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# The Unfolding Global Crisis: What It Implies for India's Growth[**]

Ladies and Gentlemen:

It is a pleasure to be with you at ASCI again after two years. It was in August 2008 when I last spoke to you about the economic turbulence and financial shocks that the global economy was about to experience. It is of no satisfaction that most of what I said has come to pass in one way or another. Today, I will try to provide further personal insights on what the future might hold for the world over the next five years and what that might mean for India.

The last two years have been difficult. The global recession that occurred in the industrialized, developed world in 2008–09 was deep but surprisingly short-lived. From peak-to-trough, the major developed countries—in America, Europe and Japan—experienced a loss of nearly 7 per cent of their aggregate output in 2008–09. In nominal dollars, that loss amounted to US$ 2.5 trillion, or twice the size of India's economy. In 2009–10, we saw a shallow recovery of less than 1 per cent in these three economic blocs. But the gap between global productive capacity and output remains large at around 9 per cent of global GDP. That size of gap demands a much greater amount of global growth before a sustained investment-led recovery can take hold and establish itself firmly once again.

Many who believed in coupling and contagion were surprised that the major emerging markets—comprising mainly Brazil, India and China—did not experience recession. Some contagion was apparent in the last quarter of 2008 as global markets went into meltdown after the Lehman debacle. In the early months of the crisis, the inter-linkage across national financial

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systems—even relatively closed ones with capital controls like India's—was undeniable. But global markets realized quickly that *emerging* countries were in better shape than developed economies, which were *submerging*. Large emerging economies like Brazil, Russia, India and China, the BRICs, were quite capable of growing with their own large internal markets and robust domestic demand from an emerging middle class. Compared to the *submerging* economies, the large emerging economies went through a relatively small growth recession.

In Brazil, growth fell from 5 per cent to 3.5 per cent. In China, it fell from over 10 per cent to 8 per cent and in India from over 8 per to 5.5 cent at the bottom of the recessionary cycle. All three recovered swiftly. In 2009–10, growth in Brazil has been restored to 5 per cent. In China, growth exceeded 11 per cent earlier this year with some clear signs of over-stimulation emerging. It has since cooled to below 10 per cent. China is stepping hard on the monetary brakes in the face of: resurgent inflation, overborrowing by local authorities and a property market bubble. In India, growth is back to over 8 per cent. Here too, inflation has run ahead of itself, but for different reasons. In India, the monetary brakes are also being applied; but perhaps, more artfully than in China.

The shallowness and brevity of the recession—which many commentators saw in 2008 as signalling the end of market capitalism and Anglo-Saxon finance—is widely attributed to timely fiscal and monetary intervention on a coordinated basis by governments around the world. The consensus established in the G-20 meetings of late 2008 and early 2009 held firm. But, though the crisis is not yet over, consensus and coordination in the G-20 have become elusive. Governments no longer agree on a single course of action. Continued stimulus no longer suits all countries. Why? For two reasons:

- First, it is clear that there are different and diverging trends in the three major economies of the world, i.e., America, Europe and Japan.
- Second, these divergences have fractured consensus about the advisability, feasibility and sustainability of continuing with fiscal and monetary stimulus, of the kind applied in 2008 and 2009, and whose impact is now fading.

Estimates of the aggregate fiscal and monetary stimulus provided since 2008 vary from US$ 3.5 trillion to US$ 7 trillion or between 6 per cent and 12 per cent of total global product. These estimates vary widely because of the 'guarantee' element of the fiscal stimulus provided to support banking systems around the world. Most of the fiscal stimulus needed for government intervention in bank recapitalization will be recovered when bank shares acquired by treasuries are resold to private shareholders. Similarly, many of the guarantees provided to underpin the value of bank assets may not be used. Thus, the net fiscal cost of the crisis may be lower than first thought. But that net cost will be reduced only over time. At present, the cost still seems very high.

