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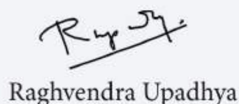
From the editor's desk

Dear Readers,

Over the past ten months, the PGPEX batch has been exposed to a range of views on economic theory from professors, bankers and bureaucrats. With the budget season upon us, we thought it appropriate to dedicate this issue to analysing the various facets of the economy.

We are honoured to present an article by Professor Menahem Prywes (visiting faculty to PGPEX and former World Bank economist) on his opinions on Raghuram Rajan's bestseller Fault Lines. Other articles include an article on the growth-inflation dilemma analysing India's need for productive investment; an article on Japanese loans to India trying to uncover the gamut of motives that developed countries have in providing loans to developing countries; and an article on honking that takes an interesting look at the problem in India and suggests some solutions using the field of behavioural economics.

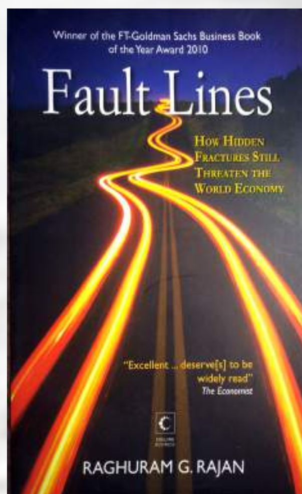
We thank you for your encouragement and response to the first issue of *PGPEX Business Review*. As ever, your thoughts and comments are most welcome as we strive to shape this exciting new venture into one that will add value to every reader. Please e-mail us at pgpexconnect@email.iimcal.ac.in with 'PBR' in the subject with your suggestions



Fahd Fakih Raghvendra Upadhya

"We are honoured to present an article by Professor Menahem Prywes, former World Bank economist, on his opinions on Raghuram Rajan's bestseller Fault Lines"

Fault Lines: A Book Review by Professor Menahem Prywes



Raghuram Rajan taught for many years at the University of Chicago's School of Business. He served as Chief Economist of the IMF, and is now Governor of the Reserve Bank of India. His book is one of what must be hundreds written on the global financial crisis of 2007-2009 but deserves to be read for delving beneath the superficial explanations for the crisis: such as greed, fraud, and bankers' excessive salaries - although these played a role. He identifies three underlying fault lines:

1. Rising income inequality in the US;
2. Developing country dependence on exports to the US: and the
3. Clash between industrial and developing country financial systems.

Rising Income Inequality in the US: Over the past several decades, the real incomes of the top 10 percent of Americans rose steadily relative to the median income—which was nearly flat. Moreover, the real income of Americans with university degrees rose relative to those with secondary degrees. This is partly because technological change increased the importance of education in the labor market. American politicians from both parties are acutely sensitive to the resulting political pressures and to the consequences for their reelection.

"...real income of Americans with university degrees rose relative to those with secondary degrees. This is partly because technological change increased the importance of education in the labor market"

However, it's difficult and time-consuming to correct the causes of inequality. The first step would be to fix the American education system. The quality of American primary and secondary education is often poor and many colleges and universities have to teach material that should have been learned at the secondary level. Limited English language skills constrain the opportunities and incomes of some migrant workers. Despite the partial failure of the system, teachers' unions often resist reforms.And the evidence suggests that the reform agenda of holding schools accountable through standardised testing, private competition with public schools, and linking teacher salary to pay may not be working.

Unaffordable health care is probably a further source of inequality. The US Congress adopted President Obama's Affordable Care Act, but health insurance reform is still politically poisonous. Further, mental health issues and especially depression, anxiety, and addictions, although rarely discussed by economists, are probably a source of unemployment and of low incomes.

Rajan differs from the conservative tradition—for which Chicago is famous—in urging the US to deepen its social protection system. He reasons that a social safety net relieves political pressures on a government, giving it time to achieve fundamental reforms, and that it relaxes pressure on a central bank to run an irresponsibly expansionary monetary policy.

His insight into the financial crisis that, in the absence of quick solutions and of an adequate safety net, politicians pressured the Federal Reserve to increase middle class consumption and home ownership by expanding the money supply and driving down interest rates. To reinforce this policy, they pressured banking and housing regulators, and government-related mortgage agencies to relax regulations on mortgage lending. The result was an expansion of mortgage lending, a deterioration of the credit-worthiness of mortgage loans, and a bubble in housing prices. Since the US is connected to the developing countries through trade and financial markets, this left everyone exposed to deflation of the bubble.

