Saumitra Chaudhuri
Member, Planning Commission & Economic Advisory Council to Prime Minister

A Perspective from India on the Eurozone Crisis

CEPII – EIEBG
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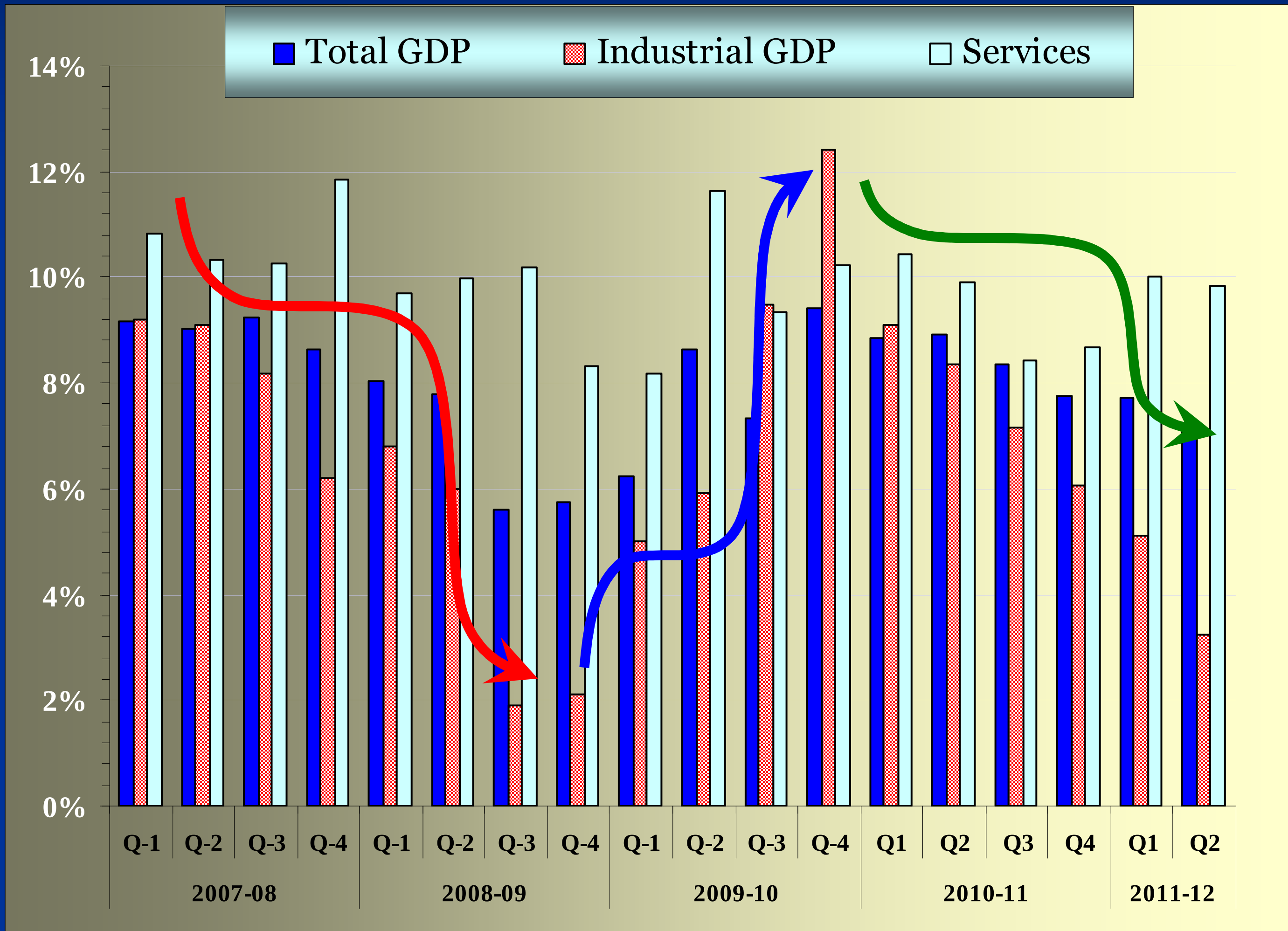
India, Global crisis & our Plan for the Future

