

In Conversation With Dr. Pulapre Balakrishnan

Pulapre Balakrishnan is currently Professor at the Centre for Development Studies at Thiruvananthapuram. He has served as Country Economist for Ukraine at the World Bank and been consultant to the International Labour Organisation, the Reserve Bank of India and the United Nations Development Program. He has been actively involved in public debate in India through his writings. His published work spans the inflationary process in the Indian economy, productivity growth in manufacturing, the macroeconomics of the transition to the market in Ukraine, agricultural involution in Kerala and economic growth in India. He is the winner of the Malcolm Adiseshiah Award for Distinguished Contribution to Development Studies (2014).



EB: Having served as the Country Economist for Ukraine at the World Bank, what are the lessons from the Ukraine economy that you would like to point out to Indian policymakers?

That was a long time ago, approximately 15-20 years back and Ukraine was going through a very complex transition. For almost 80 years, Ukraine had been a communist economy with complete control on price and output determination. Suddenly, all of that was thrown to the winds. From a completely controlled economy, there was a movement towards a completely unregulated economy. The economy was struggling to find a new equilibrium. Economics does not have a fixed guideline on how to make a transition, especially this extreme a transition. The strategy is unique to every situation.

However, in hindsight, it is clear to me that what was being attempted was slightly ideological. The strategy was of doing it with a big bang! Those who were in charge of it were not in control of the situation and that was reflected in the chaos that prevailed afterwards.

One of the conditions for a market economy to work is a well-functioning democracy and Ukraine had its own challenges with a legitimately elected Government, opposition, *dharnas* and civil disobedience. Ukraine's problem was as much as that of a lack of a well-functioning democracy as that of the transition that was being attempted without a clear route map.

However, China may be an exception in the sense that it does not have a democracy. It has a communist political power with a capitalist economy. The difference is that there has never been a loosening of political control in China. Moreover, a transition of this scale has never been attempted there. The learning point is that things should not be done overnight. Rather, meticulous planning is a necessity.

EB: How can we improve the quality of our PSUs in India?

This is a very important question. They do need more autonomy and less meddling. Frankly, I find that there are extreme cases like Air India but otherwise, PSUs don't really account for a large share in the economy. Having said that, I do not think there is much scope for Air India and there is a strong argument possibly for privatising it. On the other hand, there is a large private airline industry in India already that is working efficiently. In case of coal and refineries- the core PSUs, they are inefficient and they stand in the way of coal supply being increased accompanied with increase in demand for electricity. This is an issue that needs expert attention. What we need is more autonomy and we certainly need less continuing public support in the form of a soft budget constraint.

EB: How about the railways which have been much in news in view of the government's proposal to raise the tariff?

I don't think railways are doing badly. However, on the other hand there should be strong resistance to populism and I think the railway rates should be raised according to the inflation rates. It makes no sense to not raise tariffs of your public utility services as inflation increases, otherwise those public utilities will go down under. They cannot invest, they cannot expand and when they cannot expand they are not much use as public utilities because the population is growing and there is demand. What is the point of having railways, which don't raise fares, and in some sense are a moving hygiene trap. It's extremely disturbing - there is no cleaning because they don't have funds for that.

I was in a meeting of the Finance Minister with the economists yesterday and a fellow economist pointed out that over the past 4 years, the real value of the relative price of tariffs in relation to the general price level has deteriorated 30% or 40%. So, I am not someone who believes that railways should be privatized but there is a strong argument for improving their financial position.

But, Air India I am not very hopeful about. There is extreme political influence. The board chaired by Mr Praful Patel proposed to increase the air fleet by a factor of five. In an airline that is already making such large losses and requires public intervention to keep it alive, the question of whether this type of expansion is required is where autonomy matters. If the politicians can come in and it is funded by General budget, there is no limit to the populism that these PSUs can undertake. Air India is an extreme example of a highly modern sector of an economy performing so badly while the railways are one of the oldest sectors of the modern economy (150 years old).

