often tried to explain to the public when I was the CEA, that a rise in price is not inflation, it is a one-time change. It becomes inflation when the rate of increase of prices increases. Yes, the perceived inflation or the rate which is announced goes up, and then you have a one-time increase in price of diesel, gas, and petrol. But it does not affect the inflation that is, or should really be, the target of monetary policy. Now of course this is very easy to say but harder to do when the public starts clamouring, because prices do go up faster for a while; however, it is still important. But the way to look at it in the Indian situation is you have a trade-off. You can either have an explicit increase in prices or you raise the fiscal deficit and that feeds through the whole economy and has an inflationary impact on the whole economy, not just on the relative price of diesel or petrol or LPG. So my understanding of the research is that at worst, this effect over a reasonable period of time is neutral and optimistically it has a positive effect because a fiscal deficit affects the whole inflationary environment as against the diesel price which affects the particular price of those sets of goods. So in a reasonable time period, let us say over a period of 9–12 months, it may actually reduce the rate of inflation. Of course the initial impact is a rise in prices, there is no doubt about that.

CS: That is a good point and I think the market does not understand that the rise is a one-time occurrence; it does not impact inflation and the link through gross fiscal deficit.

We have been reading your research and you have mentioned savings and investment rates. How do we raise the savings and investment rates? They have both suffered in the recent past. And how do you think we should deal with the widening current account deficit?

AV: When I analysed the balance of payments crisis of 1991, some simple research showed that every 1% rise in the current account deficit of the Central Government resulted in roughly 0.5% rise in the current account deficit. Now I do not know what the exact numbers are currently because that was 20 years ago, but I would not be surprised if one got similar sort of results today.

The second point is that the decline in savings rate is unprecedented. Historically we have never had such a
FDI reform; the supply chain needs to be modernised. It is goods
With regard to agriculture, the relative price of agricultural
period relates to i) agriculture and ii) the energy sector.
The preliminary analysis that I have done of the recent
demand balances. The analysis reveals two major issues.

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of inflation?

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of growth.
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be done if we want a quick return of the growth rate to the
neously. The Government made a beginning in the October
gradually. Everything does not have to be done instanta-
whole host of policy reforms which need to be implemented
had this huge pump priming, which was not sustainable.
which did not happen. On the contrary, in 2010
complacent and then the investment rate collapsed
pumped up the economy which may have caused us to get
illusion of high growth for two years when we
had to wind down in 2009–10, which did not happen. On the contrary, in 2010–11, you
had this huge pump priming, which was not sustainable.

So what do we need to do for investment? There is a
whole host of policy reforms which need to be implemented
gradually. Everything does not have to be done instanta-
eneously. The Government made a beginning in the October
to December 2012 quarter. But in my view, more needs to
be done if we want a quick return of the growth rate to the
8% level, which I believe is the underlying sustainable rate
of growth.

CS: Inflation, you just mentioned, has been sustaining
for a very long time. And it has been very high for the last
three years. It influences all the policy areas. What would
be your advice to policy makers and to the general public
on inflation?

AV: We have already talked about the fiscal, so I will not
repeat that. But besides that, one needs to look at the
individual sources of inflation and at the sectoral supply-
demand balances. The analysis reveals two major issues.
The preliminary analysis that I have done of the recent
period relates to i) agriculture and ii) the energy sector.
With regard to agriculture, the relative price of agricultural
goods — inflation has been high and we need to try and
address those issues. A beginning has been made through
FDI reform; the supply chain needs to be modernised. It is
ancient and inadequate to the faster growth and bigger
demands from the urban areas.

Second is the energy sector where you have a combi-
nation of things. One is the pricing, because the price has
become distorted. It is not just a question of subsidy
because you can delink subsidy from prices and you must do
that. The prices must reflect the opportunity cost which is
why you get the imbalance. You need to bring down rate of
growth of demand, by freeing prices. If you need to give
subsidy it has to be done in a different way rather than by
holding prices. There are certain other problems associated
with energy. For instance, we finally managed to get a lot
of investment into power, which has been a problem for ages,
but then we have a monopoly coal producer. It is a Gov-
ernment monopoly. Though we have all this capacity there
is no coal to run these power plants, which are just lying
idle. So there are number of policy reforms needed in the
energy sector. One of the simplest would be to de-
nationalise the coal industry, if not formally through the
legal system, then by allowing more entry. For example,
you could break up Coal India into the four coal companies
which you used to have earlier and allow them to compete.
You could allow private sector companies to set up coal
mining companies. The cleanest way would be to change
the Coal Nationalisation Act. But you can do a lot without
doing that.