The Impact of Global Crisis …

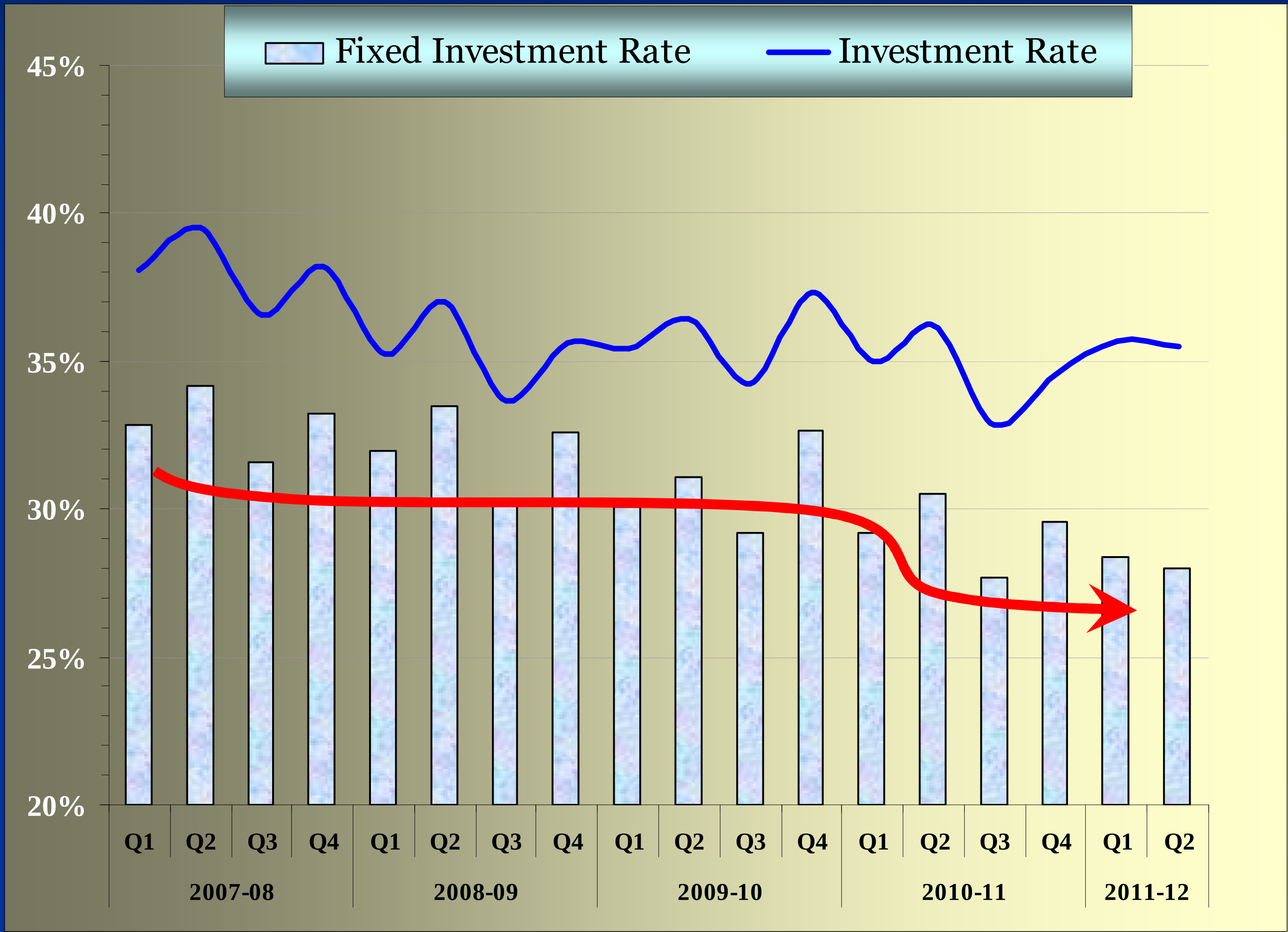
- On the Indian economy was significant. It slowed down growth by adversely impacting the channels of
  - External trade in both goods and services
  - Investment Financing
  - Business Confidence
- Recovery in output growth was sharp, but recovery in the pace of investment was much less pronounced
- Though domestic factors contributed, high inflation (partly due to high world commodity prices), poor global investment climate and risk aversion is not helpful in the recovery of the pace of domestic investment

Quarterly GDP Growth Rates



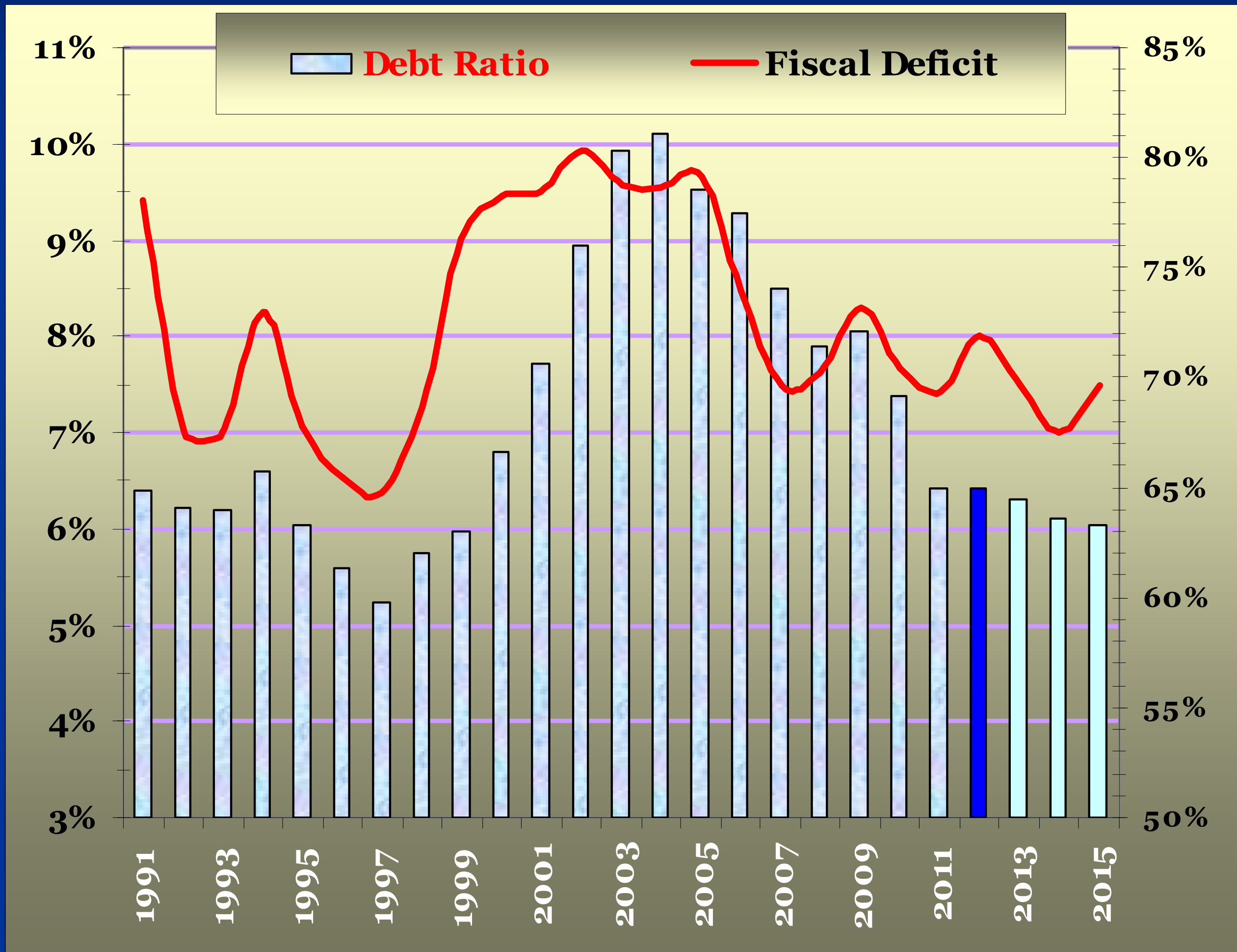
A rapid recovery followed by weak-ness in the pace of growth

