Emerging Market Turmoil on the Eve of the G-20: Part II

Arvind Subramanian says that India's problems are real and of its own making and that it must get control of inflation, deficits, corruption, and infrastructure problems.

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Steve Weisman: The turmoil and challenges faced by the emerging market countries will be addressed at the G20 Summit in the first week of September in St. Petersburg to be attended by President Obama.

This is Steve Weisman with Arvind Subramanian at the Peterson Institute. We have just been talking in general terms about the emerging market countries having been buffeted by US policies, but also having problems of their own. India, in particular, is perhaps a victim of forces outside its control, but you have written that its problems derive principally from its own making. Tell me a little bit about that.

Arvind Subramanian: Yeah, you know Steve, for about 30 years since 1979, more than 30 years; India has posted a growth rate of about 6.5% a year. That's spectacular by modern standards. I think probably only China and many of the East Asian's, but a handful of countries, only a handful of countries in the postwar period have matched that kind of economic performance. And in fact in the last ten years, beginning around 2002, India's growth rate was 8% and almost Chinese style rates of growth. So there was the sense that India was the kind of the new kid on the block, one of these shining emerging market countries. I think a part of what went wrong was assuming that this growth would be on autopilot.

India has a very unusual pattern of development. It has grown based on using its skilled labor rather than its unskilled labor and that did well for some time, but it kind of ran out of steam because India was not able to produce the kind of skilled labor that would keep India competitive. Skilled labor in India has been growing at about 14-15% a year in dollar terms for 20 years. That's means Indian skilled laborers are almost at global levels of salaries, at global salaries, so India-

Steve Weisman: I'm sorry; when you say it's being growing at 14% in a year it-

Arvind Subramanian: Wages, skilled wages.

Steve Weisman: Oh, oh, I'm sorry wages.

Arvind Subramanian: Yes, skilled wages of India.

Steve Weisman: Oh really, so that would mean they've doubled in the last few years.

Arvind Subramanian: No, no, well they've increased five or six fold over the last 20 years now.

Steve Weisman: So you can't-

Arvind Subramanian: Be competitive anymore, right.
Steve Weisman: And we’re talking about-

Arvind Subramanian: IT programmers, call centers, business process, outsourcing, all the things that require skills, and so the challenge was that at some stage India should have done all that it could to refocus and become a kind of manufacturing powerhouse, if not a powerhouse, at least a place where a lot of unskilled manufacturing was done. But that correction never happened, so we have this odd situation where today, the skilled model of development has run out of steam and we just don’t have the conditions; for example, to do manufacturing; you need cheap labor.

All our laws, labor laws, regulations militate against using cheap labor because it’s so difficult to fire, therefore it’s difficult to hire and if you look at clothing and apparel firms, compare India and China, the scale that China achieves for its clothing firms is just orders of magnitude bigger than Indian firms because Indian firms just can’t become big because all the incentives are against becoming big.

Steve Weisman: Because government regulations multiply and increase when you get bigger.

Arvind Subramanian: When you get bigger, exactly, and then manufacturing requires infrastructure and India’s infrastructure; ports, power, roads are-

Steve Weisman: Still substandard.

Arvind Subramanian: Substandard to say the least by financial standards, so you don’t get the private investment in manufacturing that will sustain India’s next phase of growth.

Steve Weisman: Does India ever say to itself, however, that looking at examples like China and Vietnam and well, Bangladesh, which is part of South Asia’s civilization, that it just doesn’t want to go that route, it doesn’t want to have kind of slave labor and destitute conditions that you’ve found in these countries with their unsafe dormitories and their long working weeks and working days. India, just as a democracy, could not sustain that sort of thing, I’m wondering?

Arvind Subramanian: Well Steve, you know, if you look at the postwar experience and go back to the original Asian tigers, Singapore, Taiwain, Korea, Malaysia, Indonesia, true they were autocratic, they were not democratic, but that didn’t affect—that didn’t lead to a kind of slave labor type conditions. They used their unskilled labor, they were rewarded very well. Unskilled labor did very well under these postwar successes. So I don’t think it’s a fear of owner’s conditions for labor, long working and that’s, I think it’s just India, I think India wants to do low skill manufacturing, it just hasn’t created the conditions. So that’s I think one big mistake, Steve.

The second big mistake, I think, which leads directly to the current crisis is that, in the boom years the Indian government thought that we can hold this money because of the boom, so this is a good time to make growth inclusive so it embarked on all these spending programs for the poor. Because after all, in a democracy, generally in a democracy there are compulsions to make growth inclusive, but then if you have these very unequal starting points, the compulsions to make it inclusive are even greater.
So India embarked on these programs, guaranteed rural employment, power subsidies, fuel subsidies, fertilizer subsidies, et cetera, et cetera, and I think we underestimated how much these programs caused high inflation, very high deficits, and because of that, that’s led to huge imports of gold and India finds itself increasingly unable to finance these large external deficits. Import are much greater than export and you need capital to finance that and so, I think we underestimated how much imbalance and how much problems India inflicted on itself by assuming that this growth would generate the revenues to keep spending on these programs.

Steve Weisman: So when is the next election in India?

Arvind Subramanian: Well, I think the elections to the central government are—they have to take place before May of next year.

Steve Weisman: So what, I think you have said that just like in the United States, the year leading up to an election are not necessarily a year of when bold reforms are undertaken. But what should happen, what should India do ideally, to reverse these problems that you’ve discussed?

Arvind Subramanian: I think the big thing that has to happen is that the government’s finances are out of control. I think we need a major program of fiscal retrenchment to bring spending under control, the deficit under control, and to just convey the sense that policy is in control. I think what is happening in the last few days is that there’s a sense in which the government has lost control and therefore markets are panicking and the rupee is kind of declining precipitously and so in a sense there’s a loss of confidence in the basic policy-making of the government.

Now, of course, there are many options. I think one would be to start on a political clean slate by having early elections because can you imagine this continuing for the next eight months? I think it’s impossible. I think markets just will not, I think, buy it. I think they will bring about more, there will be much more financial confusion and chaos, which will, I think, force the hand of government either calling early elections or taking drastic steps to reform the economy or who knows, maybe at some stage it will need international help as well.

Steve Weisman: Wow, okay, Arvind, thank you very much.

Arvind Subramanian: Thanks Steve.