CS: Sir, you seem to have done lots of work on J-curve on
productivity and growth. And in the recent months Gov-
ernment of India has introduced a number of reforms.
Given the J-curve analysis, how do you expect the growth in
the economy to take off now?

AV: Interesting question. The point about the J-curve
was the difference between marginal reforms and major
reforms. The argument of the J-curve was, when you have
very large reforms, they lead to a change in the structure of
the economy. And to change the structure of economy, it
takes time and it requires extra effort. For example when
you liberalise or reduce tariffs and quantitative restrictions
(QRs), some sectors suddenly become uncompetitive and
others become competitive. Therefore you could get a fall
in the measure of productivity. It will take a little time
before you see the benefits of competition and productivity
increase. This is what happened in the early 1990s and
through the 90s.

In the current situation, we are talking about the case
where reforms came to a halt or became very slow. So the
question is to revive the reforms. While it is not directly
relevant to the current situation, we do get a related or
opposite phenomenon of hysteresis because in some
sense there was a lag in addressing the real problems. If
the same reforms had been carried out two years ago
(let’s say), the economy would have revived much faster.
But given that for two years we did not do certain things,

2 In economics, hysteresis arises when a single disturbance affects
the future course of the economy. An example of hysteresis would
be the long-term effect of unemployment. Hysteresis results
because unemployed resources are permanently changed, through
loss of skills, determination or seniority. The result is a permanent
increase in structural and frictional unemployment and a higher
natural unemployment rate.
this leads to an accumulation which is the inverse of the J-curve, and this means that the recovery will be a little slow or you have to make a bigger effort to get it back on track. I expect that it will take at least six months for us to see the impact of the reforms carried out at the end of last year and hopefully in this budget. But the economy will not suddenly go back to 8% growth. For that to happen, we will need many more reforms and it will take probably another year.

CS: We now want to talk to you about the international scenario, specifically the FDI flows to India. Comparatively they are reasonably lower than FDI flows to other countries. And this, despite the fact that India is a democratic country and has been generally doing well. What would be the reasons? How do we improve the FDI flows to India?

AV: That is a good question. There are two broad reasons. One, a positive reason, is that in some senses Indian entrepreneurship, particularly Indian dynastic entrepreneurship is very strong. In one of my earlier papers, I labelled India's growth since 2004 as "Entrepreneur Led Growth". I had pointed out that the problem holding India back was poor governance. The Government was actually a drag on the economy and because of the good dynastic entrepreneurship we were able to overcome that drag. Now what that means is, in some sense, there is less of an opportunity or scope for FDI. That is a positive.

But on the negative side is a huge problem, which is the attitude of the bureaucracy and of our systems, including our political system resulting from what I call the heritage of the East India Company. We still have a suspicious attitude towards companies and the private sector when most of the world, the part which is doing well and which attracts a lot of FDI, has a positive attitude. They look at investment as a generator of jobs and income. Unfortunately our bureaucracy has not been trained to think like that. It is beginning to change, it has changed among the young, but I do not think it has changed as a system. These indices of governance, of corruption, of whatever you want to call it, affect both domestic investment and FDI. But because the foreigners are not used to dealing with this type of governance or corruption, while (to some extent) our domestic entrepreneurs have got used to it, this constrains FDI. If we want to grow faster, we have to address this issue.

We have tried to address this problem several times before, but not successfully. The basic attitude towards those who create jobs and income has to change. For example (perhaps it is a dream), if you could incentivise bureaucrats and Government servants, to be rewarded on the basis of the number of jobs they maintain or create, in whichever area they are running, that could transform the whole picture, both in the economy and with respect to investment.

CS: China has been doing so very well in the last two decades or more. Also, China has been strategically gaining on all fronts. They have very good relationships with their neighbours, they are taking very strong steps in far off countries, as well as international institutions, and they have established themselves in a big way. Would you like to comment on India's foreign policy and diplomacy and any learning that Indians need to do from China's diplomatic strategy?

AV: It is an extremely good, but complicated question. So let me just give a few observations. We must remember that China’s GDP is now about two to two and half times ours, in real terms. So they have more money. Secondly because theirs is a Communist party led government, they are less subjected to short-term pulls and pressures than a democracy like India is. What does that mean? Well, we have so many different interests that we are unable to define or constrained in defining a simple, straightforward, clear policy with respect to the external world. Despite that we have managed to do some things. The difference really is that China is very clear about its objectives. They have a small number of very clear objectives. And the whole system works towards achieving those objectives. Once they (the party leadership) decide that an issue is of interest to them, they use all their resources and they focus everything on that.