Quarterly Investment Rates



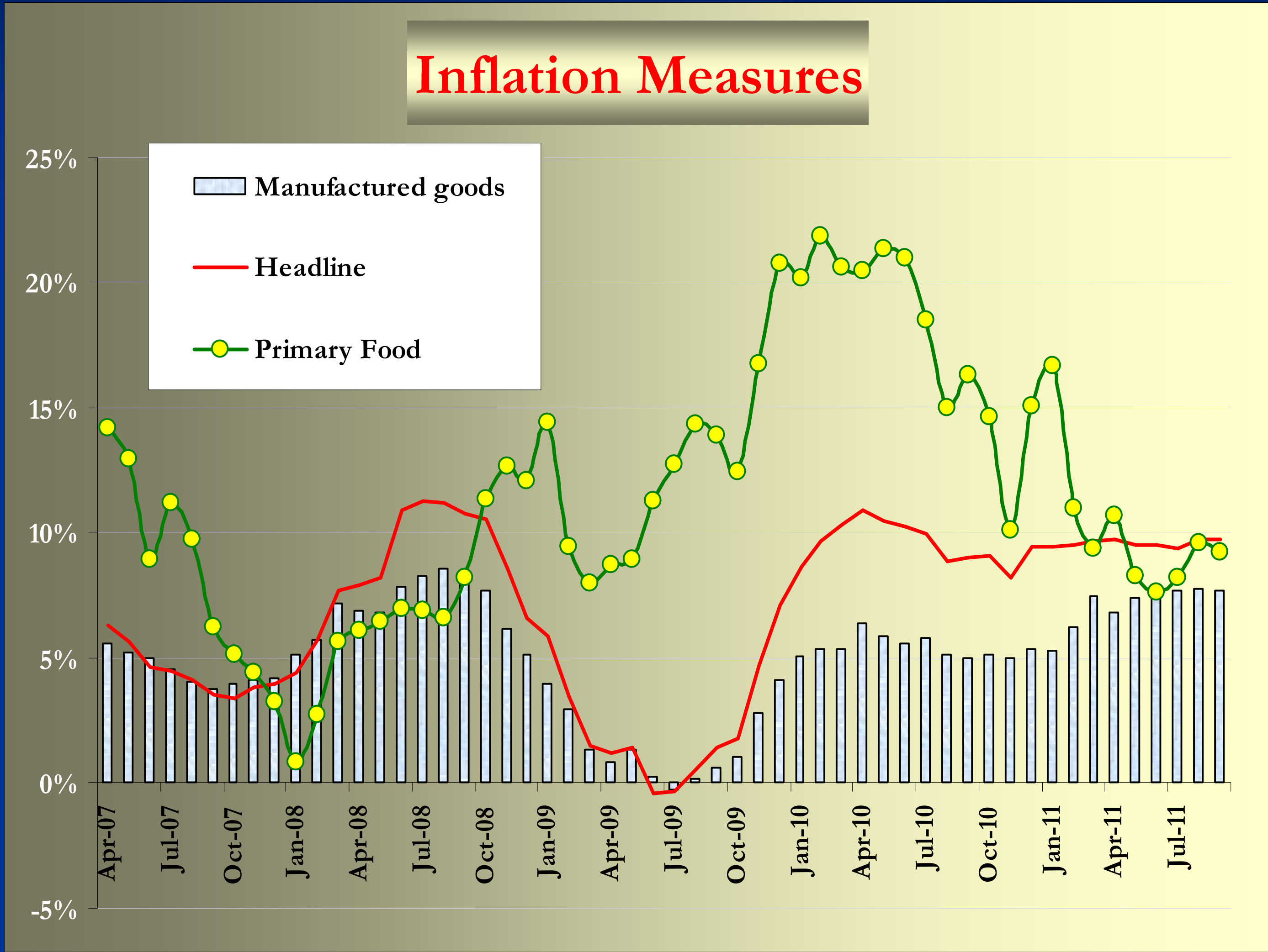
Investment has continued to slow down. Notable in Fixed Investment

Process of Fiscal Consolidation On



Fiscal situation weakened in the late 90s. Significant consolidation since then, despite the increase in deficits during the Crisis

Inflation has made things harder



Very high primary food inflation has raised money wages & passed in to pricing of manu-factured goods

Our plan for the Indian economy

- We recognize the difficult international economic and financial context
- However, we see that there are adequate sources of demand and productivity growth within the Indian economy to drive rapid growth provided our macro-economic balances are within prudent limits
- The Asian & African regions – our neighbors – can grow fairly rapidly for similar reasons, so closer trade, investment & financial integration will be helpful to provide additional sources of economic growth

12th Five Year Plan (2012–17)