The massive global fiscal stimulus administered in 2008–09 did prevent a long and deep collapse of the global economy. Yet, we are at an inflexion point in mid-2010 for two reasons:

- First, although collective stimulus seems to have worked, it has not yet restored the major developed economies back to a self-sustaining growth path.
- Second, although further stimulus may be needed, it is apparent that it is neither fiscally affordable, nor financeable in global capital markets.

The rapidly rising amount of government debt, caused by huge fiscal deficits in the EU, the US and Japan, threatens to trigger the next crisis in global finance by again destabilizing financial markets; especially global bond markets. If further stimulus were provided, it could only be done through more money printing (or 'quantitative easing') by central banks. Some monetary stimulus will have to be provided anyway, as fiscal stimulus is withdrawn, to ensure that contraction is not too large or too sudden. In the EU, the US and Japan, central banks have already printed over US$ 3 trillion since 2008. How much more can they print without financial markets losing confidence in the value of their money? Indeed, that question applies to India as well; although, the situation in India is different and more hopeful.

The sovereign debt crisis that is now unfolding around the world became most apparent in Europe when the debt problems of Greece hit the headlines earlier this year. That was followed quickly by the realization that other countries like Ireland, Italy, Hungary, Portugal and Spain were also overburdened by public debt that was unsustainable and unserviceable. But these are not the only countries that could hit the buffers. The UK, Belgium, the Netherlands and France are also building up public debt obligations on an unprecedented scale, calling into question the long-term viability of their public finances. The burden of interest payments on sovereign debt is becoming significant. It will soon amount to 15–25 per cent of annual public expenditure. Moreover, the increased holding of European sovereign debt of questionable quality by their financial systems have made European financial institutions shakier and probably under-capitalized to an extent that neither they, nor their authorities, want to make entirely transparent for fear of triggering a second round of market panic.

When this suspicion spread in global markets, there was a flight out of the euro and risky European sovereign paper in May-June of this year. There was an apparent 'flight-to-quality' with investors preferring US dollars and US treasuries instead of their European equivalents denominated in euros. But, that sense of security lasted only a couple of weeks when it became clear that the US was building up a sovereign debt burden on the same scale as Europe. In Japan, the relative size of public debt already exceeds the sovereign debt problems of the US and the EU by a considerable margin. Yet, the Japanese yen keeps appreciating against both the US dollar and the euro. Why is that?

The answer lies in how sovereign debt is financed. In Japan, as in India, about 95 per cent of sovereign debt is financed by domestic savings and domestic investors. Over 75 per cent of that debt is held to maturity. In the US and the EU, over 55 per cent of sovereign debt is financed by foreign savings and investors. For that reason, it is more vulnerable to greater volatility in perceptions of credit risk. Moreover, the sovereign debt of the US and European countries is rarely held to maturity. It is liquid and traded frequently in global financial markets. So, changing perceptions of heightened credit risk are translated more swiftly into discounted bond prices and widening credit default swap spreads. That leads to such debt becoming un-financeable when market perceptions shift in a negative direction.

All that said, what is likely to happen as a result? The heated debate among eminent economists about the need for continuing with the stimulus, versus the need for achieving swift fiscal consolidation through austerity measures, has now become irrelevant. The major economies have little choice now but to withdraw the stimulus at an appropriate pace, and consolidate their fiscal positions, so that the build-up of their sovereign debt and debt service obligations does not cripple their future. Does that imply we are on the verge of tipping into a double dip recession? The plethora of statistics on economic performance in America, Europe and Japan are emitting mixed and confusing signals. There is no clear consensus on whether a double dip—i.e., negative growth over the next two or three quarters—will actually materialize in the US, the EU and Japan. To many analysts that looks increasingly likely.

Economic output supported by the stimulus, such as housing and automobile sales, is slowing down as subsidies for such purchases are withdrawn. Household and corporate savings are increasing, while consumption and investment is adjusting in the opposite direction. Demand propped up by public finance in Europe, America and Japan will diminish as fiscal consolidation occurs and takes hold. For these economies to recover and start growing again on a sustainable basis, they will need to rely on substantially increased net exports to the major emerging economies, to oil exporters and to the developing world at large.

