

IN CONVERSATION WITH DR.RAKESH MOHAN

Rakesh Mohan is an eminent economist and former Deputy Governor of Reserve Bank of India. He was also the Executive Director at the IMF representing India, Bangladesh, Sri Lanka and Bhutan. Dr.Mohan started his career in urban economics. He remained an adviser to numerous ministries to the Government of India and later became an important part of Indian Economic reforms in the 1990s.



Editorial Board: Given the slow recovery of most advanced nations like the US, emerging nations like Brazil and Russia looking weak, what is your outlook for 2016?

Dr. Rakesh Mohan: It is not very bright. The key character of 2016 is that different economies are showing divergent trends in growth. Unlike the past, where almost all countries were growing and after the crisis of 2008, most advanced countries were going down, now the situation is much more different. Starting with the US: it is expected to continue with its slow recovery. However, past experience shows that recovery after recession does not last more than 6-7 years. So some analysts feel that this recovery might not slow down. Europe is also expected to continue its slow recovery. Coming to emerging markets, Brazil and Russia are in significant difficulty; and there are issues with the Chinese economy slowing down. However it is still expected to grow at a rate of at least 6%. This is still high in terms of magnitude. There are also the oil and energy exporters, and commodity exporters such as Australia and Brazil who will have a tough time. That leaves only a few countries such as India which has experienced significant gains from trade. It could accelerate its growth rate. However, the global economy on the whole is not expected to do very well.

Editorial Board: Should the devolution to the states in the 14th finance commission be increased in the budget in light of the 7th pay commission, in future?

Dr. Rakesh Mohan: The special category states such as the north eastern states have often raised the issue that even though their absolute funds have increased, they are not able to meet the welfare scheme expenditure and so on. No there isn't much of a possibility of that. With the recommendations of the Pay Commission, the strain on the central govt will also increase significantly so they won't have any surplus to be able to increase devolution to the states beyond that stipulated by the 14th Finance Commission.

Editorial Board: Though the IMF structure has changed post world war II and has begun to concentrate on the smaller countries affected by recession, its internal structure still continues to remain the same i.e. the heads still continue to belong to the first world countries. But do you think that the first world countries would be able to empathise with the third world countries?

Dr. Rakesh Mohan: First, the role of IMF has to be understood. The first role of IMF is the surveillance function wherein they prepare an economic report of their member countries. This is done annually for large countries and once every two years for smaller countries. Over the past ten years or so, these reports have become public and hence remain unaffected by who happens to be the head of the organisation is. The second function is the crisis resolution function, which is the most public function. Here, the IMF steps in to help if a country is facing severe balance of payments crisis. However, during the initial years of IMF's establishment most countries had fixed exchange rate systems and hence couldn't depreciate or change their exchange rate without the IMF's permission. Since the early to mid-seventies, when most countries changed to flexible exchange rate systems (such as floating, managed floating etc.) this function has also changed to some extent. Now when countries get into financial problems (most recently European countries, which got into severe banking and funding crises) the IMF plays a major role in providing financial assistance, accompanied by macroeconomic programmes that seek to bring back the borrowing country to macroeconomic and financial stability. In the case of European countries, IMF financial assistance was only a fraction of that collectively provided by the European Central Bank, the European Commission, European Stability Mechanism. Nonetheless, the IMF staff led the work that set up the macro program that these countries have to comply with as conditions for giving these funds. However, the question does arise that, in case larger countries like Brazil, India, Russia, which are also interconnected now with the international financial systems, does the IMF have enough resources to be able to deal with such a crisis? Especially, for the countries that do not have monetary assistance from other sources. It must be noticed that the US Congress finally ratified recently the long delayed IMF 2010 quota reform. This will lead to the doubling of IMF quotas from SDR 238 to SDR 476, i.e. around \$650 billion. This constitutes a good progress, but there is need for increasing IMF quota resources further if the IMF is to retain its credibility as an effective crisis fighting institution. It is clearly the case that the IMF head should not be reserved for Europeans and the most capable person irrespective of his/her nationality should be selected. It really does not make much difference in practical terms i.e. according to the operation of the IMF.