Public utilities like railways are a very important part of the economy. Public enterprises are a small part of the economy but public utilities may or may not be. Public utilities that are a central part of the production structure in the economy generally need to perform better. They should be given autonomy but also simultaneously monitored by the parliament. You cannot purely leave it to the managers either, that's not acceptable. As an economist, you know there is an interesting distinction made between ownership and control. Originally it was not thought of in the context of public sector; only in the private sector. In the private sector there are many shareholders and precisely because the shareholders are dispersed, managers cannot be left on their own- is there a guarantee that they will work in the interest of the shareholder or interest of their own i.e. maximize their own utility function? However, this problem exists in any arrangement whether it is private or public. But, in the private sector technically you can be fired and much more importantly if the company is listed in the stock market it can be taken over. Technically or theoretically, takeovers are seen as threat to self-regarding behaviour by the managers. This is also true in the public sector. On one hand you don't want public interference in the form of meddling, expansion the kind of which we talked about in the case of Air India but on the other hand you don't want it to be left completely in the hands of the manager either. You need monitoring which only politicians can do in a democracy. However, now the question comes as to who will monitor the politicians. This is like 'the monitor minds the class but who will mind the monitor'. Basically widespread democracy, awareness, peaceful demonstrations are the only checks to that.

EB: The RBI acted on the recommendations of Urijit Patel committee and shifted to CPI as a measure of inflation instead of WPI. Do you think it is a move for the better?

I am a bit skeptical of inflation targeting. There was a move against stabilization policy; the argument being that you can't fine tune the economy or fix the output level very easily. But inflation targeting seems to suggest that while you can't fix the output level, you can fix the price level or the inflation rate. So while inflation targeting and credibility etc. seem nice words, all of them assume that the price level can be targeted. I don't think it can be and I don't believe that the present decline of inflation rates really establishes beyond doubt the success of inflation targeting. So, whether it is CPI or WPI isn't the point. It doesn't mean you shouldn't have inflation control but I'm skeptical whether the central bank can do that. Or you can do that but only in conditions, which are undesirable in terms of output loss. As for the interest rates, let me put it this way, the interest rates is only one of the calculations of the firm. By the internal rate of return principal, the firm is comparing the rate of return with the cost of fund to the internal rate, which is the return on capital. Now the point is, the internal rate of return is based on the expectations of future output, and if they are not buoyant or worsen in substance, the rate of return declines. In such a situation, reduction of rate of interest is not good enough. Having said that,

ceteris paribus, the interest rate must matter. The inflation rate is coming down, so there is an argument for lowering the interest rates. Another reason why interest rates matter is that industrial bodies in India like FICCI etc. are up in arms against it, strongly arguing for reduction in interest rates. From which I assume that the interest rates matter for investment. Raghuram Rajan, himself is not saying there is no case for lower interest rates, but he is saying he would like to wait and watch. Its lower this month but how do we know it will be lower next month so he'd rather follow some kind of average. But he is somebody who is far too optimistic about the possibility of inflation targeting than I think than there is reason to be. Let me give you an example about the ability of central banks, via the rate of interest, to control inflation. In the U.S, in the past 5 years, the money supply because of quantitative easing has increased from the billion to trillion, but the inflation rate hasn't increased at all. And the American central bank is a non inflation-targeting bank. Its objective is maximizing employment consistent with low inflation. By a contrast the European Central Bank is a highly inflation targeting central bank. In the Eurozone, where the inflation target was 2%, inflation is in the negative region and they are worrying seriously about deflation. So the idea that the central bank can effectively target inflation is a highly exaggerated one. And, this is true particularly in the Indian economy where the problem is made complex by the presence of an agriculture sector, where the prices fluctuate. It is true even in the economies of Europe and U.S. In general, Europe and United States do not have an inflation problem as we do, because our inflation problem seems to come from the fact that we have a chronic agricultural inflation problem, food price in particular part of which comes from the government food procurement price setting, inclusive of political purposes and, there is also shortages in some sectors of the economy such as of milk, butter, or protein in general, which further leads to price rise. And such problems do not exist in Europe or United States.