"...to reduce their vulnerability, the newly industrialised countries should promote domestic consumption rather than exports. But these countries historically protected their inward oriented industries and these became uncompetitive..."

Export Dependence: This is especially serious for the newly industrialised countries that depend on exports to absorb new entrants to the labor market, to continue their growth, and to form a middle-class. To achieve this, the newly industrialised countries promoted export industries. These were kept efficient by economies of scale and international competition. But the newly industrialised countries' continued growth depends on industrial country, and especially in US, policies that promote household consumption, low savings rates, and housing, as well as on booming asset markets and in several countries (US, Greece, Italy), high government consumption. The problem is, "too many exports chasing poor policies."

A retreat in US consumption, or adoption of less consumption-promoting US policies, could then reduce the newly industrialised countries' exports and employment. Poor, developing countries are vulnerable to a crisis, such as that of 2007-2009, which would reduce their receipt of workers' remittances (for example to Mexico, Philippines, Sri Lanka, Moldova, and Tajikistan). Moreover, businesses in most developing countries would receive less credit as foreign financiers withdrew funds to gain liquidity and to reduce their risk.

The argument is that, to reduce their vulnerability, the newly industrialised countries should promote domestic consumption rather than exports. But these countries historically protected their inward oriented industries and these became uncompetitive. So, relatively low efficiency led to higher prices for goods and services supplied to domestic consumers. This increases the cost of stimulating domestic demand.

Clash between Industrial and Developing Country Financial Systems: Rajan observes that developing country financial systems depend on guarantees and assessments obtained through relationships and informal exchange of information. In

contrast, the industrial country and especially Anglo-American system is based on arms-length relationships,professional risk analysis, and transparency. This is of course a gross generalisation, considering the many industrial country corruption scandals discovered during the recent financial crisis.

So industrial country financiers find strategies to reduce their risk. They lend short-term so they can flee quickly. They often lend in foreign exchange to avoid inflation and depreciation risks. A further strategy is to lend through commercial banks, to gain the government's implicit guarantee. Sometimes they buy equities. While these strategies protect industrial country institutions, they reduce illiquid long-term investments and expose developing countries to rapid capital flight.

Could it happen again? Have these fault lines been resolved in the years that followed the crisis of 2007-09?

There have been several improvements. In the US, bank capital requirements are tighter, corporate statements are more transparent, and the regulation of mortgage lending is somewhat stricter, but the rules are now being loosened.The IMF is less likely to impose contractionary policies during a crisis and more likely to accept developing countries' use of capital controls to impede capital flight.

Moreover the industrial countries created or expanded stabilisation funds, but the focus is still on industrial and not on developing countries! The US government created a $475 billion rescue package (TARP) during the crisis. And the Fed bought $1.1 trillion in mortgage-backed securities, reducing the risk borne by the private sector. The European Central Bank intervened in the Greek Euro-crisis and the Europeans created the $615 billion European Stabilisation Mechanism. Member countries increased the IMF's capital by $345billion, but there was relatively little increase to funding of the World Bank or other development agencies.

Yet in many ways nothing has changed. Industrial country monetary policy is still accommodative and their real interest rates are now close to zero. With unattractive yields on bank deposits and on bonds, funds flow into the housing and equity markets, reflating the bubbles. In the US, the household savings rate is low and the government deficit is high.

Developing countries still depend on continued high US consumption and expansionary US policies to sustain and increase their exports and to absorb their unemployed. These same developing countries still finance US consumption, exposing themselves to dollar exchange rate and interest rate risk. Cautious foreigners still lend short-term to developing countries, through banks, and in foreign exchange, so that capital can flee easily.

With all these risks still in place, a global financial crisis can happen again! But the timing and circumstances are not easy to predict.