That leaves the three major world economies in a fragile and delicate state at this point in time. Self-sustaining growth in these economies, in an era of diminishing stimulus, seems to be elusive and distant. For countries like India, it implies diminishing demand in two of its largest global markets for goods. Does it also mean diminishing demand for the export of services that India specializes in providing? The answer to that question is more nuanced and bears thinking about. But, more importantly, for rebalancing to occur in the global economy, what is required is for major emerging economies to open themselves up to a greater volume and value of imports from the developed world, and to permit their currencies to be more market-determined in their relative values.

That imperative suggests that large and significant emerging markets like India, that have joined the trillion dollar club, and aspire to join the five-trillion dollar club, need to open up their economies more rapidly and more generally so as to benefit from, and contribute to, global investment and growth. These themes resonated loudly during the recent visit by the British Prime Minister and his large delegation. They will continue to echo with visits by the American President. But to add to these worthies, what India needs is similar visits by Chinese, Russian, Brazilian, Mexican and South African leaders and business delegations as well.

Like the US, the EU and Japan, the major emerging economies also resorted to fiscal and monetary stimulus in 2008–09 to ensure that global growth did not collapse. It is not completely clear how necessary that was or how much it helped. In China, it is becoming clear that the stimulus was overdone. Local authorities went on a spending spree supported by relaxed banking limits. Now they are in trouble with a debt overhang approaching US$ 1.5

trillion that they do not appear to be able to service. China has the wherewithal and the resources to tide itself over that problem without creating dislocations in either the Chinese or global banking systems. But it will mean retrenchment and domestic expenditure consolidation and adjustment that will reduce demand in China.

In India and Brazil, the *fiscal* stimulus was not overdone to the same extent as in China. But, the question does arise whether what they did was necessary. Recent indications suggest that the *monetary* stimulus may have been overdone in both countries although it was demanded by the fiscal authorities. Fiscal and monetary stimulus propped up growth by about 2 per cent in India last year and probably by about 1 per cent in Brazil. But there has been a cost to that growth-inducing stimulus. It has caused much higher levels of inflation than anticipated in both countries. Core inflation in Brazil and India is at, or is approaching, double-digit levels. Interest rates are now higher than in the developed economies in nominal terms. But, they are lower and negative in real terms. That does not augur well for the future. Negative real interest rates in high growth economies distort resource allocation and resource mobilization by providing perverse and artificial incentives to savers and borrowers alike.

The sovereign debt problems that are now so obvious across Europe—with the exception of Germany and the Scandinavian countries—have affected almost the entire developing world before, in the 1980s and 1990s. We would be sanguine if we believed that the sovereign debt mountain that has been built up in India over the last three decades—with public debt now approaching 85 per cent of GDP and more if all off-budget debt is taken into account—is not going to cause us a similar problem in the not-too-distant future. We have to take significant steps to prevent that happening. We must use the opportunity of sustained sovereign debt reduction over the long term to restructure our economy in a more efficient manner at the same time. India needs to bring down its public debt-to-GDP ratio (including all off- and on-budget debt liabilities) to a more manageable 40 per cent of GDP by 2020 if it is to retain its growth momentum and present itself to the world as an attractive destination for foreign investment.

In India, the effect of the stimulus on inflation was exacerbated by a poor monsoon in 2009, poor public food storage, distribution and supply management, and insufficient use of commodity price derivatives to provide protection against food price inflation. Unfortunately, high inflation has taken root. It has become structural in its impact. The recent reduction in fuel price subsidies—which was overdue and necessary—will add to inflation as increased fuel prices work their way through the entire supply chain for some time. From that point of view, it was mistimed. It should have been done earlier when fuel prices were low and inflation was under control. But there is never a good time for removing subsidies that have become systemically embedded for so many decades.