EB: Do you think Narendra Modi's election slogan ' minimum government and maximum governance' fits well with the objective of widening social infrastructure like health, education etc. in India?

I don't know how much of a distinction we can draw between government and governance. It is correct that in certain segments of India the government is over bloated. The ministries probably, have far too many functionaries. But the police on the other hand do not have a sufficiently large staff. The primary health centres do not have enough paramedical staff. The nurseries, the *anganwadis*, the Asha workers - in all of these sectors we are under staffed.

I'm not sure if you can draw such a big distinction between government and governance. It is a catchy slogan but even then it is correct in a way that there are far too many sectors with too much of government intervention. Government is the problem there but in some cases it is also the case that there is not enough governance. Modi wants to have greater and improved governance in various sectors of the economy.

But you are right in saying that governance is not just a matter of implementing rules. Governance should also extend to provide social infrastructure, public goods like parks, roads and sewage system etc and public services in general, like health and education for example, where the shortage in India is massive.

EB: The question of ‘ Make in India’ campaign has created a lot of buzz recently. With Make in India in place, don’ t you think that we will become too dependent on external demand and if another financial crisis was to take place, too vulnerable?

If the external demand is guaranteed then it is not necessarily a bad thing. If there exists external demand then ‘ Make in India’ is there to take advantage of that. The expression for it is- ‘ You are harvesting the demand.’ But in the current context where the world is slowing and is expected to continue (with Eurozone crisis and China’s slowdown), to base an economic strategy on “growing by exporting” to the rest of the world seems unrealistic. So, the question is not on our reliance on the rest of the world but whether or not that demand exists. In the near future there doesn’t seem to be that kind of demand that can be harvested.

EB: Recently, Raghuram Rajan suggested that instead of Make in India it should be Make for India and the Finance Minister tried to justify why it should be Make in India and not otherwise. What would be your take on that?

The point is that demand in India is slowing. That is why manufacturing is slowing. So you can’t just assume that demand exists. You also need to create that demand. One of my recommendations for the same would be public investment. Public investment is the way of creating this demand. It takes care of demand as well as the supply side and it also, potentially does create infrastructure in the economy. While Mr. Raghuram Rajan is correct in saying that the rest of the world is slowing therefore you can’t expect external demand for your product, even if you are globally competitive. And also, it is not that obvious to me that we are so competitive. Because global demand does not guarantee that you can sell your goods. The goods must be able to offer the same quality or characteristics at lower price. But assume that your goods are competitive, with the global demand you can grow by that mechanism. But I’m not sure you can so easily assume that there is global demand. One way of ensuring great internal demand is by having a more robust agriculture sector, which can lead to greater demand for manufacturing. So the demand for manufacturing constitutes of many things. It can be increased by public investment and also by good agriculture performance. Also by greater demand for manufacturing goods by people who are non-surplus farmers, who may live by the agriculture sector or outside it. A good indicator of the higher price of food in one country compared with another is the share of food in the household budget. The share of food in India, on an average is above 50%. The share of food in China, in the household budget is about 20%. So the Chinese households have greater capacity than Indian household to spend on manufacturing.

EB: And this is true despite India being primarily an agrarian economy.

Yes, but whether or not you have a “supply constraint” depends more on how efficiently you can produce. Just because you have a large agriculture sector does not mean that supply will not be a constraint for you. I think that the size does not matter that much and it is more about productivity and efficiency. So the demand for manufacture constitutes of many things. It can be increased by public investment and also by good agriculture performance (in turn by cheaper prices).

EB: You have written about how ‘ politics trumps economics’ in the Indian polity. Do you think there is a way about the tradeoffs between economics and politics in India?

Well, as far as the political process is concerned, the solution would be a better functioning democracy i.e. putting pressure on the electorate. It is really a round about process. If you want to ensure the right decisions are taken there should be better laws and better governance structure. You need to insulate to some extent economic policy making from purely political conspiracy based on vested political interests.