***Professor Manahem Prywes** is a former World Bank Economist, with over 25 years experience working in post-conflict countries leading teams in delivering effective social programs. He teaches the "Globalisation and Developing Countries" course in his capacity as a visiting faculty at IIM Calcutta.*

The Growth-Inflation Dilemma: *Who is the Real Culprit ?*

The global financial crisis affected virtually every economy in the world, and India was no exception. But India recovered from the crisis much sooner than even other emerging economies. In the crisis year of 2008/09, growth dropped to 3.9 per cent, but it recovered reasonably well thereafter. In fact, in the two years after the crisis, 2008/09 and 2009/10, growth averaged 9.0 per cent which compares favourably with the average growth of 9.5 per cent in the three years before the crisis. However in 2012/13, growth dropped to 4.7 per cent, a poor return for an economy with great expectations (Figure 1).

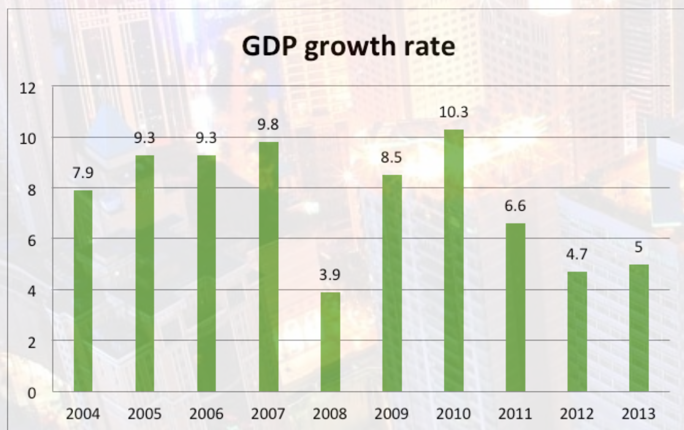


Figure 1: Sharp Decline in GDP growth[1]

To understand the latest downtrend, it is important first to understand the pre-crisis growth surge.

GDP = C + G + I + X;

It was the massive increase in capacity as investment (I) jumped from 26.9 per cent of GDP in 2003/04 to 38.1 per cent in 2007/08 (Figure 2 shows the downward trend for growth in gross fixed capital formation from very high levels in 2004/05 to very low levels in 2013/14).

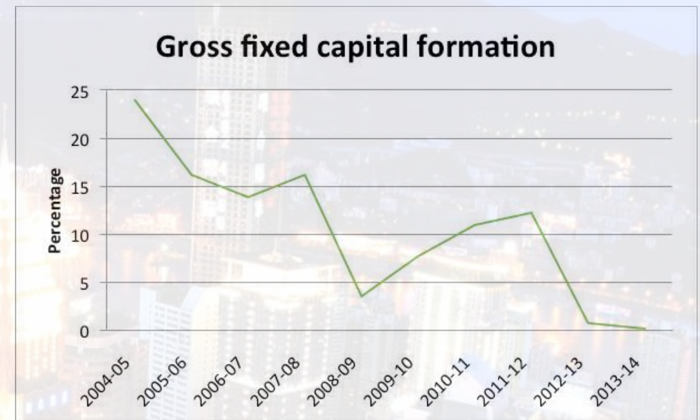


Figure 2: Decline in growth of gross fixed capital formation[2]

In the immediate post-crisis period, even as investment slowed, private consumption demand, which accounts for about 57 per cent of GDP, held up (Figure 4). This kept growth up but also fuelled inflation reflecting excess of demand over supply.

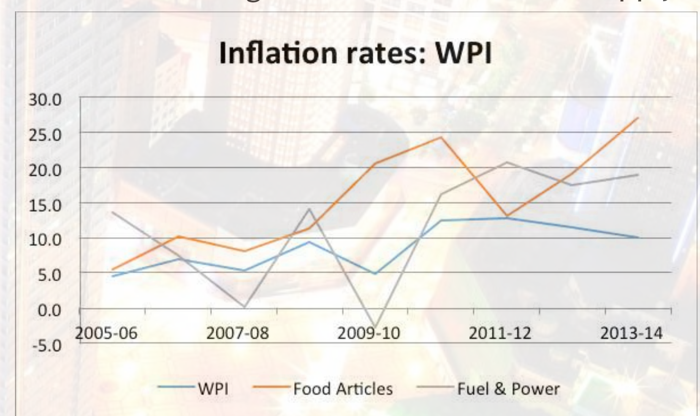


Figure 3: Rising levels of Inflation[3]

[1] http://data.worldbank.org/indicator/NY.GDP.MKTP.KD.ZG?page=1

[2] http://dbie.rbi.org.in/DBIE/dbie.rbi?site=home

[3] http://dbie.rbi.org.in/DBIE/dbie.rbi?site=home

Inflation, as measured by the wholesale price index (WPI), started rising sharply (Refer to Figure 3 for WPI details and comparison with Food articles and Fuel prices) post 2009-10. The average inflation over the last three years has been significantly higher than the average inflation of 5.4 per cent during the previous decade (2000-10).