- Planning for an average 9% GDP growth with
  - Modest increases in the fixed investment rate by ~4 percentage points of GDP from current levels
  - Domestic savings rate to go up by a similar order, mostly through fiscal consolidation
- Limiting current account deficit to 2.5% of GDP and coming down slightly in closing years
  - Inbound *net* foreign equity flows averaging 2.5% of GDP
- Headline inflation of ~5% with primary food & energy higher and other items, incl. manufactured goods at a lower level

This framework is realizable

- But tough to follow through on, in the difficult conditions that define the world today
- Uncertainty, risk aversion, high volatility are all elements that work against growth and promote under-utilization of capital and opportunity
- Which is why, India would like to see some of the uncertainty reduced.
- Thus, any improvement in the Eurozone would be a positive development to reduce instability and strengthen conditions that are conducive for growth

Crises in the Eurozone

Crisis and Destablization

- Every financial crises has great potential for destabilizing conditions for advancement
- Sovereign solvency issues are particularly problematic for they can draw out for much longer than private sector solvency crises
- Major factor that has supported broad-based and widely distributed economic growth was the favorable macro-economic conditions and policies over the better part of the past 30 years

Gains from economic openness

- The past 30 years has seen economic integration – trade & investment – on a more equal basis than ever before
- Better economic policies that emphasized fiscal & monetary stability, competition & market access did rejuvenate western economies from the economic & social crises of the late 1960s & 1970s
- Lowering of trade barriers resulted in unprecedented gains for developing economies and lifting of apprehensions about "neo-colonial intentions" of West
- South-South trade needed self-confidence regarding open policies and past 3 decades have given them that

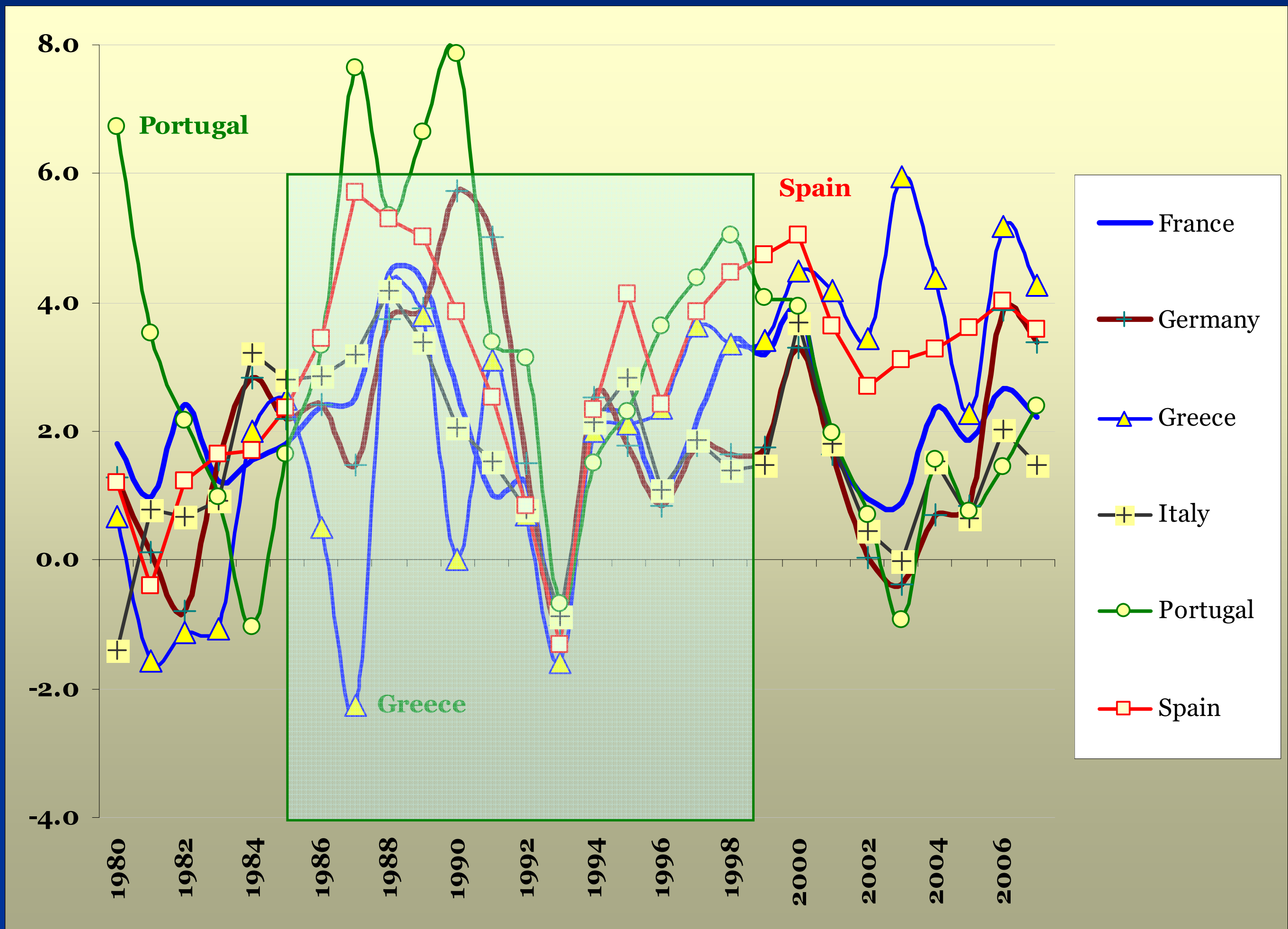
Crisis in Euro-zone is Perplexing

- And Vexing…. It is reminiscent of many things in our own experience … whether the comparisons are exactly accurate or not ….
- Despite the old economic policies evidently not working well, we were so unwilling to give up production & price controls, exchange controls …
- In Europe we see that the common currency union has yoked horses of very different caliber to the same carriage … Is it a surprise that the results are unfortunate …..