The monetary tightening needed to bring inflation under control quickly may be so harsh as to affect growth adversely. Pressing too hard on the monetary brakes will result in an uncertain and unstable stop-start cycle in the economy. The only sensible option is to tighten the availability of money gradually but relentlessly, at a pace that contains inflation over the next two years without sacrificing growth too much or too quickly. If we act precipitately, we run the risk of introducing self-defeating uncertainties about the future. That will have an adverse impact on the private investment cycle, which should be avoided.

Given this constellation of factors influencing developments in the major *submerging* and *emerging* economies, what are the growth implications for India over the next two to three years or over the remainder of this UPA-2 government's term?

India's growth is influenced more by domestic factors than by external variables. Around two-thirds of India's growth is domestically driven. A third is influenced by external circumstances. The country is not immune or impervious to what happens in the global economy. But India is less vulnerable than China or Brazil because it exports fewer consumption goods to the three largest markets in the world and its economy is more closed. But, by the same token, India's economy is less able to capture opportunity revenues that arise when global conditions are favourable.

With what is happening in the *submerging* (developed) economies, corporate India has unprecedented opportunities to invest abroad and secure a major role for itself in the global economy. The present situation provides an unusual window for corporate India to diversify income streams geographically, reduce currency concentration risk, and capture a larger global market share across the board, while acquiring knowledge and management skills it does not have.

Corporate India—especially our largest, most successful firms engaged in service outsourcing exports—must rethink their extant business models and strategies. They must reconsider what they need to do to acquire businesses in other countries, developed and developing, in a manner that ensures that they can secure and expand their market share of global services exports.

Such investment need not be at the expense of private corporate investment in India. In fact, opening the economy up will probably result in more net inward investment in Indian manufacturing, services and infrastructure. It will bring with it know-how, technology, as well as management and logistical skills that India desperately needs at this stage of its development. For that to happen, the Indian government will need to release its bureaucratic and regulatory chokeholds over investment by global foreign companies in Indian manufacturing, infrastructure (without raising the spectre of national security to prohibit such investment), and the financial sector. It will need to recognize that there is a major difference between regulation and repression and accept openly that India today veers toward repression, especially of foreign players, rather than impartial and genuinely independent regulation.

For Indian growth momentum to be durable and sustained, it cannot rely on the continuation of artificial fiscal or monetary sops and subsidies to finance it. It has to be driven by *private*, rather than public, domestic and foreign investment in the Indian economy, and by domestic and foreign consumption that favours a continuous and steady increase in Indian output and export of goods and services. Such growth has to be financed by domestic *and foreign* savings.

As this century continues to unfold, Indian policy-makers and businessmen will need to change their horizons and mindsets. They will need to realize that openness cannot be asymmetrical or a one-way street. India cannot remain open to inward flows of capital but closed to effective competition; and cannot have repressed foreign ownership of companies in its domestic market. It cannot participate freely in and benefit from an open global economy, yet insist on keeping its capital account closed and its currency managed on the lines of a dirty float.

Indian policy-makers and corporate leaders must refocus their strategic and perspectives to sustain and diversify India's future growth opportunities. They need to recognize and accept that the centre of global economic gravity has now shifted decisively from West to East. The global crisis of 2008–10 marks a vital turning point in that shift. That is not something that will occur in the future. It has already happened. As the years roll on, it is likely that trans-Himalayan flows of trade and investment—especially between India and China, but more broadly between West, Central and South Asia on the one side of the Himalayas and East Asia (including Russia) on the other—will become more important in driving global growth in the twenty-first century than trans-Atlantic or trans-Pacific trade and investment flows were in the twentieth century. India's companies and foreign policy establishment will need to turn their heads from left to right when looking at a map of the world to cope with that tectonic shift.