So, what explains the downturn in growth over the last three years? The answer would be a slowing of demand. Private investment reduced sharply, in part reflecting the global downturn, but largely owing to domestic factors. Profitability was impacted by increasing inflation, business sentiment was hit by rising fiscal deficit and governance concerns, all of which dampened investor perceptions on returns on investment.

On top of the decline in private investment, private consumption demand (C), too started slowing in recent years exacerbating the growth slowdown (Figure 4). It dropped to 4.1 per cent during 2013/14, down from an average of 8.3 per cent during the (2009-2012) period.

"Spending on fuel, food, fertiliser and other subsidies rose to 16% of India's total budget in the year ended March 2014 from 9% in 2004, while plan spending climbed to 30% from 26%, according to budget documents."

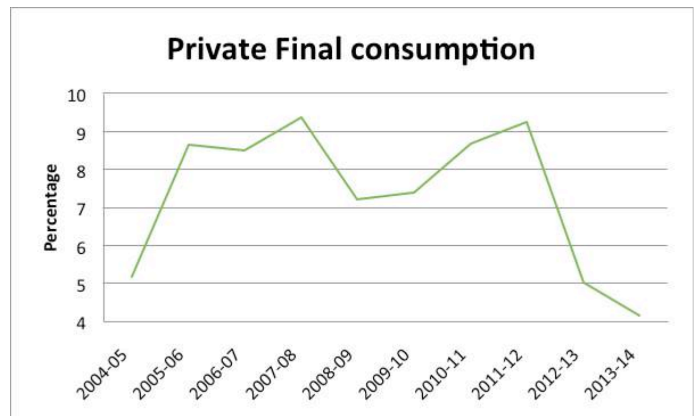


Figure 4: Decline in private consumption growth levels post 2011-12[4]

Inflation

A major driver for rise in inflation levels has been food inflation and the second major factor driving the current high trends of inflation has been rising fuel prices. India imports 80 per cent of its oil demand. The global price of oil is therefore an important variable in determining the inflation outlook. The depreciation of the rupee, starting October 2011, has compounded the inflationary impact of oil prices.

If the petroleum products were not subsidised, demand would arguably have declined in response to rising prices. But such a decline in demand was blocked by administered prices.

The increase in CAD is quite evidently a consequence of imports growing faster than exports. The increase in imports is largely accounted for by oil and gold imports. The reason oil imports have been price inelastic is due to the fact that nearly 60 per cent of petroleum products are subsidised by the government; oil demand to that extent does not adjust to price increases.

[4] http://dbie.rbi.org.in/DBIE/dbie.rbi?site=home

Spending on fuel, food, fertiliser and other subsidies rose to 16% of India's total budget in the year ended March 2014 from 9% in 2004, while plan spending climbed to 30% from 26%, according to budget documents.

In the latest budget the FM proposed to overhaul food and fuel subsidies to make them more targeted while still providing protection for the marginalised and poor. A commission would be set up to ensure that the government spends its money efficiently, said the Finance Minister.

Growth-Inflation Dynamics

India's growth-inflation dynamics pre-crisis and post-crisis present a study in contrast. In the three year period before the crisis, the economy expanded by 9.5 per cent on average, aided by growth in fixed investment above 15 per cent per year. This expanded production capacity to match growing demand and kept inflation in check. Post-crisis, the story reversed. Investment declined to half its pre-crisis rate whereas consumption demand remained at the pre-crisis level until 2012, resulting in high inflation rates.

Large amount of government's budget spent on fuel subsidies resulted in higher imports and an artificially higher demand for petroleum products. Budget spent on subsidising petroleum products could have been better utilised in increasing government investments (G).