Editorial Board: Do you think that the New Development bank or the AIIB can provide a supplementary mechanism for the Asian economies?

Dr. Rakesh Mohan: There is no overlap between the AIIB, the New Development bank and the IMF's functions. The AIIB, the NDB are just adding to the resources of the multi-national development banks and hence they are supplementing the resources available with institutions such as the World Bank, Asian Development Bank and other multilateral lending institutions. . However they have no impact as far as IMF's operations are concerned. IMF's operations are substituted by or complemented by the European Stability Mechanism for European countries, the Chiang Mai agreement for Asian countries, and the CRA with its currency arrangements for the BRICS countries. However the difference is that the CRA or the Chiang Mai agreements do not have standing secretariats with technical staff in the same way that the IMF does. The ESM is, however, building its own technical staff. They could, in principle, be more of a substitute for the IMF for European countries in the future.

Editorial Board: With regard to the European Monetary Union, what is your view of countries that are a monetary union, but not a symmetrical fiscal union? Do you foresee such a union for Asia?

Dr. Rakesh Mohan: First, the experience with EMU (the Euro zone) is being increasingly questioned. We can think of two large countries, India and the United States. The United States is like Europe in terms of income levels and size. And of course is a monetary union. A key reason that it works well is because it is a unified labour market. The exchange rate is same for every part of the Monetary Union. So, in case of US a) it's a very flexible labour market, so that its people can move between different parts of the country totally freely b) It is also very flexible in terms of differential wages prevailing in different parts of the country. What happens is that if you take an advanced part of the country, say like the North East, Boston, New York etc. and you take the less advanced part of the country, say New Mexico, you see that there's no difficulty for those in the backward parts of the country having lower nominal wages perform the same functions compared to those in Boston. Because of the flexible wages that prevail in different parts of the country, even with the same nominal exchange rate, the real exchange rate becomes different enough for all parts of the country to have the ability to be competitive enough.

Now, in case of Europe, first, even though theoretically people are allowed to move freely from one country to another in the European Community, because of different languages and other cultural barriers it is not easy to do so. It's not easy for a Greek worker to work in Germany. Second, because Europeans don't have the kind of wage flexibility that exists in US, you find that the real exchange rate does not vary as much for countries like Italy, Spain, and Greece etc, which thereby become less competitive relative to northern countries like Germany. So, suppose that there wasn't any Monetary Union then in all likelihood German exchange rates would have been much higher. Coming to Asia, the difference between countries here is much higher than the differences between countries in the European Union. I don't remember the data exactly, but I don't think that the ratio of per capita income between poorest European countries like Greece is more than 1.2 or 1.5 whereas in Asia, ratio is around 10 or 15.

Editorial Board: How important is fiscal prudence for a country like India?

Dr. Rakesh Mohan: The steady maintenance of fiscal prudence is essential for a country like India for both external and internal confidence to be maintained in the economy. This has become more important at the current time due to the recent experience of fiscal excesses that prevailed between 2009-13, from which we suffered higher inflation and other problems. So it clearly not desirable for us to be seen to be giving upon fiscal prudence so soon after that episode. . So the question here needs to be posed differently. We clearly need to give ourselves the message that the government is going to maintain fiscal prudence. The next question that comes is how can we manage greater public investment and how do we finance it? It could mean raising the tax-GDP ratio, which is in my view a bit too low. We need to improve the compliance to pay income tax. For example, the number of taxpayers declaring annual incomes above Rs 5 lakh (only about Rs 40,000 a month) was only 3.6 million in 2011-12. In the same year more than 2.5 million passenger cars were sold. If we assume that most cars are replaced once every 5 years or so, the number of people with taxable incomes over Rs5 lakh should be at least 12.5 million or so. (The min no. of people declaring incomes above Rs5 lakh shouldn't be very different from the no. of cars sold per year times 5). So there needs to be a major income tax compliance drive to increase the tax GDP ratio in order to be able to do the kind of public investment necessary in both social and physical infrastructure.