The kind of politics followed by UPAIL, for example, excessive focus on distribution, was certainly a case where politics trumps economics. If you were to interpret the elections in those terms, the results suggest that even the public was not approving of them. If they were such great schemes why were they not voted back?

EB: Sir, in one of your articles you have written that ‘ separate agencies for macroeconomic stability and financial stability might end up not coordinating on the first best solution’ and that ‘ there is a serious case for vesting all powers with respect to financial stability with the RBI’ . Can you please tell us more about this?

Macroeconomic stability is normally interpreted as low inflation apart from the other things and revolves around that especially in western macroeconomics. I believe that you cannot take your eyes off financial stability and focus only on inflation. Here is a very simplistic example- there is a crude level tension between financial stability and macroeconomic stability. Macroeconomic stability if it is being brought about by raising the rate of interest to reduce inflation can have an effect of contributing to financial instability. Because as the interest rate rises those who have borrowed at the flexible interest rate might find their projects unviable. Even large projects with high gestation period; 5% increase in rate of interest when you borrow in crores can tip the balance. So, if you have two separate bodies doing this they might be doing it at the cost of each other’s goal. Therefore, there is a strong argument for vesting the powers of macroeconomic and financial stability in a single organization.

EB: You have stressed on the importance of agricultural performance for the Indian economy. Do you think the present government has devoted enough attention to this sector?

No, it has not. UPA did not pay the right kind of attention to this sector either. It had taken on the responsibility of shifting the terms of trade towards the rural sector. But, they had absurd policies like raising the procurement prices by 40% when inflation was 10%. So, the relative price was around 30%. In such a situation it is only the surplus farmers that benefit and not the rural landless, at least not directly. The base of agriculture is not strong in this country. One of the indications of which is food price inflation. From 1991-2015, food prices have increased by almost 30% which is definitely not the sign of a strong, modern economy. It is not only attention in pecuniary terms that is required rather improvement of infrastructure, public services and extension services is much more important. For example, irrigation spending has been increasing over the years but the real expansion in irrigated areas is doubtful. But, States need to devote more attention than the Centre. Agriculture is a State subject and much more attention has to be devoted to this sector.

EB: How important do you think is it for the government to reduce their role in the functioning of the public sector banks? Do you think the poor or the Jan Dhan Yojana will suffer in such a scenario?

I don't see why the poor would suffer if there is greater autonomy to public sector management. You can still impose targets on them. And maybe the Jan Dhan Yojana is overplayed. The question is whether greater autonomy would lead to better lending. There must also be some oversight because there is corruption in India. And with all public sector units, whether enterprises or banks, you can't leave them completely to public sector managers either. There has to be some kind of oversight. But whether the oversight takes the form of continuous meddling is one thing. I don't know if the P.J. Nayak committee has talked about it enough. But I'm for greater autonomy and there must also be an emphasis on choosing the best people for the best job. In India there is a serious underplaying of that aspect even when it comes to vice chancellors of universities. There is insufficient attention given to the fact whether the person has academic standing or not, which is also very demoralizing. So, there is a serious argument for greater autonomy and foster a culture of excellence, across the government sector, because leaving public money with private managers who would go on to maximize their private utility function is worrisome. The problem of ownership and control is relevant to all ownership forms whether public or private. You also want efficient control mechanism. You have seen terrible banking outcomes in the United States. So laidback were they about the private sector being good and then eventually they were bailed out by public money. You need a good regulatory mechanism.

EB: Productivity growth in manufacturing is one of the themes on which you have written extensively. What are some themes that may be taken up for future research by young researchers like readers of Aapoorti?

I could say that a great deal of time has gone for measurement of productivity and I think it is important because we need to get our measures right, where measures are analytically well founded and clearly interpretable. I think it would be very nice to have a research on what underlies productivity growth what can be done to increase productivity growth which I believe is not sufficiently analyzed. Most of the work on productivity in Indian economy has to do with measurement and not with respect to factors underlying productivity growth while in the western economy there has been a lot of focus on the latter including such interesting questions like how technology made a difference to productivity growth.