With apologies ….

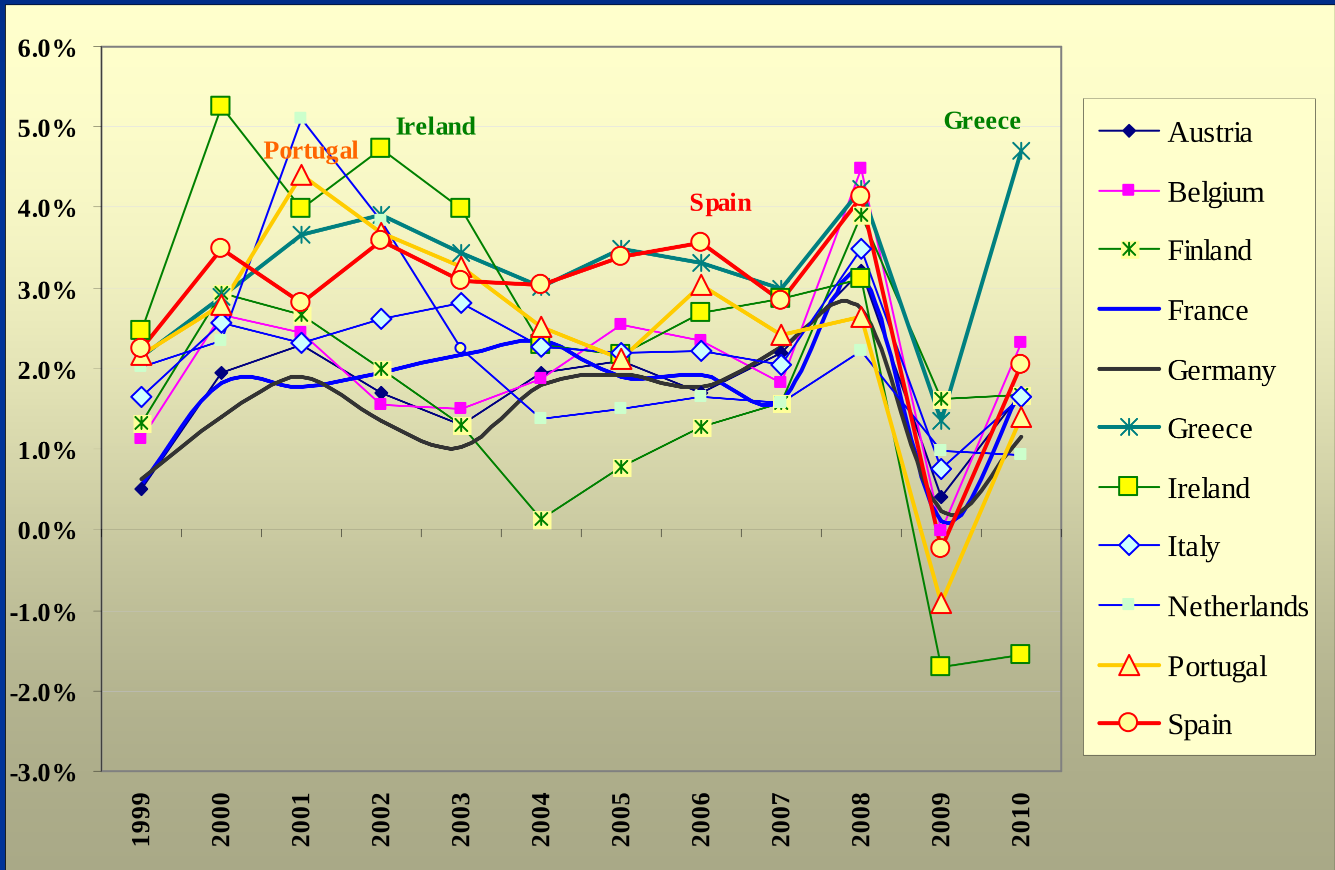
- I do not claim any special knowledge of Europe, but would like to put to you, what one can clearly observe
- If one looks at some outcomes, it can be argued that distance between members of Euro-zone has reduced, i.e. convergence has happened
  - However, even this is not really true ….
- And in so many critical outcomes determining sustainability, divergence has been so marked
- Finally, there is much difference in the most affected economies and that makes both understanding the problem and visualization of a solution so much harder