The government, in October 2013, deregulated diesel prices. Following the decision, retail prices of the fuel now reflects international movement in oil prices. Aided by global crude oil price plunge, the lowest since 2009, government expects the oil subsidy bill to be dropped by 60 percent in 2014-15. The petroleum subsidy would account for 3.5 per cent of the government's total expenditure in the current financial year as against 5.4 per cent in the previous financial year, the decline mainly on account of diesel deregulation.

For Indian consumers, the oil price crash translates into gross annual savings of Rs.48, 000 crore on fuel cost for transport. This includes Rs.28, 800 crore savings for truck owners, Rs.9, 000 crore for petrol car owners, Rs.8, 600 crore for two-wheeler owners and Rs.800 crore for diesel car owners. The savings on fuel prices will increase the discretionary spending of customers, leading to a pickup in India's consumption. For the government, the crash means reduced pressure on current account deficit (CAD). It will also help create a healthy foreign exchange reserve, which will boost the rupee's stability against the dollar.

The reduction in subsidies will reflect true demand, improve efficiency and provide a much better investment environment.

To sum up, today's investment is tomorrow's production capacity. India needs to not only reverse the investment downturn but also increase it significantly to raise production to match the growing consumption demand. Increase in investment is necessary also to raise production for exports. Making this happen requires a response from the government by way of providing public goods and creating a conducive environment for private investment.

"For Indian consumers, the oil price crash translates into gross annual savings of Rs. 48,000 crore on fuel cost for transport"

Rajit Goel *is a student of PGPEX batch 8 with over five years of global experience in the mining industry*

Loans for Developing India, Gains for Japan?

Is it just good karma for developed nations to give aid to developing countries? Or is it actually good for their own development too? It is interesting to note that 95% of the United States' top trading partners were, at one time, US aid or loan recipients. Today, 45 percent of all U.S. exports go to developing countries which also happen to be the largest beneficiaries of American loans.

In this article I explore the benefit the aid giver receives from giving loans. While the article is primarily set in the context of Japan's loans to India, the same can be said for many other similar transactions. Also by no way do I intend to demean the loans that Japan gives to India nor do I intend to attribute any ulterior motives for these. It is an undeniable fact that some of the best development work in India has happened due to Japanese loans.

Japan recently announced "low interest" loans worth ¥210 billion to India. Indians received the news with much fanfare. On closely examining the details of the loan details it can be inferred that this not philanthropic charity as perceived by many people. According to the World Bank, the prevailing lending rate in Japan is 1.3%. India repays a large part of the loan at a "Low Interest Rate" of 1.4%. Simple arithmetic indicates an earning of 0.1% on the loan for Japan. For a country that offers to its citizens practically 0% interest rate loans, which are still unsubscribed, the earning from the loan to India is beneficial.

Other interesting caveats to the loans reveal the benefit Japan will draw from this loan. The loans to India are given in Japan's national currency, the Japanese Yen. While Japanese, South Korean and European companies are bidding competitively for the infrastructure contracts linked to the loan funded projects, it is not difficult to guess companies of which country will be most open to payments in Japanese Yen.

While the Yen loans by themselves do not appear to confer much advantage for Japanese firms, a set of clauses in some loans to India state that contracts can only be given to organisations or projects having a Japanese company as the lead partner. This restriction not only ensures that major business opportunities are created for Japanese firms but, by restricting competition, the contract prices could also be higher than what might have been in an open market.

"a set of clauses in some loans to India state that contracts can only be given to organisations or projects having a Japanese company as the lead partner"

The Japanese loans are not to be spent as per India's sweet will. The loans are for specific projects and purposes. A major loan is for development of the Delhi-Mumbai industrial corridor. Is it just a co-incidence that plenty of Japanese businesses are present in this industrial belt and will be a major beneficiary of the proposed development?

On announcing a major loan to India, President Obama conveyed to the American public that American loans to developing countries would generate thousands of jobs in America. By a very

similar logic the Japanese loans to India should be generating thousands of jobs back in Japan as well.

It is evident that the Japanese loans to India will reap plenty of benefits for Japan apart from the interest income. The multiplier effect on Japanese GDP cannot be ignored. While I am not arguing that the gains made by the Japanese are not justified, I am perturbed when the motives for these loans are ascribed to charity and goodwill.