To my mind, Indian growth is less likely to be influenced by, or dependent upon, factors affecting growth in demand in the recession-disabled submerging economies of the EU, the US and Japan, which today are our main export markets. At worst, these markets will contract or stagnate for the next five years. At best, they will grow at an annual average rate of 2 per cent while attempting to: overcome their chronic problems of over-indebtedness; maintain standards of living they can no longer afford; and cope with a lack of global competitiveness because of inbuilt high social overhead costs.

To the extent that external influences matter, India's growth from now is more likely to be influenced by growth in demand in the emerging economies of West and East Asia, Africa, the Middle East and Latin America. It is also more likely to depend on lowering and removing decisively the domestic barriers to growth that exist in the form of: *(a)* infrastructure constraints that are becoming more acute and binding by the day; and *(b)* a lack of urgency concerning policy, governance and management reform across the board.

Sadly, I hear much rhetoric about both. But I see little real progress being made to relieve these binding constraints rapidly. I would not expect India to emulate China in these respects. But I would expect India not to languish in the bottom quartile of middle-income developing countries when it comes to making progress on these two critical frontiers. An interesting case study in contrasts lies in the difference between the way in which India has managed the Commonwealth Games and China managed the Olympics in 2008. We have much to learn from that contrast and to be embarrassed by.

Our infrastructure constraints are by now legendary. They need no further elaboration. One just has to drive a car or use public transport on any Indian road, take a train or plane, use an air-conditioner, wash basin or phone, to realize every minute how deficient our infrastructure is in absolute and relative terms.

Our reform agenda is as broad as it is deep. We have a large unfinished agenda in virtually every sector that affects every activity. Yet, India's growth remains impeded though not crippled by our:

- Dysfunctional political systems at the central, state and local levels.
- Overly bureaucratic and frankly ineffectual systems of public governance and administration, which get worse at every descending hierarchical tier.
- Judicial and legal systems that deny justice by delaying it unconscionably and by elevating technicality and process over substance and delivery.
- An inefficient, repressed and consequently underdeveloped financial system, which is not permitted to play the role that it should in mobilizing savings, financing corporate investment, as well as public and private investment in long-term infrastructure, and financing development more efficiently and effectively.
- Counterproductive legacy of state ownership and state intrusion in every economic activity without the state being able to perform the more basic functions of proper regulation and governance of these same activities.
- A public education system that is appalling, with islands of excellence in an ocean of mediocrity. That system denies the bulk of our people the basic human right of access to employment opportunities and self-enlightenment.

I have expatiated on all these themes too often and at length before. So I shall not repeat myself yet again in further detail. I am not sure what it will take to wake us up to make more rapid progress on these multiple and challenging fronts. In 2009, we thought that the results of the election would bring about a sea change in the volume and pace of progress in all these areas. But in the year that has followed, I am disappointed and disillusioned by what we have achieved. And we cannot blame the global crisis for our lack of progress on all these fronts.

The UPA-1 government put out the message that, between 2004 and 2009, little progress had been made on reform because of the constraints on government in a coalition including the Left parties that were opposed to market liberalization and reform. Those parties were punished by the electorate in 2009 as were communal parties bent on exclusion rather than inclusion. Yet with the clear mandate provided by the electorate for pushing ahead with reforms, progress still remains abysmally slow although the position of the reformers has been strengthened. All this is difficult to explain and sad to witness.

One can only conclude that resistance to change and reform was never a monopoly of the Left. Such resistance to reform and progress is probably as strong if not stronger within the political leadership of the current coalition and particularly in the leadership of the party dominating that coalition. No other reason makes any sense in explaining the lack of progress by a government that has three of the most progressive reformers in India at the helm of managing the country's economic affairs.