GDP Growth 1980 - 2007



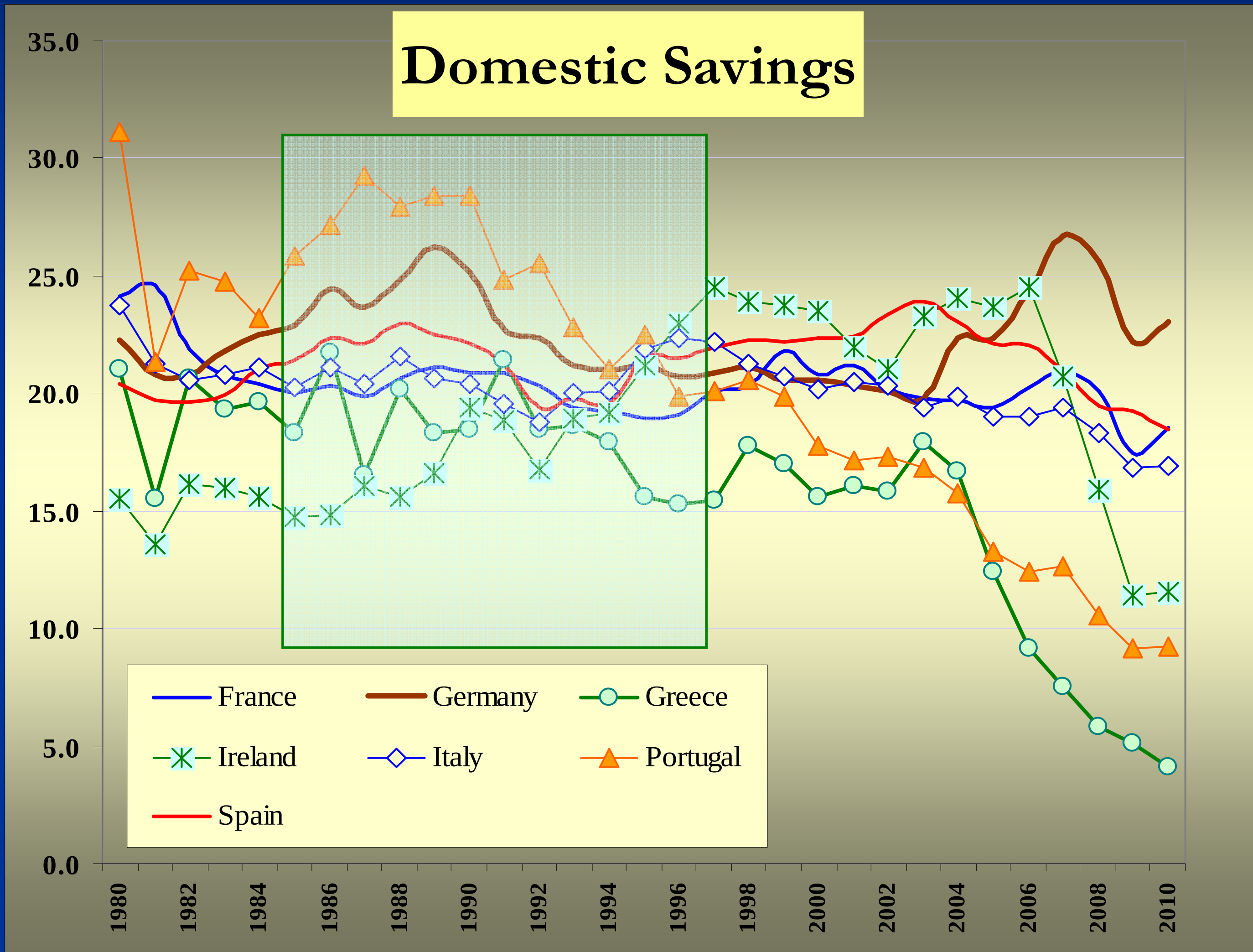
Volatility in growth in affected countries less in post-euro period, but through lower growth rates in Greece & Spain

Inflation seems closely dispersed



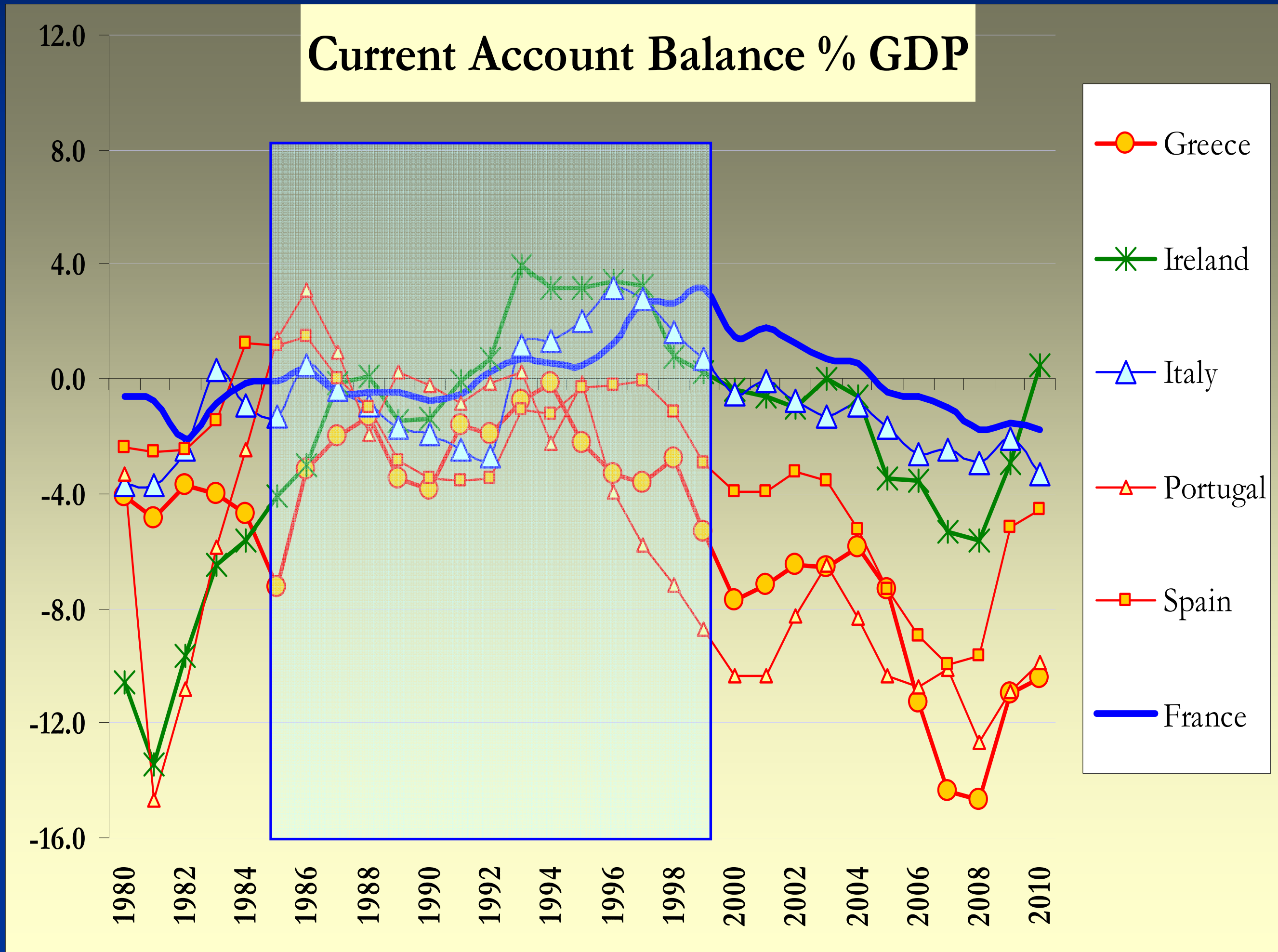
Divergence of Inflation seems to be low, but even here problem countries had sustained higher inflation