The India-Japan story has only gained strength over the years. Both countries have geo-political ambitions that are synergetic. The strengthening of the G-4 and India's strong allegiance to the group in-spite of lucrative incentives to break away signals the strength of the alliance.

"...to term the loans given by Developed Nations to Developing Nations as philanthropy would be a bit naïve..."

However to term the loans given by Developed Nations including those that are reeling under economic hardships to Developing Nations as philanthropy would be a bit naïve. Politics and charity kept aside, economics seems to be the key driver behind these actions.

Vaibhav Mathur *is a student of PGPEX batch 8 with six years of experience in the development sector and consulting industries*

(Don't) Horn OK Please!!

The Problem

BEEP-BEEEP!! BEEP-BEEP-BEEEEEEP!! If you have ever traveled by road in India, this sound will most probably haunt your nightmares. There is simply no escaping the omnipresent sound of vehicles honking on Indian streets. Honking exacerbates the frustration faced by daily travellers in the country. Not only is the incessant sound of honking plain annoying, but it is also linked to increased stress levels and road rage.

Habitual honking is a quintessential Indian habit, with almost no parallel anywhere across the world. An interesting anecdote that my father shared with me really underlines this phenomenon. A German colleague was travelling with him in Mumbai, when the colleague's cell phone rang. The person at the other end asked, "Where are you?" In reply the colleague simply rolled down the window of the car and held his phone there for a couple of seconds. Instantly the person on the other line said, "Oh, you are in India!!"

> **"Habitual honking is a quintessential Indian habit, with almost no parallel anywhere across the world"**

Where does this need to constantly honk arise from? What possible joy does it provide? What purpose could it serve? I think the underlying reason for the impatience, and the accompanying need to honk, is the belief that, "My time is more valuable than yours." There is an unwavering certainty in the irrational thought that honking will cause the traffic in front to disappear. When vehicles are waiting at a traffic light, the second the light turns from red to green, drivers start instinctively honking. The reflex action is almost Pavlovian in nature.

Academic Research

As you can imagine, honking is quite an issue in India. Lots of blogs and articles have been written about this subject. Surprisingly, however, there is little academic research done on the causes or solutions to this problem. Hence, the solutions offered below are based on my thoughts and understanding of behavioural economics.

Possible Solutions

There are a few ways to approach this problem. The *first* would involve increasing the number of "no honking zones" and applying strict fines for flouting the norms. The "no honking zones" in India are generally placed near hospitals and schools. However, the adherence to these rules is sporadic at best and there would be no fair method to assign newer places to the "no honking zone".

The *second* method would be to increase the awareness and educate the population on the impact of honking on noise pollution, and its consequent impact on the overall health of the populace. Polio, for example, has been eliminated through systematic campaigns to increase awareness, with the famous