Editorial Board: In your experience as a policy maker with the Indian Government, do you think , like you talked about cars sale to detect potential tax payers, has there been an innovative index to measure GDP growth in China. So, are conventional measures being really used in policy making?

Dr. Rakesh Mohan: When Yashwant Sinha was the finance minister, he had introduced a one by six scheme. Under the scheme, persons falling in any one of the six categories — mobile phone subscribers, credit card holders, owners or occupants of immovable property, motor vehicle owners, club members and foreign travelers — were required to file income tax returns. People need to be forced to file income tax returns and many of these things are now easier because of IT. Now, we are increasingly saying that for many activities you are required to have a pan card. If you have a pan card then you get registered with the tax authorities. So in my view you do need to have schemes where pan card is made increasingly compulsory. And also, exemption limit should be kept at a real constant value. Even if people are paying 100 or 200 hundred rupees as income tax, you essentially want to get people into the habit of paying tax on a regular voluntary basis. And because of the availability of IT, the compliance cost is no longer high. It used to be the case that they didn't want to mess with millions of people not paying taxes, because of compliance and bureaucratic costs of collecting the money which wasn't worth it. Now, that's not an issue anymore, as everything could be done online. It should be made easier to pay the tax, even if a small amount. So in the US, for example income from share dividends is taxed in the hands of the recipients, which is not so in our case. We do have a dividend distribution tax which the companies pay on the dividend distribution that they do. In

the US, even if you get \$2 of dividend, they automatically tax it at source. It is costless to collect since it is all electronic. When we abolished the dividend tax in 1998, it was very expensive to collect because people had to keep pieces of paper that they got as dividend warrants. And it was almost impossible for the government to monitor who the shareholders were, who got the dividends etc, so it wasn't worth collecting. Now it's easier to collect because all listed shares are dematted. I am giving this example to tell that you shouldn't be shy to collect even small amounts from every person because it's almost costless to collect. When you students start your first job, you should be used to paying tax, even if it is a very small amount of tax. In the US, when students work as research assistants, and they earn some amount, they have to pay tax. Even if it is just as much as \$100. So that it becomes a habit, a part of what you do when you earn money.

Editorial Board: In the light of the recent cases of deflation how do you think should the structure and role of the central banks change since deflation requires a collusion and cooperation between the monetary and the fiscal rather than collision. And also in the same context how long can the CBs avoid the political and ideological confrontations?

Dr. Rakesh Mohan: Let's look at a little bit of history of central banking. Many central banks have adopted inflation targeting as the guiding regime of monetary policy. It started almost 20 years ago and it was in response to the high inflation that western countries had in the '1960s and 1970s till the early 1980s. It was when Mr. Paul Volcker became the chairman of the Federal Reserve in the late 1970s that he really turned the screws on and killed inflation. Consequent to that, because of the previous 20-25 year experience of relatively high inflation around the world inflation targeting regimes came into being. Monetary policy needs to do inflation targeting so that people's expectations are affected and the central bank has greater credibility which reduces people's expectation of inflation.

Now the situation has changed. Inflation has been very low and because of the oil price fall and to some extent, commodity price fall, two things have happened which is making it difficult for central banks. One is that average inflation has come down tremendously and despite the quantitative easing programmes of the US Federal Reserve, the European Central Bank, the Bank of England and the Bank of Japan, inflation hasn't gone up. If you increase base money tremendously it was expected that inflation would go up. That was the fear everyone had. The second thing that has now happened because of the oil price fall and the commodity price fall is that it has affected the prices of all goods. Since the price of iron ore, copper, and other major commodities has come down, prices of all products made from them has also fallen. There also seems to be excess capacity in the world of manufacturing, especially in China. There is a downward pressure on all product prices. The consequence of this is that there is a large wedge between PPI and the CPI, in almost all countries. In India WPI is about -2 % and CPI is about 5%. So the question is, inflation targeting for whom? This kind of wedge between producer

prices and consumer prices is now worldwide so central banks will need to do new thinking on how to do inflation targeting. This is a conundrum for which thinking has not begun yet. I would predict that over the next few years we will see some changes in the monetary policy framework of the central banks. If you look at the history of central banks, they had to keep changing the monetary policies depending on grounds of economic development and in terms of economic thinking behind the theory of central banking.