So what is the lesson for India? I think the lesson is that one, we have to have a little more clarity on our external objectives. Second, we must co-ordinate across departments which deal with the outside world. Often that common understanding is not there, to the same extent as it is in every country which is successful diplomatically. And third, sometimes one needs more resources. There does not seem to be enough interest in India to do the academic work or the background work which one finds most successful countries have done. They have a number of options generated by think tanks. We lack that. So these are the three simple things I would point out.

CS: Sir, there has been a slowdown globally and China’s economy is still maintaining some growth, though slowly. What are your views on the impact of China’s growth trend on the Indian economy?

AV: Since around 2000, I have been forecasting a gradual slowdown in the Chinese economy. If you look at their rate of growth relative to the world, it has actually been on a declining trend. I think that will continue. And the reason is very simple. It is what we call catch up growth; we know from history that growth always slows down as the per capita income rises and though China has been able to beat the odds over two or three decades, at some point, this will not continue. So China's economy is slowing down and I had earlier forecast that it would slow down below India’s by around the middle of this decade. Unfortunately India’s economy has slowed down even more in the past year or so, so my forecast is in doubt right now. But I am hopeful; if India does what it has started to do in the last six months, and follows through and does not give up, we could still get back to our kind of rising trend relative to China.

As far as the second part of your question is concerned, I do not think there is a direct link between China's growth trend and the Indian economy. China is really an export oriented economy and the only countries that benefitted from China (this is not conventional wisdom, it is my view) are the resource exporting countries. As we are not a major resource exporter, there is no clear direct link between China’s growth and the Indian economy.

CS: The next question is on external shocks. In view of the global meltdown and repercussions, according to you, what should be the focus areas of reform initiatives to shield India from external shocks?
AV: As I mentioned earlier, if we had reaccelerated or stepped up our reforms two years ago, we would have been shielded from the slowdown. Unfortunately because that was not done the slowdown has affected us. We need to reaccelerate the reforms in various sectors. One specific factor is that the net asset position of India abroad has deteriorated during this process. We have already discussed one aspect of this — the current account deficit. What that means is that our net debt position globally as a country has worsened over the last two to three years. Since the problem has accumulated, it will take a longer time to solve and that is unfortunate. However, in many of the developed countries fiscal deficit has worsened even more. So relative to them perhaps the danger is not so much. That gives us a little hope and a small window to solve it. But if these problems go unaddressed along the lines we have indicated earlier, then there could be a real problem. But I am very hopeful that measures will be taken to address the problems.

CS: Sir, there has been some news that BRIC nations could be using local currencies or local currency could be considered for trade in BRIC countries. What do you think about this?

AV: Well I think it is more of a political statement, more to do with the trust between whichever countries are involved. Given our current power position in the global institutions, at least three of us, India, Russia, and Brazil are not in a position to independently exercise great influence. So acting jointly with Brazil and Russia helps us to raise our profile internationally. And of course if China joins to form a solid BRIC, which it does occasionally, that helps even more. So I would say this is more a political statement than an economic statement.

CS: Sir, you have been the Executive Director at IMF. Could you guide us or tell us how India can improve its quota and say in the IMF?

AV: What we have done in the last two to three years in the IMF (as ED) is to say that the basic quota formula which determines the quota share and the vote and say in the IMF, is flawed. And that we need to reform it. We have given many suggestions which have proved convincing and probably so strong that people opposed to these changes are falling back on politics to counter them. So the battle or debate has shifted from real economic issues to the basic political issue that those who are in power do not want to give it up. So it will have to be fought at some political level now.

CS: Finally there was a proposal of the Asian Monetary Fund. What would you think of this proposal?

AV: It is called the “Chiang Mai initiative”, but it is exclusive. It is based on what people call ASEAN plus three. The ASEAN countries, plus China, Japan, and South Korea. It is a system that is exclusive or exclusionary because it does not include all Asian countries. It certainly does not include India. And in my view, that is not a good way to develop Asian institutions. As of now I do not see any move or effort to develop it into an inclusionary system like the Asian Monetary Fund where by definition if it is Asian, all Asian countries should have the right to be members. I do not think that is a very immediate or even medium term possibility.

CS: Sir, thank you so much for your time. It has been very illuminating for us to listen to your opinion on various aspects of the domestic economy as well as international evolutions.

References