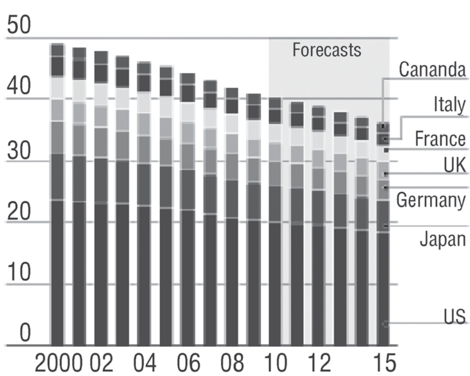
If that is where resistance to reform lies, then I see little hope of India making the kind of progress it needs to make to elevate Indian growth from a trend of 8 per cent to a new trajectory of over 10 per cent—or Chinese-style growth as our admirable and respected Prime Minister has mused about in public.

India needs such growth to address the problem of population growth and expanding labour force absorption. It needs such growth to anchor its place as one of the three most important and influential global economies of the twenty-first century and possibly the first among global economies at the end of that century. But, most of all, it needs such growth to deliver a decent life to all of the Indian population; not just the rich and the middle class. It needs such growth to deliver on the promises of internal and external peace, stability and prosperity made by our founding fathers but that remain unfulfilled.

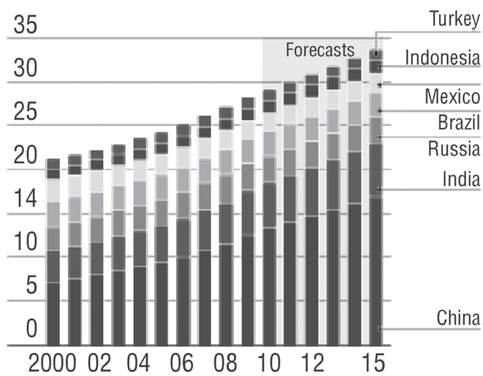
India needs rapid growth to rectify long legacies of: *(a)* development strategies and policies that have been proven to be misguided and misconceived; *(b)* endemic mis-governance at the central, state and local levels; and *(c)* a profound misunderstanding of the role of government in a modern, rapidly growing economy. In such economies, government needs to be an impartial leveller of the playing field, a promoter of fair competition and innovation; an independent regulator of economic activity, and not a player in its own right. Finally, such growth is needed to secure India's image of itself as the future *primus inter pares* in the community of civilized, democratic nations, as well as to secure its rightful place at the top table in managing and influencing the world's affairs and destiny.

That is all I shall say for the moment. Let me take this opportunity to thank the Chairman and Director General of ASCI for inviting me to this occasion and thank all of you for being here.

**Advanced countries' shares of global output**
% on PPP* basis

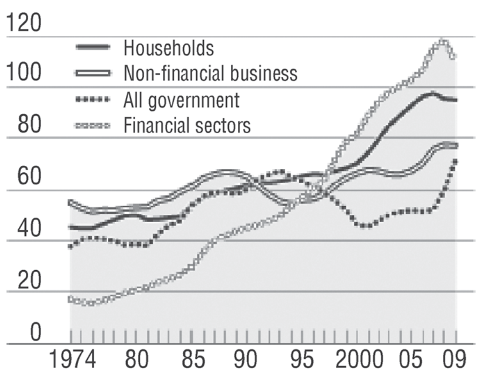



**Emerging countries' shares of global output**
% on PPP* basis

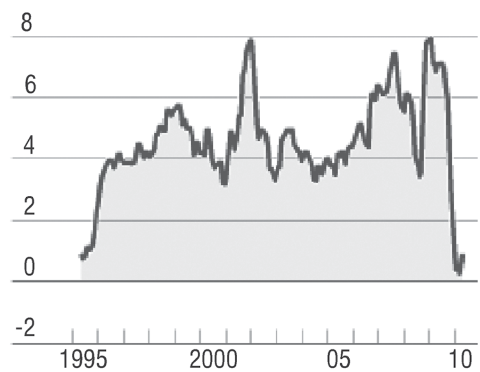



* Purchasing power parity

**US sectoral debt**
As % of GDP




**Global real broad money growth**
Annual % change




***Sources:*** IMF: Federal Reserve; Schroders