Editorial Board: As soon as inflation came down, there was a clamour from the finance ministry and corporate sector, for the RBI to cut interest rates. Should the central bank cut interest rate just because inflation has come down?

Dr. Rakesh Mohan: In our country we don't have any significant social security and our experience of inflation was roughly 6-7% a year between the late 1950s to the mid 1990s. It has never been less than 5% on average for a period of 10 years. For the consumer, even if inflation is coming down, consumer's expectations can't be much below 6-7% since that has been the long term experience. From the consumer's point of view, they are not happy with less than 7-8 % deposit rates. Connected to this, we have administered saving rates for postal savings, provident funds and so on, where you get risk free savings and thus it is difficult for banks to reduce their interest rates for deposit below 6%. There has to be more complex thinking on how to tackle this.

Editorial Board: Most global pacts put many countries on the same runway in spite of some being socially disadvantaged, having political agendas etc. So do you think these pacts should be more comprehensive and include these issues and if so how is it possible?

Dr. Rakesh Mohan: One issue on which 90% economists agree on is free trade. For most countries thus, it would be good idea to be a part of a global future agreement where there are multi-lateral rules. What is complicating the situation now is the emergence of plurilateral pacts such as the new trans-pacific and trans-Atlantic trade agreements which are going beyond what we normally thought of as trade agreements. They are now going into issues like intellectual property and protection, labour standards, mutual recognition issues etc. These may not be in favour of the less well- off countries. Over the last fifty years or so because of WTO, tariff levels have really come down globally. Thus they have become less important. The developed countries are looking for newer kinds of trade agreements. A lot of problems have to be tackled for the less well-off countries. Therefore these countries have to give more attention to their own domestic regimes for product standards, mutual recognition standards etc. Thus we have to set up institutions in our own countries for upgrading our standards even for domestic consumption as we get better off. There is a trade-off faced between selling this appliance to a common person and the up gradation. Thus there are various complex issues that arise in

raising the standards of your labour, education etc, to then be able to compete in the world in a free trade situation.

Editorial Board: Won't the socially backward regions be further disabled due to intellectual property rights as it prevents people from accessing some basic amenities like medicines?

Dr. Rakesh Mohan: There are trade-offs. Being a backward country which does not have its own innovation we could suffer from some exclusion if intellectual property protocols do not permit differential pricing in products such as essential medicines. At the same time if developed country manufacturers try to sell the product at really high prices, they could get excluded from the trade as other countries might find it difficult to buy their products. Protocols are required along with protection before you invest in new research and development. Thus, such negotiations have to be done on a purposive basis. Many such negotiations are going on between drug companies. For example an Indian company made a breakthrough on the AIDS drug which helped Africa tremendously because it was more than one-tenth of the cost being provided by other countries. Thus ways and means of protecting intellectual property has to be found but not to the extent of getting excluded.

Editorial Board: What would your advice be to the budding economists of today? What are the most pertinent skills that are required ten-fifteen years down the line?

Dr. Rakesh Mohan: For students who wish to further delve into the subject matter of economics, it is important to get in-depth knowledge about the core economic subjects such as microeconomics, macroeconomics and econometrics at the undergraduate level. If you wish to do graduate courses make sure you do these courses properly before you go into applied work. Don't be in a hurry to do applied work. Really concentrate on your basics and get the basic principles under your hat if you want to be an economist. Also in the current and future scenario there is much more need for people to be multi-disciplinary whether in legal, energy, and IPR issues and so on. However, never disregard your core-economics in lieu of the multi-disciplinary subjects.

Editorial Board: Do you think the discipline of economics would become much more quantitative?

Dr. Rakesh Mohan: I hope not. Though it is very important to be competent in terms of quantitative economics in every area of economics but there is much more need for economists to be related to the economy. Mathematics is a tool and adequate tools are required to be able to understand the economic issues at hand whether they are micro or macro.