

Raghuram Rajan: Make in India, largely for India

Talk by Dr Raghuram Rajan, Governor of the Reserve Bank of India, at the Bharat Ram Memorial Lecture, New Delhi, 2 December 2014.

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The global economy is still weak, despite a strengthening recovery in the United States. The Euro area is veering close to recession, Japan has already experienced two quarters of negative growth after a tax hike, and many emerging markets are rethinking their export-led growth models as the industrial world stagnates. In the last couple of years, the IMF has repeatedly reduced its growth forecasts. After 6 years of a tepid post-crisis recovery, the IMF titled its most recent World Economic Outlook “Legacies, Clouds, Uncertainties”.

The conventional diagnosis and remedy

Why is the world finding it so hard to resume pre-Great Recession growth rates, let alone restore the levels of GDP that would have been attained if the Great Recession had not happened? The obvious answer is that the legacy of the financial boom that preceded the Great Recession is debt, and the overhang of debt, whether on governments, households, or banks, is holding back growth. In the colourful words of the IMF’s Managing Director, we are experiencing “the New Mediocre”. The implication is that growth is unacceptably low relative to potential, and more can be done to lift it, especially given that a number of economies are flirting with deflation. Hence the conventional policy advice urges yet more innovative monetary interventions with an ever expanding set of acronyms, even while governments are urged to spend on “obvious” needs such as infrastructure. While the need for structural reforms is acknowledged, they are typically deemed painful, and possibly growth-reducing in the short run. Hence the accent is on monetary and fiscal stimulus, and as much of it as possible given the deadening effects of debt overhang.

The efficacy of such policy advice remains to be seen. But the Japanese checked each of these boxes over the last two decades, including interest rates held low for long, quantitative easing, and massive debt-financed spending on infrastructure. Few would argue that Japan has shed its seeming malaise.

A different diagnosis

A different narrative of the pre-crisis period is now emerging that may explain why the efforts at stimulating economies back to the pre-crisis growth paths have not been successful, even six years after the crisis.¹ The term “secular stagnation” used by Larry Summers to describe the current persistent economic malaise, echoing Alvin Hansen’s speech in 1938 in the midst of the Great Depression, has caught on.² But different economists focus on different aspects and causes of the stagnation. Summers emphasizes the inadequacy of aggregate demand, and the fact that the zero lower bound as well as the potential for financial instability prevents monetary policy from being more active. The reasons for weak aggregate demand include ageing populations that want to consume less and the increasing income share of the very rich, whose marginal propensity to consume is small.

¹ See, for example, “The Crises of Democratic Capitalism”, Wolfgang Streeck, *New Left Review* 71, Sept/Oct 2011 or “The True Lessons of the Recession: The West Can’t Borrow and Spend its Way to Recovery”, Raghuram Rajan, *Foreign Affairs*, Volume 91, no 3, May/June 2012.

² Summers, L. (2014), “U.S. Economic Prospects: Secular Stagnation, Hysteresis and Zero Lower Bound”, speech delivered to the National Association for Business Economics, Economic Policy Conference, February 24, 2014.

Tyler Cowen and Robert Gordon on the other hand, emphasize a weak supply potential.³ They argue that the post-World War II years were an aberration because growth was helped in industrial countries by reconstruction, the spread of technologies such as electricity, telephones, and automobiles, rising educational attainment, higher labour participation rates as women entered the work force, a restoration of global trade, and increasing investments of capital. However, post-war total factor productivity growth – the part of growth stemming from new ideas and methods of production – fell from its 1920–50 high. More recently, not only has productivity growth fallen further, but growth has been held back by the headwinds of plateauing education levels and labour participation rates, as well as a shrinking labour force in some countries because of population ageing.

It is obvious from these lists of factors that it is hard to disentangle the effects of weak aggregate demand from slow growth in potential supply. Population ageing contributes to both. Indeed, one may cause the other. For example, anticipating a slowdown in growth potential, households, worried about impending retirement in the face of promised social security entitlements that are unlikely to be delivered upon, may try and build savings. This will depress demand further. Conversely, anticipated weak demand may reduce incentives for corporations to invest, causing supply potential to grow more slowly.

Whatever the reasons for slow underlying growth starting in the 1970s, the traditional adverse consequences such as the growing unemployment of the system's outsiders such as immigrants and the youth was compounded by the growing realization that economies could also not deliver on social security promises without growth. These promises, as sociologist Wolfgang Streeck writes, were made to the wider public during the growth years of the 1960s when visions of a "Great Society" seemed attainable.⁴ Promises have been augmented since then by increases in pension and old age healthcare commitments to public sector workers. These have been made to avert budget-breaking wage increases, but they have created huge liabilities for the future, which is approaching fast.