But, savings have clearly worsened



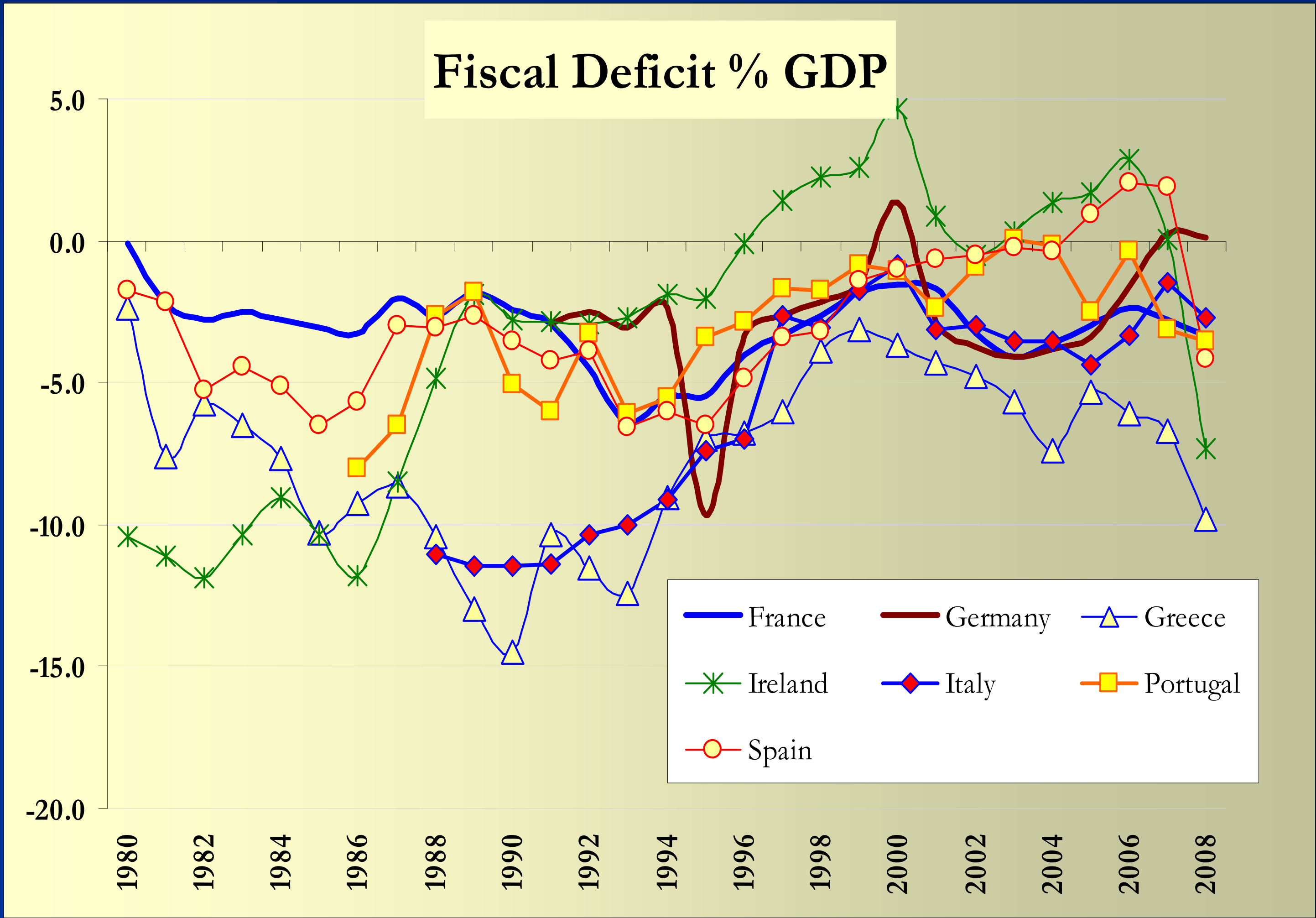
Savings as % GDP have clearly weakened in affected economies & become even worse in recent years

Even more has the CAB



CAD becomes sharply weaker in affected countries – both in run up to the Euro and thereafter