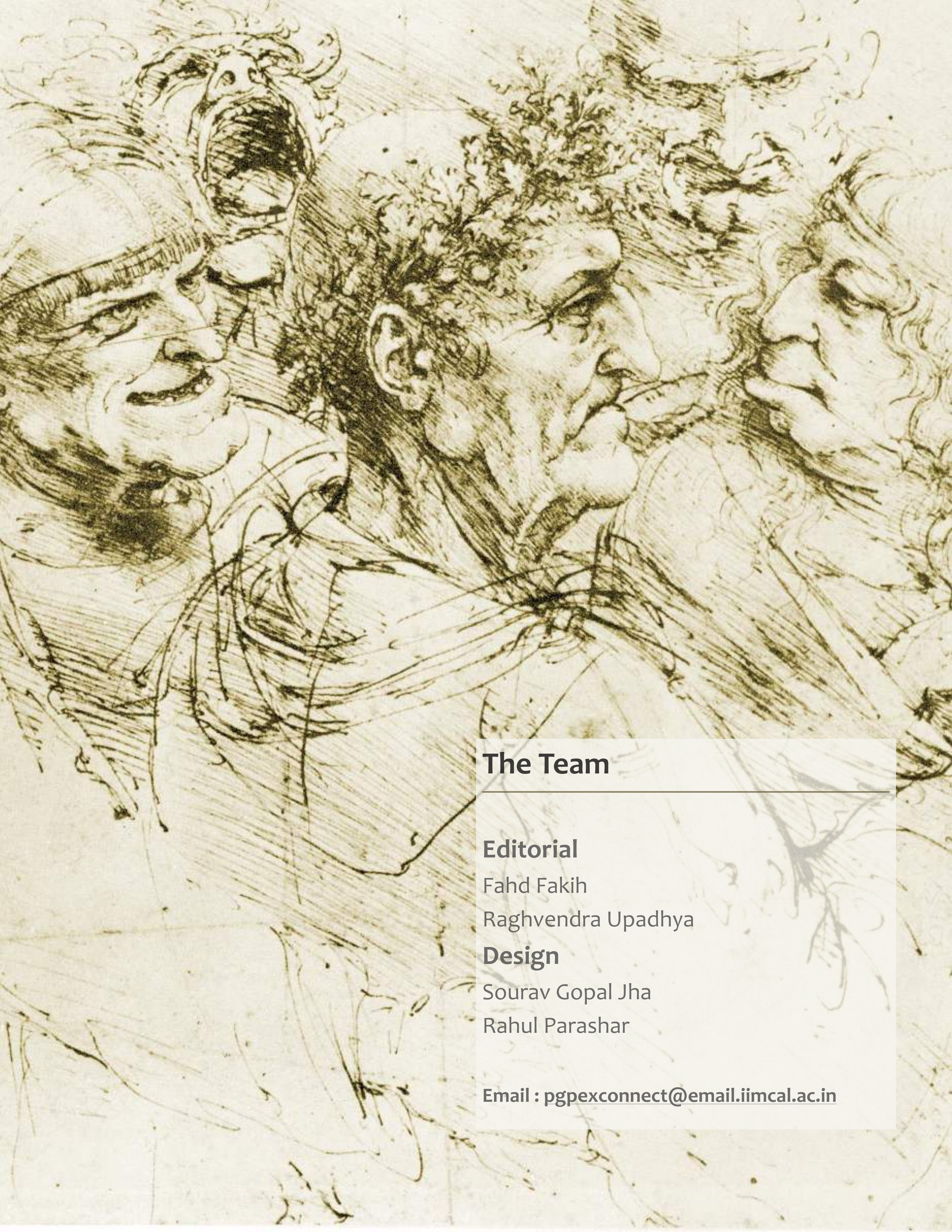
"*Do boondh*" (two drops) campaign. Print and television commercials can be used along with enlisting the help of motor training schools to spread the message. This method is unlikely to produce results in the near future (if at all) due to the long gestation period required for a critical mass of drivers to be educated on the impact of honking.

> **"...Once, the driver runs out of honks, she can approach the manufacturer and have the honks replenished, for a nominal fee..."**

The *third* approach would be to offer visual cues or nudges to the drivers by placing posters of babies covering their ears or putting their finger over their lips (as if to say, "Shhhhh"). This is likely to have a greater impact on drivers than the current "no honking zone" signs. However, it would be difficult to cover enough of the country with these posters.

The *final* method would involve encouraging automobile manufacturers to develop vehicles that have only a limited number of honks available. Once, the driver runs out of honks,
she can approach the manufacturer and have the honks replenished, for a nominal fee. The vehicles would be fitted with a meter on the dashboard that would inform the driver of the number of honks available. The meter would also calculate the rupee equivalent of each honk. For example, there are 100 honks remaining and each honk costs you ten paisa (a hundred paisa equals to one rupee), so you have 10 rupees remaining. The next time you honk, the meter will read 99 honks and 9.90 rupees remaining. As human beings are especially sensitive to watching money leave their possession, drivers are likely to be more frugal with their usage of the horn. Loss aversion will form a powerful deterrent to honking. Additionally, by limiting the amount of honks that can be replenished in a vehicle in one refill, the drivers will be forced to make small payments on a regular basis. Making continuous micro-payments is likely to weigh on the mind of the vehicle owner and provide further disincentive to honk. This initiative will, however, require the Government of India to pass a regulation that will compel all vehicle manufacturers in India to have this meter installed in their cars.

Fahd Fakih *is a student of PGPEX batch 8 with almost six years of experience in the management consulting industry*



The Team

Editorial

Fahd Fakih

Raghvendra Upadhya

Design

Sourav Gopal Jha

Rahul Parashar

Email : pgpexconnect@email.iimcal.ac.in