Growth therefore became an imperative, and with underlying growth slow from the 1970s on, governments began to spend more to stimulate the economy. With supply potential also stagnant, the spending translated into inflation, which spiralled upwards. Streeck argues that industrial country successes in curbing inflation in the 1980s meant something else had to take the place of the inflation tax in financing spending. And that was debt, first public debt, then as governments narrowed fiscal deficits, an encouragement to the private sector to take on debt. Growing leverage of all kinds, whether on banks, corporates, households, or governments, led to the financial crisis of 2008–11. Some of the private debt has morphed into government liabilities, but the overall level of debt in industrial countries as a fraction of GDP is still growing.⁵

Governments that are not forced by market pressures to undertake productivity-enhancing reforms prefer to delay them. As a result, overall debt is still growing because the policies of "*reaching for growth*" through monetary and fiscal stimulus have not abated. Further complicating all this is a growing sense amongst the middle class that they need quality higher education and training to not slip back into the ranks of the poor, but the poor quality early education they have received, as well as the prohibitive cost of quality higher education, puts better livelihoods out of reach. Populist middle class movements, as epitomized by the Tea Party in the United States or UKIP in the United Kingdom, reflect these worries. The possibility of a backlash against technology, global finance, and foreign

³ Tyler Cowen (2013), *The Great Stagnation*, Ebook, Gordon, R. (2012), "Is US Economic Growth Over? Faltering Innovation Confronts Six Headwinds", NBER Working Paper 18315.

⁴ Cited in footnote 1.

⁵ Luigi Buttiglione, Philip Lane, Lucrezia Reichlin and Vincent Reinhart, *Deleveraging? What Deleveraging?*, 2014, Geneva Reports on the World Economy.

immigration and trade, which the middle class is led to believe are responsible for its plight, is very real.

The mediocre economic outlook might change. Strong US growth could pull the world out its funk, while low oil prices could also give a substantial boost to aggregate demand. The industrial world may well muddle through for a while before it figures how to harness and monetize (as well as measure) new technologies. New well-paying middle class jobs that we cannot imagine today may emerge once again, as they always have. But overall, there is a palpable sense of gloom in the industrial world, a belief that growth is unlikely to be strong enough to satisfy for the foreseeable future.

If secular stagnation persists, industrial countries will have to figure out how to restructure their promises, whether debt, social security, or low taxes, and how to distribute the burden. After filing for bankruptcy, the city of Detroit in the United States has already had to make tough choices, between servicing its pensioners or its debt, keeping its museums open or its police force intact. More such difficult decisions will have to be made.

What about emerging markets?

Slow industrial country growth has made more difficult a traditional development path for emerging markets – export-led growth. Indeed, in the last decade, even as China developed on the back of its exports to industrial countries, other emerging markets flourished as they exported to China. Emerging markets now have to rely once again on domestic demand, always a difficult task because of the temptation to overstimulate. That task has become more difficult because of the abundance of liquidity sloshing around the world as a result of ultra-accommodative monetary policies in industrial countries. Any signs of growth can attract foreign capital, and if not properly managed, these flows can precipitate a credit and asset price boom and exchange rate overvaluation. When industrial country monetary policies are eventually tightened, some of the capital is likely to depart emerging market shores. Emerging markets have to take extreme care to ensure they are not vulnerable at that point.

What implications should an emerging economy like India, which has weathered the initial squalls of the “taper tantrums” of the summer of 2013, take away for its policies over the medium term? I would focus on four: 1) Make in India; 2) Make for India; 3) Ensure transparency and stability of the economy; and 4) Work towards a more open and fair global system.

Lessons for India

1) *Make in India*

The government has the commendable aim of making more in India. This means improving the efficiency of producing in India, whether of agricultural commodities, mining, manufacturing, or services.

To achieve this goal, it has to implement its ambitious plans on building out infrastructure. This includes

- Physically linking every corner of the country to domestic and international markets through roads, railways, ports and airports. The kind of economic activity that is generated when a pukka all-weather road is built into a village – the explosion of horticulture, poultry, and dairy farming, the opening of clothing and assorted goods shops, the increasing use of powered vehicles – is extraordinary, as is the kind of activity that emerges around national highways.
- Ensuring the availability of inputs such as power, minerals, and water at competitive prices.

- Linking everyone electronically and financially to the broader system through mobiles, broadband, and intermediaries such as business correspondents.
- Encouraging the development of public institutions such as markets, warehouses, regulators, information aggregators and disseminators, etc.
- Making possible affordable and safe homes and workplaces.

A second necessity for increasing productivity in India is to improve human capital. This requires enhancing the quality and spread of health care, nutrition, and sanitation to start with so that people are healthy and able. People also need better and more appropriate education, skills that are valued in the labour markets, and jobs where firms have the incentive to invest more in their learning.