and of course, so has Fiscal Deficit



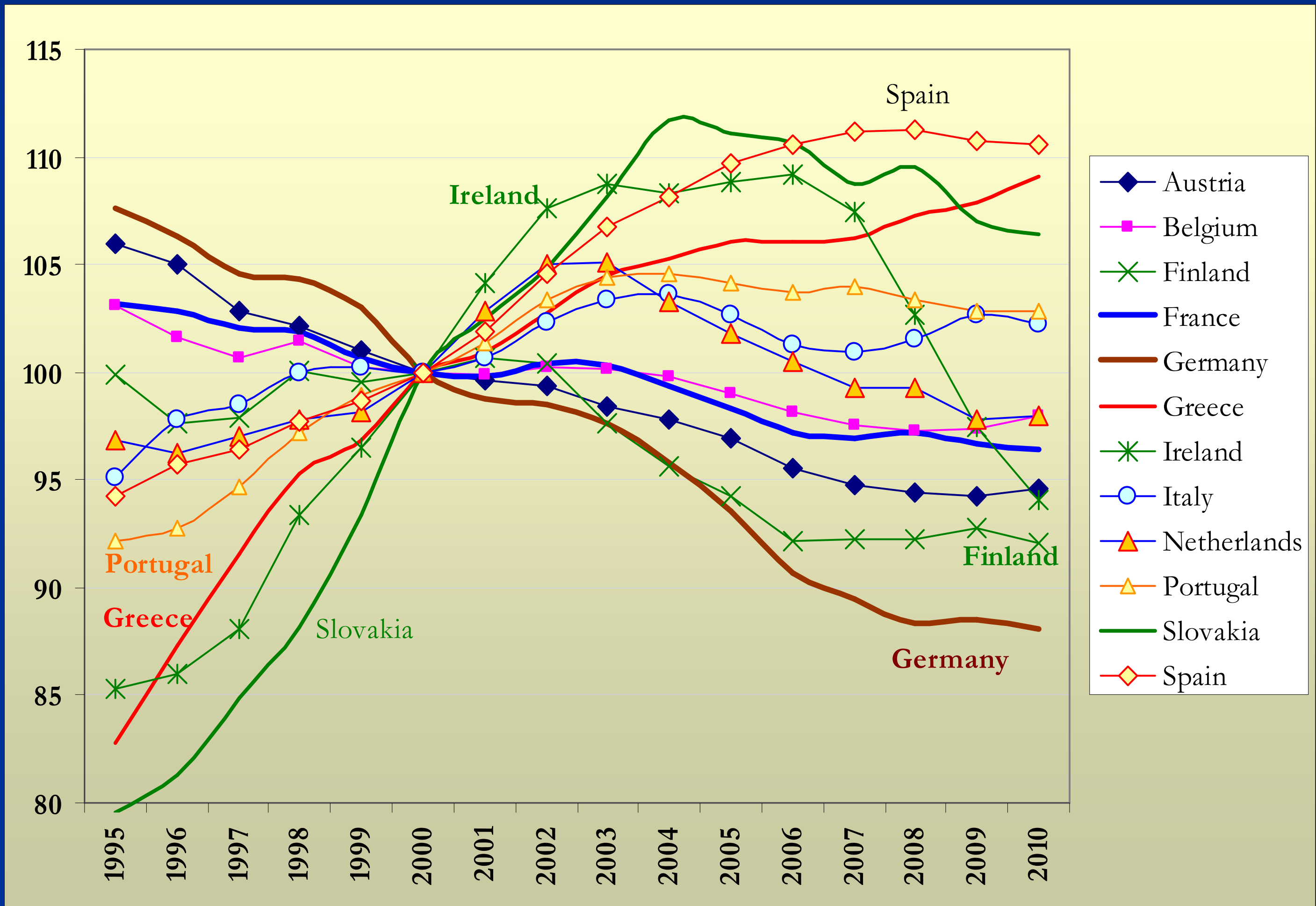
Except for Ireland & Italy, of fiscal deficit always south of average, before & after the Euro

Is it a 2-track system?

- It would appear so. With Greece, Portugal & Spain on a different track from other Euro-zone members – though Greece is more of an outlier
- Ireland clearly is in an altogether different category, doing well on most counts, except for their critical mishandling of credit growth and then bank liabilities
- Italy seems to be in an altogether different situation – with the numbers not showing excesses on macro-parameters, except for slower growth, but there may be much more than meets the eye, especially in the banking sector and un-crystallized fiscal liabilities

The effect of the fixed exchange rate

Implied PPP conversion rate to $ - relative to 2000



Change for each country w.r.t. 2000, index =100 implied PPP rate. Exchange rate is fixed, it shows rel. hardening /weaken-ing

Past corrections through MER

- Devaluation between early 1981 and end 2000:
  - Greece 7.2 x
  - Spain 2.1 x
  - Italy 2.0 x
  - France 1.4 x
  - Germany 1.0 x
- … and in the same period in India and China
  - India 5.6 x
  - China 4.8 x
- Without correction in the exchange rate it is unlikely that growth would have picked up in India & China, thus permitting them to resolve other structural problems, incl. poverty reduction

Resolution has to be sustainable

- Resolving crisis involves expense all around, but in order to be worth it, the future trajectory of the concerned economy must be seen to be sustainable
- The crisis for Greece and others too seems to be a conventional BoP + fiscal problem + bank problem
- Solution to this used to pivot on devaluation, fiscal correction and financial sector correction – e.g. resolving the *Asian Currency Crisis*, which was successful
- The imbalances that are most in evidence do not get addressed other than by large scale re-pricing in which exchange rate correction provides the way

Unchanged MER - Implications

- Not correcting for accumulated erosion of competitiveness. Without this, future economic sustainability is in doubt
- If solution does not generate economic growth, fiscal correction is not likely as a possibility
- Further, without exchange rate correction, "internal devaluation" = wage earners taking the adjustment burden. Disinflation is hostile to growth
- Without growth, unemployment will not be reduced, social tensions likely to rise, creating more instability
- In elective systems, with already weak credibility, unpopular decisions are hard to carry through, especially over such a protracted period

Sympathy, but no conviction …

- Early resolution of the Eurozone crisis is in all of our collective interests
- We have full sympathy for the efforts undertaken
- However, it is hard for us to be persuaded that the problem is being resolved in a comprehensive manner
- The accumulation of unresolved issues is becoming ever more dangerous
- Unintended consequences & resultant contagion has a large negative potential that is perhaps being missed in the heat of the moment

Thank you for your kind patience