The government is examining the cost of doing business in India with a view to bring it down. The woes of the small entrepreneur, as she confronts the myriad mysterious regulations that govern her, and the numerous inspectors who have the power of closing her down, are well known. The petty bureaucrat, empowered by these regulations, can become a tyrant. It is appropriate that the government intends to make him help business rather than hinder it. As regulators, we too have to continuously examine the costs and benefits of the regulations we impose.

Finally, we need make access to finance easier. I have spoken about that in other contexts, and will not dwell on it here. Before I move on, let me add some caveats.

There is a danger when we discuss “Make in India” of assuming it means a focus on manufacturing, an attempt to follow the export-led growth path that China followed. I don’t think such a specific focus is intended.

First, as I have just argued, slow growing industrial countries will be much less likely to be able to absorb a substantial additional amount of imports in the foreseeable future. Other emerging markets certainly could absorb more, and a regional focus for exports will pay off. But the world as a whole is unlikely to be able to accommodate another export-led China.

Second, industrial countries themselves have been improving capital-intensive flexible manufacturing, so much so that some manufacturing activity is being “re-shored”. Any emerging market wanting to export manufacturing goods will have to contend with this new phenomenon. Third, when India pushes into manufacturing exports, it will have China, which still has some surplus agricultural labour to draw on, to contend with. Export-led growth will not be as easy as it was for the Asian economies who took that path before us.

I am not advocating export pessimism here – India has been extremely successful at carving out its own areas of comparative advantage, and will continue to do so. Instead, I am counselling against an export led strategy that involves subsidizing exporters with cheap inputs as well as an undervalued exchange rate, simply because it is unlikely to be as effective at this juncture. I am also cautioning against picking a particular sector such as manufacturing for encouragement, simply because it has worked well for China. India is different, and developing at a different time, and we should be agnostic about what will work.

More broadly, such agnosticism means creating an environment where all sorts of enterprise can flourish, and then leaving entrepreneurs, of whom we have plenty, to choose what they want to do. Instead of subsidizing inputs to specific industries because they are deemed important or labour intensive, a strategy that has not really paid off for us over the years, let us figure out the public goods each sector needs, and strive to provide them. For instance, SMEs might benefit much more from an agency that can certify product quality, or a platform to help them sell receivables, or a state portal that will create marketing web sites for them, than from subsidized credit. The tourist industry will probably benefit more from visa on arrival and a strong transportation network than from the tax sops they usually demand.

A second possible misunderstanding is to see “Make in India” as a strategy of import substitution through tariff barriers. This strategy has been tried and it has not worked because it ended up reducing domestic competition, making producers inefficient, and increasing costs to consumers. Instead, “Make in India” will typically mean more openness, as we create an environment that makes our firms able to compete with the rest of the world, and encourages foreign producers to come take advantage of our environment to create jobs in India.

2) *Make for India*

If external demand growth is likely to be muted, we have to produce for the internal market. This means we have to work on creating the strongest sustainable unified market we can, which requires a reduction in the transactions costs of buying and selling throughout the country. Improvements in the physical transportation network I discussed earlier will help, but so will fewer, but more efficient and competitive intermediaries in the supply chain from producer to the consumer. A well designed GST bill, by reducing state border taxes, will have the important consequence of creating a truly national market for goods and services, which will be critical for our growth in years to come.

Domestic demand has to be financed responsibly, as far as possible through domestic savings. Our banking system is undergoing some stress. Our banks have to learn from past mistakes in project evaluation and structuring as they finance the immense needs of the economy. They will also have to improve their efficiency as they compete with new players such as the recently licensed universal banks as well as the soon-to-be licensed payment banks and small finance banks. At the same time, we should not make their task harder by creating impediments in the process of turning around, or recovering, stressed assets. The RBI, the government, as well as the courts have considerable work to do here.

We also have to work on spreading financial services to the excluded, for once they learn how to manage finances and save they can be relied on to borrow responsibly. New institutions and new products to seek out financial savings in every corner of the country will also help halt the erosion in household savings rates, as will a low and stable inflation rate. The income tax benefits for an individual to save have been largely fixed in nominal terms till the recent budget, which means the real value of the benefits have eroded. Some budgetary incentives for household savings could help ensure that the country’s investment is largely financed from domestic savings.

3) *Ensure transparency and stability of the economy*

As I argued earlier in the speech, even developed countries like Portugal and Spain have been singularly unable to manage domestic demand. Countries tend to overstimulate, with large fiscal deficits, large current account deficits, high credit and asset price growth, only to see growth collapse as money gets tight. The few countries that have avoided such booms and busts typically have done so with sound policy frameworks.

As a country that does not belong to any power blocks, we do not ever want to be in a position where we need multilateral support. It will be all the more important to get our policy frameworks right.

Clearly, a sound fiscal framework around a clear fiscal consolidation path is critical. The Dr Bimal Jalan Committee’s report will provide a game plan for the former, while the government has clearly indicated its intent to stick to the fiscal consolidation path that has been laid out. Whether we need more institutions to ensure deficits stay within control and the quality of budgets is high, is something worth debating. A number of countries have independent budget offices/committees that opine on budgets. These offices are especially important in scoring budgetary estimates, including unfunded long term liabilities that the industrial countries have shown are so easy to contract in times of growth and so hard to actually deliver.

On the monetary side, a central bank focused primarily on keeping inflation low and stable will ensure the best conditions for growth. In reacting to developments, however, the central bank has to recognize that emerging markets are not as resilient as industrial economies. So the path of disinflation cannot be as steep as in an industrial economy because an emerging market is more fragile, and people's buffers and safety nets are thinner. A "Volker" like disinflation was never on the cards in India, but an Urjit Patel glide path fits us very well, ensuring moderate growth even while we disinflate. Going forward, we will discuss an appropriate timeline with the government in which the economy should move to the centre of the medium term inflation band of 2–6%.

In addition to inflation, however, a central bank has to pay attention to financial stability. This is a secondary objective, but it may become central if the economy enters a low-inflation credit and asset price boom. Financial stability sometimes means regulators, including the central bank, have to go against popular sentiment. The role of regulators is not to boost the Sensex but to ensure that the underlying fundamentals of the economy and its financial system are sound enough for sustainable growth. Any positive consequences to the Sensex are welcome but are only a collateral benefit, not the objective.

Finally, India will, for the foreseeable future, run a current account deficit, which means we will need net foreign financing. The best form of financing is long term equity, that is, Foreign Direct Investment (FDI), which has the additional benefit of bringing in new technologies and methods. While we should not be railroaded into compromising India's interest to attract FDI – for example, the requirements to patent a medicine in India are perfectly reasonable, no matter what the international drug companies say – we should ensure policies are transparent and redress quick. If we make it easier for young Indian companies to do business, we will also make it easier for foreign companies to invest, for after all both are outsiders to the system. This means a transparent and quick legal process to deal with contractual disputes, and a proper system of bankruptcy to deal with distress. Both are issues the government has taken on.

Let me turn finally to the international framework.

4) *Work towards a more open and fair global system*

As a country that does not belong to any power block, and that does not export vital natural resources but is dependent on substantial commodity imports, India needs an open, competitive and vibrant system of international trade and finance. Our energy security, for example, lies not in owning oil assets in remote fragile countries but in ensuring the global oil market works well and is not disrupted. We need strong independent multilateral institutions that can play the role of impartial arbiter in facilitating international economic transactions.

Unfortunately, the international monetary system is still dominated by the frameworks put in place in the past by industrial countries, and its governance is still dominated by their citizens. To be fair, it is changing, albeit slowly. But there is a more immediate reason for faster change. With slow growth, as well as the need to finance large debt loads, the interest of industrial countries in an open global system cannot be taken for granted. For instance, regulations that have the appearance of shoring up safety and soundness of the industrial country financial system may have the collateral effect of discouraging investment in emerging market assets. We have to recognize that slow growth may direct industrial economy policymakers' attention inwards, even while politics turns protectionist. The multilateral governance system, still dominated by industrial countries, may not provide a sufficient defence of openness.

Emerging markets may therefore have the responsibility of keeping the global economy open. For this, not only do emerging markets have to work on quota and management reforms in the multilateral institutions, but they also have to work on injecting new agendas, new ideas, and new thinking into the global arena. No longer will it suffice for India to simply object to industrial country proposals, it will have to put some of its own on the table. And this

means that our research departments, universities, and think tanks have to develop ideas that they can feed to India's representatives in international meetings.

Conclusion

Let me conclude. We are more dependent on the global economy than we think. That it is growing more slowly, and is more inward looking, than in the past means that we have to look to regional and domestic demand for our growth – to make in India primarily for India. Domestic-demand-led growth is notoriously difficult to manage, and typically leads to excess. This is why we need to strengthen domestic macroeconomic institutions, so that we can foster sustainable and stable growth. At the same time, we cannot let foreign markets shrink further, and we have to take up the fight for an open global system. Rather than being reactive, we have to be active in setting the agenda. That requires investment in our idea-producing institutions – research departments of official bodies, think tanks, as well as universities. In sum, the diminished expectations in the world at large should not be a reason for us to lower our sights.